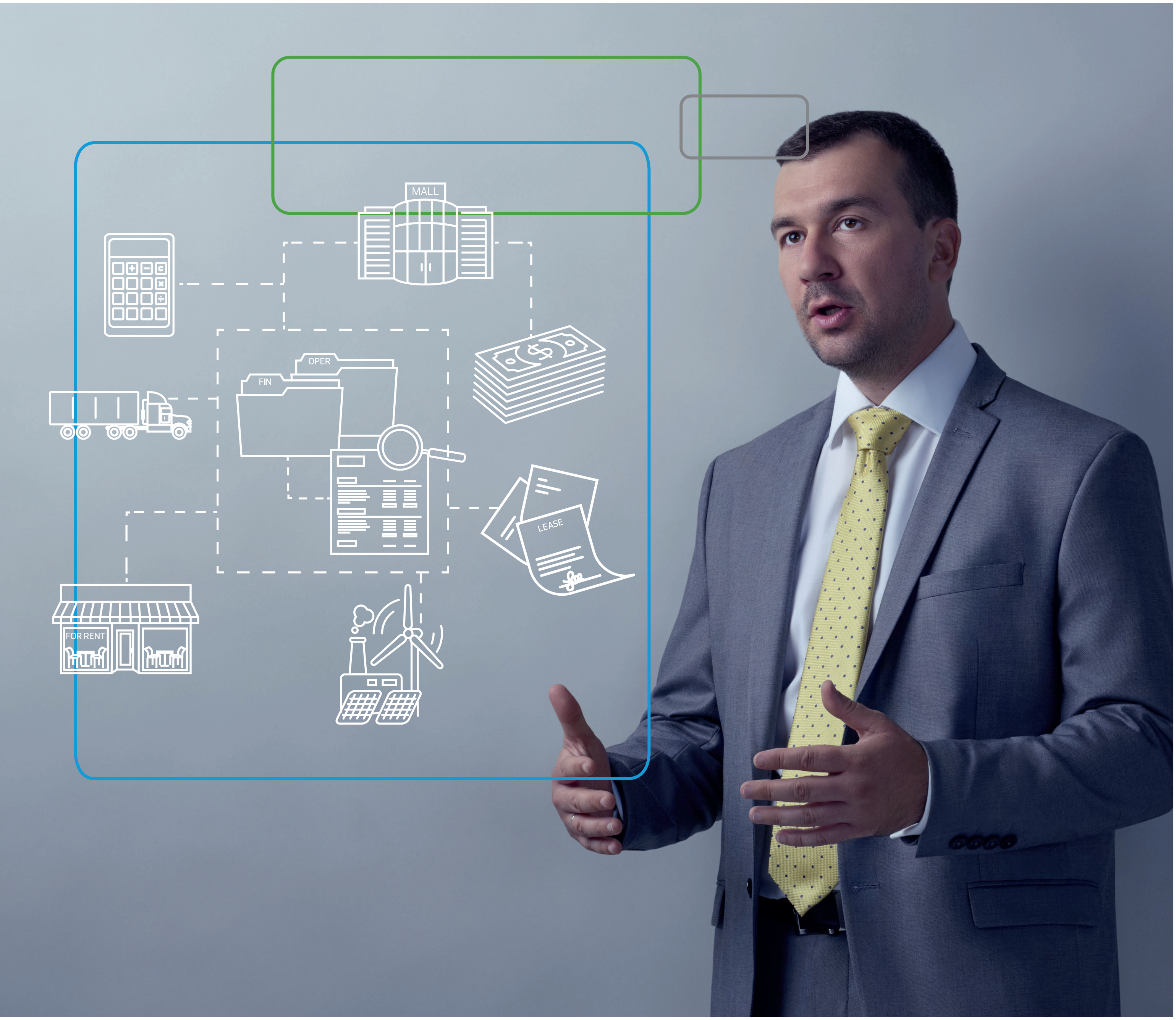

A GUIDE TO LESSEE ACCOUNTING UNDER ASC 842

Third Edition

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July 2022

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1. Introduction

1.1 Background information

In February 2016, the FASB issued ASU 2016-02, its long-awaited final standard on the accounting for leases, which was codified in ASC 842. On its effective date, ASC 842 replaces the legacy U.S. GAAP for leases in ASC 840. For ease of use, definitions for acronyms and titles for ASUs, ASC topics and subtopics and other guidance referred to in this guide are included in Appendix A.

As many entities started implementing ASC 842, numerous questions arose, many of which were submitted to the FASB for further consideration. Upon considering many of these questions, the FASB decided certain changes to ASC 842 were necessary. In addition, the FASB and the SEC staff provided limited effective date relief for ASC 842 (see Section 10.1) and the SEC staff superseded almost all of its preexisting guidance on accounting for leases (which was included in the S99 sections of ASC 840). To incorporate its and the SEC staff's changes to ASC 842 and ASC 840, the FASB has issued the following twelve ASUs since the issuance of ASU 2016-02:

ASU 2017-13	ASU 2018-01	ASU 2018-10	ASU 2018-11
ASU 2018-20	ASU 2019-01	ASU 2019-10	ASU 2020-02
ASU 2020-04	ASU 2020-05	ASU 2021-05	ASU 2021-09

This guide is based on the guidance in ASC 842 as of July 31, 2022.

1.2 Most significant change under ASC 842

The most significant change resulting from ASC 842 is the requirement for lessees to recognize ROU assets and lease liabilities for all leases, other than those that meet the definition of short-term leases for which a lessee may elect an accounting policy under which ROU assets and lease liabilities are not recognized (see Section 7.1.1). This change will result in lessees recognizing ROU assets and lease liabilities for most leases accounted for as operating leases under legacy U.S. GAAP.

Middle Market Insights

Middle market companies that are lessees and have traditionally entered into operating leases could be significantly affected by the requirement to recognize ROU assets and lease liabilities on their balance sheets for all but short-term leases. Adding these assets and liabilities to the balance sheet could significantly affect the financial ratios a middle market company uses for various reporting purposes. For example, if a middle market company has a debt covenant based on its debt-to-equity ratio, its ability to satisfy that covenant after implementing ASC 842 could be seriously compromised. It is possible that the only remedy available in this situation may be to modify the covenants in the debt agreement.

1.3 Contents of this guide

This guide addresses whether a contract is within the scope of ASC 842 and a lessee's accounting under ASC 842 for its contracts that are leases (or include) leases. It does not address a lessor's accounting for its leases (or contracts that include leases). The structure of the guide follows the thought process a lessee should go through when determining if a contract should be accounted for in accordance with ASC 842, and if so, how to account for that contract under ASC 842:

- Determine whether the contract is within the scope of ASC 842 (see Chapter 2)
- Determine whether the contract is or includes a lease that meets the definition of a lease in ASC 842 (see Chapter 3)

- If the contract is or includes one or more leases, determine the unit(s) of account in the contract, which involves identifying the lease and nonlease components in the contract, as well as noncomponents (e.g., taxes, insurance), and determining whether the lease and nonlease components should be treated as separate units of account (see Chapter 4)
- Identify or determine the key inputs needed to classify and account for a lease under ASC 842 (see Chapter 5)
- Determine the lease's classification under ASC 842 (see Chapter 6)
- Apply the appropriate accounting model in ASC 842 to the lease (which depends on its classification) (see Chapter 7)
- Present and disclose the lease in the financial statements in accordance with ASC 842 (see Chapter 9)

In addition, this guide discusses accounting for sale-leaseback transactions (see Chapter 8), the effective date and transition requirements in ASC 842 (see Chapter 10) and differences between how lessees account for leases under ASC 842 and IFRS 16 (see Chapter 11). Appendix E provides a list of examples included throughout all the chapters in this guide.

ASC 842 provides lessees with the opportunity to select an alternative accounting policy or practical expedient in certain cases. All of these opportunities are summarized in Appendix B.

ASC 842 requires lessees to reassess certain decisions or remeasure certain amounts in specific situations. A summary grid of these reassessment and remeasurement requirements is included in Appendix C.

ASC 842 requires lessees to disclose certain information about its leases, as well as its transition to ASC 842. A checklist with these disclosure requirements is included in Appendix D.

2. Scope

2.1 General

ASC 842 applies to all leases (as defined [see Chapter 3]), including subleases. Based on the definition of a lease included in Chapter 3, ASC 842 does not apply if the contract provides the customer with a right to use any of the following types of assets:

- Intangible assets
- Biological assets (e.g., timber)
- Inventory
- Assets under construction

In addition, ASC 842 does not apply if the contract provides the customer with the right to explore for or use nonregenerative resources, such as minerals, oil and natural gas. This exclusion extends to the right to use land to explore for these resources, unless the land can be used for more than exploration. However, rights to use equipment used in exploring for nonregenerative resources are included in the scope of ASC 842.

2.2 What's in a label?

The fact that a contract is labeled as something other than a lease does not mean the contract is not, or does not include, a lease. If a contract requires one entity to use specified property, plant or equipment to fulfill its contractual obligations to the other entity, the terms of the contract should be evaluated to determine whether it includes a lease (i.e., an embedded lease). Consider the following examples:

- *Take-or-pay contract or a power purchase agreement*. An entity agrees to take all of the power produced by an electrical plant or otherwise pay for that power.
- *IT outsourcing agreement*. An entity outsources its information technology department to a technology firm that will take over the entity's hardware and supplement as needed with additional hardware, which may or may not be dedicated to the entity.
- *Construction services contract*. An entity hires a construction services provider to double the size of their primary manufacturing facility, and to do so, the construction services provider will use specialized construction equipment for a significant period of time.

Both parties to each of these agreements or contracts must evaluate their terms in the context of the definition of a lease (see Chapter 3) to determine whether they are or include a lease. Other agreements or contracts that may also require such an evaluation include transportation contracts, internet services agreements, service contracts, airplane use agreements and manufacturing supply arrangements involving specific equipment or tooling.

2.3 Embedded derivatives

While leases within the scope of ASC 842 are not derivative instruments subject to ASC 815-10, a derivative instrument may be embedded in a lease, in which case the guidance in ASC 815-15-25 must be considered. Residual value guarantees provided by the lessee are not subject to ASC 815-10 (see Section 5.5.6).

2.4 Land easements

As discussed in ASC 842-10-65-1(gg), a land easement is a right of way that provides one entity with "the right to use, access, or cross another entity's land for a specified purpose." For example, an electric company may have a land easement to build and maintain electric towers or poles on land owned by others. Both parties to a land easement (e.g., the landowner and the electric company) must evaluate the contract and (or) law under which the easement is granted to determine whether it meets the definition of a lease (see Chapter 3). If the land easement meets the definition of a lease, it is accounted for as such under ASC 842.

It is not uncommon for a land easement to be perpetual, which means there is not a specific end date to the right of way. For example, if an electric company is granted a perpetual land easement, its rights to use the land go on in perpetuity. Based on the example in ASC 350-30-55-30, a perpetual land easement is not a lease because it is not conveying the right to use the land for a *period of time*, which is a required element in the definition of a lease (see Chapter 3). When a land easement or any other right to use is characterized as perpetual, an entity should ensure the terms of the land easement or other right to use (including the contractual terms and any applicable law) support that characterization.

Given that land easements were not necessarily thought of as leases under legacy U.S. GAAP, the FASB provided a practical expedient with respect to addressing land easements in transitioning to ASC 842, which is discussed in Section 10.3.3.

2.5 Service concession arrangements

ASC 853-10-05-1 defines a service concession arrangement as “an arrangement between a grantor and an operating entity for which the terms provide that the operating entity will operate the grantor’s infrastructure (for example, airports, roads, bridges, tunnels, prisons, and hospitals) for a specified period of time.” In addition to operating the grantor’s infrastructure, the operating entity may also be required by the arrangement to construct, maintain and (or) upgrade the infrastructure. A typical service concession arrangement involves a public-sector entity (as the grantor) contracting with a third party (as the operating entity) to provide a public service. In essence, the public-sector entity is delegating its responsibility to provide a public service to a third party for a period of time.

ASC 853 provides guidance applicable to the operating entity in a service concession arrangement in which the grantor is a public-sector entity. In addition, service concession arrangements within the scope of ASC 853 must provide for both of the following:

- The public-sector entity (as the grantor) either has control of all the following or is able to modify or approve all the following: (a) the services provided by the operating entity using the identified infrastructure, (b) the recipients of the services provided by the operating entity and (c) the price at which the services are provided to the recipients.
- The public-sector entity (as the grantor) controls any residual interest in the infrastructure when the arrangement ends, with control of the residual interest resulting from ownership, beneficial entitlement or otherwise.

When a service concession arrangement is within the scope of ASC 853, it is not within the scope of ASC 842. Revenue from service concession arrangements within the scope of ASC 853 is accounted for by the operating entity in accordance with ASC 606 (see our publication, A guide to revenue recognition [our revenue recognition guide]). Other aspects of the service concession arrangement are accounted for in accordance with other applicable U.S. GAAP.

When a service concession arrangement is not within the scope of ASC 853, the operating entity should consider whether it includes a lease by evaluating the terms of the arrangement in the context of the definition of a lease (see Chapter 3).

2.6 Sales with repurchase agreements

Forwards and call and put options are all considered repurchase agreements for accounting purposes. A forward exists when the transferor sells an asset to a transferee and the transferor is obligated to repurchase the asset at some point in the future. A call option exists when the transferor sells an asset to the transferee and the transferor has the option to repurchase the asset at some point in the future. A put option exists when the transferor sells an asset to a transferee and the transferee has the option to require the transferor to repurchase the asset at some point in the future. For these purposes, the asset that the transferor repurchases or may repurchase can either be the same asset it sold to the transferee, a different asset that is substantially the same as the asset it sold to the transferee, or a different asset that includes the asset it sold to the transferee as a component.

Based on the guidance in ASC 606-10-55-66 to 55-78, the accounting for a repurchase agreement depends on whether the entity is the transferor or transferee and the nature of the agreement.

2.6.1. Forwards and call options

The initial transfer of an asset subject to a forward or call option is not considered a sale for purposes of the transferor's accounting because control of the asset is not considered to have transferred to the transferee. The transferor's accounting for the transfer depends on how the asset's repurchase price compares to its original selling price and whether the forward or call option is part of a sale-leaseback transaction. Depending on the facts and circumstances, the transferor accounts for the forward or call option as either a lease (as discussed in this guide) or a financing arrangement. For additional information about determining the appropriate accounting by the transferor for a forward or call option, including the accounting for a financing arrangement, see Section 9.7.1 and Section 9.7.3 of our revenue recognition guide. Conversely, the transferee typically accounts for the initial transfer of an asset subject to a forward or call option as a purchase of the asset.

2.6.2. Put options

For a put option, the transferor's accounting for the initial transfer of an asset subject to a put option depends on whether the repurchase price of the asset is more or less than its original selling price, whether the transferee has a significant economic incentive to exercise the put option and whether the put option is part of a sale-leaseback transaction. Depending on the facts and circumstances, the transferor accounts for the initial transfer of an asset subject to a put option as either a sale subject to the right of return (as discussed in Section 7.3.6 of our revenue recognition guide), a lease (as discussed in this guide) or a financing arrangement. For additional information about determining the appropriate accounting by the transferor for put options, including the accounting for a financing arrangement, see Sections 9.7.2 and 9.7.3 of our revenue recognition guide. Conversely, the transferee accounts for the initial transfer of an asset subject to a put option as a purchase or lease of the asset, depending on the facts and circumstances.

2.7 Portfolio basis

A lessee may apply most aspects of ASC 842 at a portfolio level for leases with similar characteristics. In doing so, however, lessees should keep in mind the following observations included in paragraph BC120 of ASU 2016-02:

> The Board acknowledged that an entity would need to apply judgment in selecting the size and composition of the portfolio in such a way that the entity reasonably expects that the application of the leases model to the portfolio would not differ materially from the application of the leases model to the individual leases in that portfolio. In the discussion, the Board indicated that it did not intend for an entity to quantitatively evaluate each outcome but, instead, that the entity should be able to take a reasonable approach to determine the portfolios that would be appropriate for its types of leases.

When electing to apply some or all of ASC 842 on a portfolio basis, a lessee should be able to support the following:

- *How the accounting for all leases with similar characteristics in similar situations is consistent*. Accounting for leases on a portfolio basis is optional. In other words, a lessee may account for one group of similar leases in a portfolio and account for another group of leases with different similarities on a lease-by-lease basis. However, the lessee should ensure a portfolio of leases is complete in that it is not accounting for some leases with similar characteristics in similar situations in a portfolio while accounting for other leases that would also qualify to be in that portfolio on a lease-by-lease basis.

- *How the characteristics of leases included in a portfolio are similar.* We believe that accounting for leases on a portfolio basis would require that the leases have, at most, insignificant differences in contractual provisions and that the underlying assets be similar in nature.
- *How the estimates, judgments and assumptions used when accounting for the portfolio of leases reflect the size and composition of the individual leases within the portfolio.* For example, if a lessee is estimating the incremental borrowing rate for a portfolio of leases, it should be able to support how the payment terms on which the incremental borrowing rate is based reflects the payment terms of the leases in the portfolio.
- *Why application of ASC 842 on a portfolio basis is not reasonably expected to be materially different from the application of ASC 842 on a lease-by-lease basis.* While the lessee is not expected to quantitatively prove that there is not a material difference by comparing the accounting results for the portfolio to the aggregate accounting results for the individual leases in the portfolio, the lessee is expected to provide a substantive analysis to support its position that there is not a material difference between applying ASC 842 on a portfolio basis vs. a lease-by-lease basis.

Once a lessee identifies a group of leases to be accounted for on a portfolio basis, it should have procedures in place to monitor the portfolio and its leases to determine whether any changes occur (e.g., change in the lease term, modification of lease terms) that should result in a lease being removed from a portfolio and accounted for on a standalone basis or removed from one portfolio and included in another portfolio.

3. Determine if the contract is or includes a lease

3.1 Overall definition and decision points

The definition of a lease in ASC 842-10-15-1 is "a contract, or part of a contract, that conveys the right to control the use of identified property, plant, or equipment (an identified asset) for a period of time in exchange for consideration." An entity must determine whether a contract is or includes a lease at contract inception.

For a contract (or part of a contract) to meet the definition of a lease, the following must be true:

- **Decision point 1:** The contract includes an identified asset (see Section 3.2).
- **Decision point 2:** The contract conveys to the lessee the right to control the identified asset over the period of use (or for at least a portion of the period of use).

The need to consider these decision points is to differentiate a lease from a supply or service contract (see Section 2.2).

For the contract to convey the right to control the identified asset, both of the following must be true:

- **Decision point 2A:** The customer has the exclusive right to use the identified asset or otherwise has the right to obtain substantially all of the economic benefits from using the identified asset over the period of use in accordance with the contract terms (see Section 3.3).
- **Decision point 2B**: The customer has the right to direct the use of the identified asset over the period of use.

For the customer to have the right to direct the use of the identified asset over the period of use, one of the following must be true:

- **Decision point 2B1:** The contract provides the customer with the right to direct how and for what purpose the asset is used over the period of use (see Section 3.4).
- **Decision point 2B2:** The relevant decisions about how and for what purpose the asset is used over the period of use are predetermined (e.g., by the contractual terms) and either: (a) the customer has the right to operate the asset (or to direct others to operate the asset in a manner that it determines) over the period of use without the supplier having the right to change those operating instructions (see Section 3.5) or (b) 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 over the period of use (see Section 3.6).

In many cases, determining whether a contract (or part of a contract) meets the definition of a lease will be a relatively straightforward exercise. In other cases, however, that determination will require exercising a significant amount of judgment. In addition, it is important to note that what a contract appears to be on its surface may not be what it is in substance. For example, a contract that appears on its surface to be a contract for network services may be a lease for network servers in substance, or a contract that appears to be for the purchase of an asset with a put option may be a lease of the asset in substance because the customer (or lessee) has a significant economic incentive to exercise the option (see Section 2.2). As such, great care should be taken in understanding the terms of a contract and applying the definition of a lease to that contract.

Considerable guidance is provided in ASC 842 related to each of these decision points, including ten examples (addressing application of these decision points to 16 different scenarios) provided in ASC 842-10-55-41 to 55-130. Each of these decision points is focused on in the next several sections. Example 3-1 to Example 3-4 and those other scenarios in ASC 842-10-55 that are specifically referenced in these sections, and the many others that are not, may assist in understanding how to apply the decision points to a live set of facts and circumstances. However, each specific set of facts and circumstances should be independently analyzed given the likelihood of a live set of facts and circumstances differing from those in the examples and illustrative scenarios and the effects those differences could have on the analysis as to whether a lease exists.

Spotlight on change: Definition of a lease

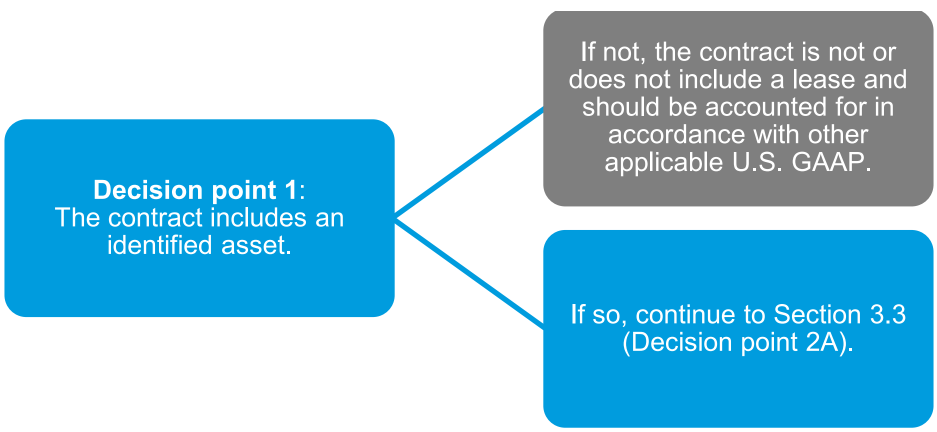
Under ASC 840, a lease may exist solely based on the contract conveying to the customer the right to obtain substantially all of the economic benefits related to the underlying asset. While this continues to be an important part of the definition of a lease under ASC 842, a contract must also convey to the customer certain decision-making rights for a contract to meet the definition of a lease under ASC 842. As a result, we expect that some contracts previously identified as leases under ASC 840 would not be identified as leases under ASC 842.

As discussed in Section 10.3.1, if a lessee elects the package of transition practical expedients upon transition to ASC 842, it does not determine whether a preexisting contract at the date of initial application is or includes a lease. In other words, it retains the conclusion reached upon the application of ASC 840 with respect to whether a lease exists.

3.1.1 Period of use

Typically, the period of time covered by the contract is based on a specific duration of time, such as the customer having the right to use an identified asset from January 1, 20X6 through December 31, 20X8. However, the period of time may also be measured in terms of use of the asset, such as the customer having the right to use an identified asset until it produces a specific quantity of output. In addition, the period of time over which the customer has the right to use an identified asset does not have to be the entire contract term. If the customer only has the right to use an identified asset for part of a contract term, the contract may (depending on the facts and circumstances) include a lease for just that part of its term.

3.2 Identified asset



3.2.1 Property, plant or equipment

An identified asset must be property, plant or equipment. If the contractual right to use involves an asset other than property, plant or equipment, the asset cannot be an identified asset, which means the contract is not a lease.

3.2.2 Explicit identification of the asset

In many cases, the asset subject to the right of use is explicitly identified in the contract. For example, a truck or other vehicle may be explicitly identified in a contract by its vehicle identification number, a building may be explicitly identified in a contract by its specific location and address, and network equipment may be explicitly identified in a contract by its serial numbers.

3.2.3 Implicit identification of the asset

Implicit identification of an asset occurs when there is only one asset that can realistically be used by the supplier to fulfill the contract. It may also occur when all of the supplier's assets of a particular type will need to be used by the supplier to fulfill a contract. Example 8 in ASC 842-10-55-100 to 55-107 addresses a situation in which a factory is an implicitly identified asset in a contract to produce shirts because the supplier only has one factory in which it can produce the shirts that will fulfill its obligations under the contract. For another example, if a customer requests the right to use 10 trucks for a period of time and the supplier only has 10 trucks, the 10 trucks are implicitly identified assets. Whether the customer actually has the right to substantially all of the economic benefits from using an implicitly identified asset must always be considered when determining whether a contract is or includes a lease (see Decision point 2A in Section 3.3), but making that determination may be less straightforward than it is when an explicitly identified asset is involved.

3.2.4 Supplier substitution rights

If the supplier has substantive substitution rights throughout the period of use, the contract does not include an identified asset.

Substitution rights that are only in effect for part of the period of use (e.g., substitution rights that are effective on or until a specific date or event occurrence) do not factor into whether an identified asset exists because those rights do not exist for the entire period of use.

Whether a substitution right is substantive is based on the facts and circumstances at contract inception and future events that are considered likely to occur. In evaluating whether future events are considered likely to occur, a customer should not assume it is likely that another customer would pay more than market rates for a right to use the asset subject to the substitution rights, nor should a customer assume it is likely that a new technology that would affect whether the supplier would exercise its substitution rights will be introduced over the period of use, unless the technology was substantially developed at contract inception. For a substitution right to be substantive both of the following must be true:

- *The supplier must have the practical ability to substitute the asset with an alternative asset throughout the period of use.* One point to consider in the evaluation of whether the supplier has the practical ability to substitute the asset with an alternative asset throughout the period of use is whether the asset subject to the right of use is a specialized asset (and, if it is, how the specialized nature affects the supplier's ability to substitute the asset). The customer should consider whether the supplier has readily available replacements for the asset subject to the right of use, and if not, what would be involved in the supplier creating or obtaining replacements. If it will take a significant amount of time or cost to obtain or create replacements for the asset subject to the right of use, any substitution rights for that asset may not be substantive. In addition, the supplier does not have the practical ability to substitute the asset with an alternative asset throughout the period of use if the contract allows the customer to refuse the substitution.

- *The supplier would have to benefit economically from exercising the substitution right (i.e., the economic benefits of exercising the substitution right outweigh the related costs*). In evaluating whether this is true, one point to consider is whether the asset subject to the right of use requires installation, and if so, the complexity of that installation. In addition, the customer should consider where the asset subject to the right of use is located. Examples of situations in which substitution rights for an asset subject to a right of use may not be substantive include those in which the asset requires complex installation, the asset is in a remote location that is difficult or costly for the supplier to reach, or the asset is real estate and moving the customer to different real estate may be difficult or costly for the supplier.

Substitution rights are not substantive when the supplier only has the right (or is obligated) to substitute an asset when the asset is not operating properly or when repairs, maintenance or a technical upgrade are necessary.

If the customer cannot ascertain whether a substitution right is substantive without exerting undue effort, the right is presumed to *not* be substantive.

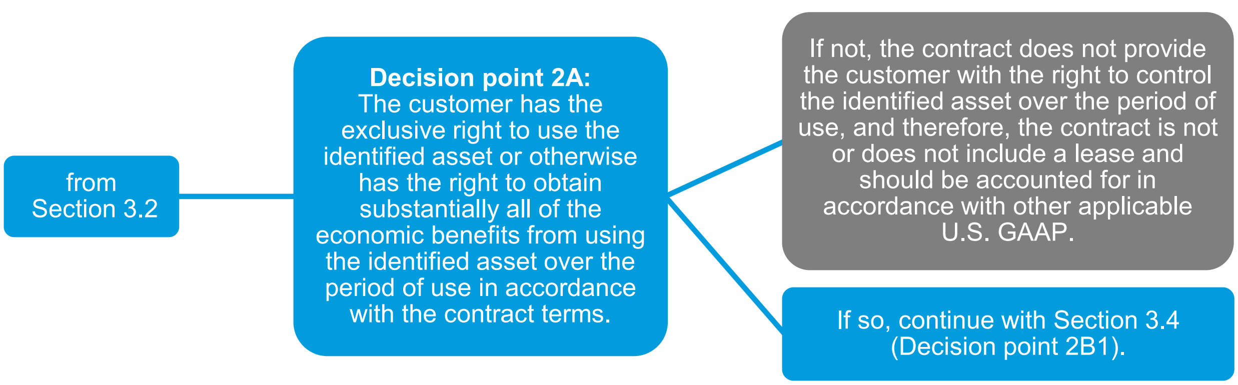
Case B of Example 1 in ASC 842-10-55-48 to 55-51 addresses a situation in which the supplier has substantive substitution rights related to rail cars because: (a) it has the practical ability to substitute the rail cars used to fulfill the contract with readily available alternative rail cars without obtaining approval from the customer and (b) it would benefit economically from exercising its substitution rights due to the minimal costs involved in substituting its rail cars and the operating efficiencies it would gain by having the ability to substitute its rail cars (e.g., the ability to substitute one rail car with another that is closer to the point of origin). Conversely, Example 7 in ASC 842-10-55-92 to 55-99 addresses a situation in which the supplier does not have substantive substitution rights related to an aircraft because of the significant costs it would incur to outfit another aircraft to meet the contract's interior and exterior specifications for the aircraft.

3.2.5 When the right to use a capacity portion of an asset represents an identified asset

A capacity portion of an asset represents an identified asset if: (a) it is physically distinct (e.g., a specific floor in a building) or (b) it represents substantially all of the asset's capacity. In the context of one of the lease classification criteria (see Section 6.5), ASC 842 indicates that one reasonable approach to defining *substantially all* would be to use a threshold of 90% or more. We believe use of a 90% or more threshold generally is also appropriate for purposes of determining whether the capacity portion of an asset that a customer has the right to use represents substantially all of the asset's capacity.

For example, Case B of Example 3 in ASC 842-10-55-60 to 55-62 addresses a situation in which the right to use a portion of the capacity of a fiber-optic cable should not be considered an identified asset because the supplier may use any of the 15 fibers in the cable to provide the equivalent capacity of three fibers to the customer. The right to use 20% of a fiber-optic cable's capacity does not represent the right to use substantially all of the cable's capacity. As a result, an identified asset does not exist. In comparison, consider a situation in which the customer has the right to use 90% of the capacity of a specific pipeline of the supplier. While 90% of the pipeline's capacity is not physically distinguishable from the other 10%, it still represents substantially all of the pipeline's capacity. As a result, an identified asset exists. Determining whether the contract providing the customer with the right to use this identified asset also results in the customer obtaining substantially all of the pipeline's economic benefits over the period of use is discussed in Section 3.3.3.

3.3 Right to obtain substantially all of the economic benefits from use of the identified asset



3.3.1 Nature of the economic benefits

Determining whether the customer has the right to obtain substantially all of the economic benefits resulting from the use of the identified asset requires consideration of any contractual restrictions related to use of the asset. For example, if the customer is limited to using the identified asset in a particular area (e.g., the customer may only use a truck within the continental U.S.), only the economic benefits related to use of the truck in that particular area should be considered in the analysis.

Using, holding or subleasing an identified asset are ways in which a customer may obtain economic benefits from using the asset. The output or by-products from using an identified asset may provide economic benefits (e.g., cash flows) to the customer as would entering into a commercial transaction with a third party. For example, Example 3-4 addresses whether tax credits and renewable energy credits are economic benefits that should be considered in assessing whether the customer has the right to obtain substantially all of the economic benefits from using a solar farm over the period of use. In this example, it is important to differentiate between credits that result from *owning* the asset and credits that result from *using* the asset. Only the latter should be considered economic benefits for purposes of assessing Decision point 2A. Based on the facts presented in Example 3-4, the tax credits result from owning the solar farm and, consequently, are not considered an economic benefit for purposes of Decision point 2A. In contrast, the renewable energy credits in that example are considered economic benefits from *using* the solar farm for purposes of Decision point 2A because they are a by-product of that use.

3.3.2 Exclusive use of the identified asset

A customer that has an exclusive right to use an identified asset has the right to obtain substantially all of the economic benefits from that asset's use over the period of use. The right to exclusively use an identified asset may be explicitly or implicitly provided. To determine if an implicit right exists, the capacity of the identified asset must be considered. Case A of Example 6 in ASC 842-10-55-79 to 55-84 addresses a situation in which the customer implicitly has exclusive use of a ship because the cargo the customer is shipping will take up substantially all of the ship's capacity. Conversely, Example 8 in ASC 842-10-55-100 to 55-107 addresses a situation in which the customer does not implicitly have exclusive use of a clothing factory because the quantity of shirts the customer has ordered does not constitute substantially all of the factory's capacity, and the supplier is free to use the excess capacity to fulfill contracts with other customers.

3.3.3 When use of a capacity portion of an asset results in customer obtaining substantially all of the economic benefits from its use

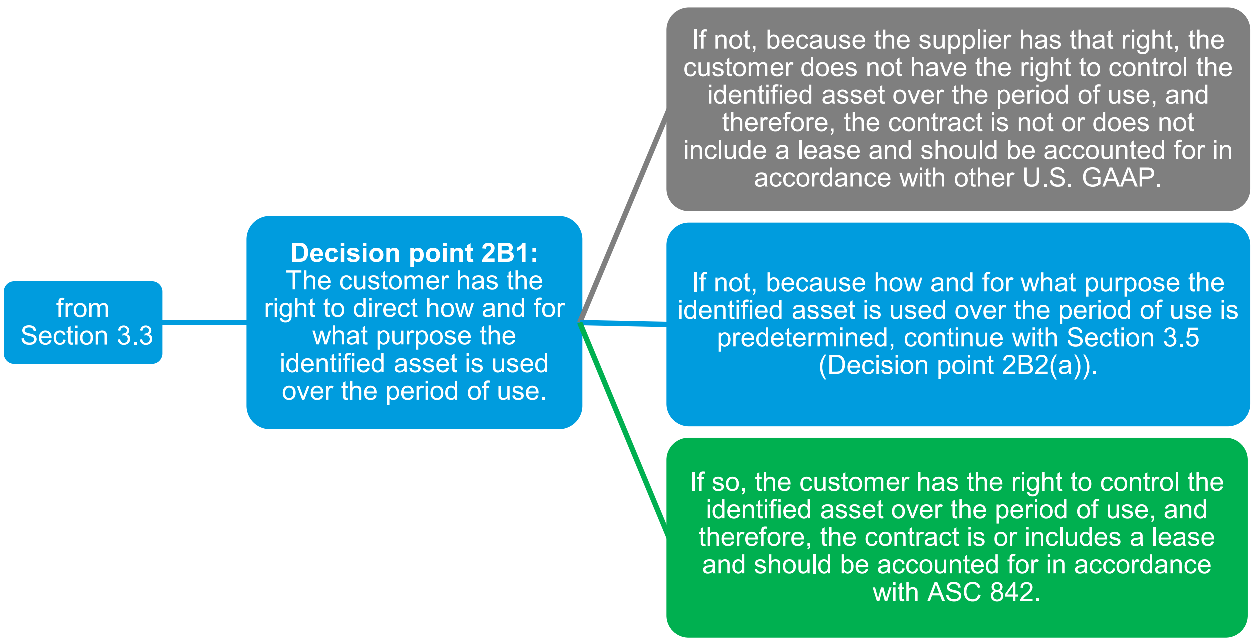
A customer that has the right to use substantially all of the capacity of an identified asset may have the right to obtain substantially all of the economic benefits from the asset's use. Whether that is the case will often depend on considering additional facts and circumstances present in a specific situation. In the context of one of the lease classification criteria (see Section 6.5), ASC 842 indicates that one reasonable approach to defining *substantially all* would be to use a threshold of 90% or more. We believe use of a 90% or more threshold generally is also appropriate for purposes of determining whether a customer having the right to use substantially all the capacity of an identified asset provides the customer with the right to obtain substantially all of the economic benefits from use of the identified asset.

For example, consider a situation in which the customer has the right to use 90% of the capacity of a specific pipeline of the supplier. While 90% of the pipeline's capacity represents substantially all of its capacity, whether that capacity provides the customer with the right to obtain substantially all of the economic benefits from the pipeline's use should take into consideration additional facts and circumstances present in the specific situation, such as whether the customer has the right to use 90% of the pipeline's capacity at all times, or if the supplier has the right to connect an additional branch line to the pipeline for other parties' use when the customer is not using its 90% of the pipeline's capacity.

3.3.4 Payments to supplier based on use of the identified asset

The assessment of whether the customer has the right to obtain substantially all of the economic benefits from use of an identified asset should consider any payments subsequently made to the supplier for use of the asset. In other words, when the customer has to pay a portion of the economic benefits to the supplier for use of the identified asset, the portion of the economic benefits paid to the supplier are still considered economic benefits of the customer because they first flowed to the customer. For example, consider a situation in which the supplier provides the customer with the exclusive right to use retail space and in return the customer remits an amount equal to 20% of its net sales to the supplier. The requirement to remit an amount equal to 20% of its net sales does not prevent the customer from concluding that it has the right to obtain substantially all of the economic benefits from use of the retail space. Although a portion of the cash flows derived from the use of the retail space will eventually flow to the supplier, those cash flows are still part of the economic benefits that first flowed to the customer.

3.4 Right to direct how and for what purpose the identified asset is used



3.4.1 Decision-making rights

In determining whether the customer has the right to direct how and for what purpose the identified asset is used over the period of use, one must consider whether the customer has the right to make decisions that can *change* how and for what purpose the asset is used over the period of use. In addition, this determination requires consideration of those decision-making rights that affect the economic benefits to be derived from use of the identified asset. For this purpose, only the most relevant decision-making rights and only those decisions that may be made during the period of use (and not those decisions that are predetermined before the period of use) should be considered.

Examples of decision-making rights that may provide the customer or supplier with the right to direct how and for what purpose the identified asset is used over the period of use may include the right to change the following about the output:

- The type of output produced by the identified asset (e.g., mix of products to be sold in a retail unit, use of a shipping container for storage or transport).

- When the output is produced (e.g., when a piece of machinery will be used to produce a widget, when a truck will be used to make a delivery).
- Where the output is produced (e.g., the destination of a truck, the location of equipment).
- Whether, and if so, how much of the output is produced (e.g., how much, if any, power will be produced by a power plant).

Case A of Example 3 in ASC 842-10-55-55 to 55-59 explains that the key decision-making rights related to three fibers in a fiber optic cable are when and whether to light the fibers and when and how much data will be transmitted over the fibers.

Examples of decision-making rights that do not provide the customer or supplier with the right to direct how and for what purpose the identified asset is used over the period of use include those limited to operating or maintaining the asset. The difference between decision-making rights that result in the customer or supplier having the right to direct how and for what purpose the identified asset is used over the period of use and decision-making rights related to operating the identified asset is a subtle, but important, one. One way to think about this difference is to understand that decisions about how and for what purpose the identified asset will be used over the period of use are typically made first, because decisions about how to operate the identified asset typically depend on how and for what purpose the asset will be used. In other words, decisions about how to operate the identified asset are typically executing on the decisions about how and for what purpose the identified asset will be used. Example 3-1 illustrates how the supplier being responsible for delivering, installing, repairing and maintaining a network server is not the same as the supplier having the right to direct how and for what purpose the network server is used over the period of use because the decisions the supplier makes in carrying out those responsibilities relate to operating and maintaining the network server and not to how and for what purpose the customer will use the network server over the period of use (e.g., how the customer's data is stored on the server or transported to or from the server, whether the server needs to be reconfigured or whether the server should be used for a different purpose). In contrast, Example 3-2 provides an example in which the supplier does have the right to direct how and for what purpose network servers located at the customer's premises are used over the period of use.

Example 3-1: How and for what purpose the identified asset (network servers) will be used is determined by the customer

The following example is Case B in *Example 10—Contract for Network Services* from ASC 842-10-55-127 to 55-130:

> Customer enters into a contract with an information technology company (Supplier) for the use of an identified server for three years. Supplier delivers and installs the server at Customer's premises in accordance with Customer's instructions and provides repair and maintenance services for the server, as needed, throughout the period of use. Supplier substitutes the server only in the case of malfunction. Customer decides which data to store on the server and how to integrate the server within its operations. Customer can change its decisions in this regard throughout the period of use.
>
> The contract contains a lease. Customer has the right to use the server for three years.
>
> There is an identified asset. The server is explicitly specified in the contract. Supplier can substitute the server only if it is malfunctioning.
>
> Customer has the right to control the use of the server throughout the three-year period of use because:
>
> a. Customer has the right to obtain substantially all of the economic benefits from use of the server over the three-year period of use. Customer has exclusive use of the server throughout the period of use.

b. Customer has the right to direct the use of the server. Customer makes the relevant decisions about how and for what purpose the server is used because it has the right to decide which aspect of its operations the server is used to support and which data it stores on the server. Customer is the only party that can make decisions about the use of the server during the period of use.

Example 3-2: How and for what purpose the identified asset (network servers) will be used is determined by the supplier

The following example is Case A in *Example 10—Contract for Network Services* from ASC 842-10-55-124 to 55-126:

> Customer enters into a contract with a telecommunications company (Supplier) for network services for two years. The contract requires Supplier to supply network services that meet a specified quality level. To provide the services, Supplier installs and configures servers at Customer's premises; Supplier determines the speed and quality of data transportation in the network using the servers. Supplier can reconfigure or replace the servers when needed to continuously provide the quality of network services defined in the contract. Customer does not operate the servers or make any significant decisions about their use.
>
> The contract does not contain a lease. Instead, the contract is a service contract in which Supplier uses the equipment to meet the level of network services determined by Customer.
>
> Customer does not control the use of the servers because Customer's only decision-making rights relate to deciding on the level of network services (the output of the servers) before the period of use—the level of network services cannot be changed during the period of use without modifying the contract. For example, even though Customer produces the data to be transported, that activity does not directly affect the configuration of the network services and, thus, it does not affect how and for what purpose the servers are used. Supplier is the only party that can make decisions about the use of the servers during the period of use. Supplier has the right to decide how data are transported using the servers, whether to reconfigure the servers, and whether to use the servers for another purpose. Accordingly, Supplier controls the use of the servers in providing network services to Customer. There is no need to assess whether the servers are identified assets because Customer does not have the right to control the use of the servers.

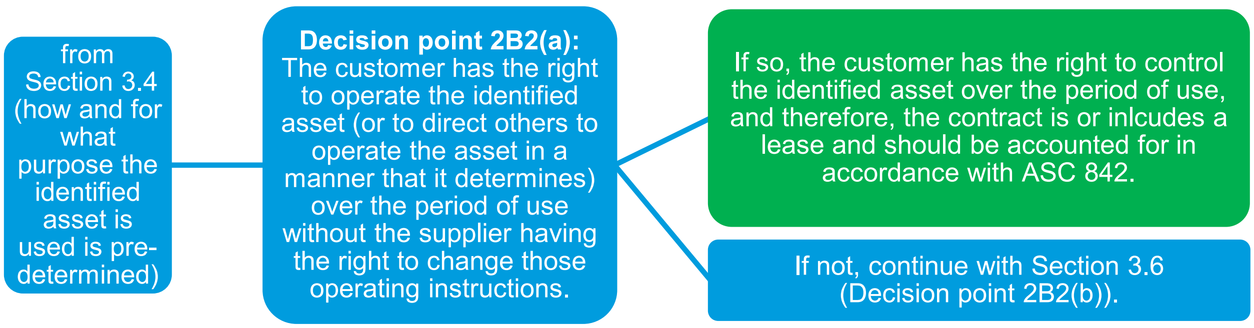
3.4.2 Protective rights of the supplier

Protective rights provided to the supplier in the contract may protect the supplier's interest in the identified asset, another of its assets, its personnel or its ability to comply with laws and regulations. Protective rights do not, in and of themselves, prevent the customer from having the right to direct how and for what purpose the identified asset is used over the period of use. Case B of Example 6 in ASC 842-10-55-85 to 55-91 addresses a situation in which the supplier is protected by contract terms that restrict the type of cargo that may be carried by a ship (e.g., hazardous materials are prohibited) and the waters in which the ship may sail. These protective rights have no bearing on whether the customer has the right to direct how and for what purpose the ship is used over the period of use. Other contract terms that may provide protective rights include limitations on how much the identified asset may be used, how much output it may produce and how it should be operated.

3.4.3 Predetermined decisions about the identified asset's use

Whether the customer or the supplier has the right to make the relevant decisions about how and for what purpose the identified asset is used over the period of use should only consider the decisions that may be made during the period of use and not those decisions that are predetermined before the period of use. As highlighted in decision points 2B2(a) and 2B2(b) (see Sections 3.5 and 3.6, respectively), separate considerations arise if neither the customer nor the supplier has the right to make the relevant decisions about how and for what purpose the identified asset is used over the period of use because those decisions have been predetermined by the design of the asset or specific contract terms.

3.5 Right to operate (or direct others to operate) the identified asset over the period of use with no supplier rights to change operating instructions



In situations in which how and for what purpose the asset is used is predetermined, entities must understand whether the customer or the supplier is responsible for making operating decisions related to the identified asset. This is important to understand because, as discussed earlier in Section 3.4.1, operating decisions related to the use of the identified asset are not relevant when how and for what purpose the asset is used is *not* predetermined (because either the customer or the supplier makes those determinations). Example 5 in ASC 842-10-55-72 to 55-78 addresses a situation in which the use of a truck is predetermined by contract terms requiring the transport of specified cargo from New York to San Francisco within a specified time frame. While how and for what purpose the truck will be used is predetermined, the customer has the right to direct the use of the truck over the period of use because it alone is responsible for making the decisions related to operating the truck (e.g., choosing the speed and route) over that period. Conversely, Example 3-3 addresses a situation in which the use of a power plant is predetermined by the contract, but the customer does not have the right to direct the use of the power plant because the supplier is responsible for making the decisions related to operating and maintaining the power plant over the period of use in accordance with industry-approved operating practices. As a result, the contract does not include a lease because the supplier, and not the customer, has the right to control the use of the power plant.

Example 3-3: How and for what purpose the identified asset (power plant) will be used is predetermined in the contract and supplier makes operating and maintenance decisions

The following example is Case B in *Example 9—Contract for Energy/Power* from ASC 842-10-55-112 to 55-116:

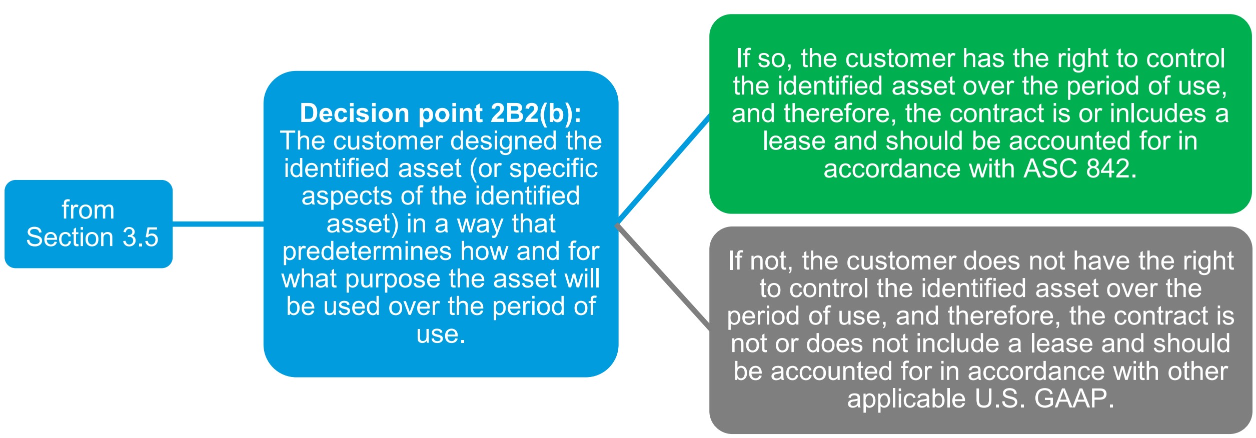
> Customer enters into a contract with Supplier to purchase all of the power produced by an explicitly specified power plant for three years. The power plant is owned and operated by Supplier. Supplier is unable to provide power to Customer from another plant. The contract sets out the quantity and timing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

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

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

RSM commentary: Case C in *Example 9—Contract for Energy/Power* from ASC 842-10-55-117 to 55-123 deals with a very similar fact pattern as this example (which is Case B of Example 9). The primary difference relates to the determination of how and for what purpose the power plant is used. For purposes of these examples, how and for what purpose the power plant is used equates to who makes the decisions about whether, when and how much power is produced by the power plant. In Case B of Example 9, those decisions are predetermined by the contract, which lays out the amount of power that will be produced, and the timing of that production, over the period of use. As a result, Customer next looks to whether it or Supplier makes the operating and maintenance decisions related to the power plant. Because Supplier makes those decisions, Customer concludes it does not have the right to control the power plant, which leads to the conclusion that the contract is not a lease. Conversely, in Case C of Example 9, whether, when and how much power is produced by the power plant is dictated by Customer in the instructions it provides to Supplier, which Supplier is obligated to follow. As a result, Customer concludes it has the right to control the power plant, which leads to the conclusion that the contract is a lease. These two examples illustrate the importance of understanding exactly how decisions are made about how and for what purpose an identified asset will be used, and how failure to obtain this understanding could result in reaching an inappropriate conclusion about whether the customer has the right to control the identified asset.

3.6 Customer designed the identified asset in a way that predetermines how and for what purpose the asset will be used



Considering whether the customer designed the identified asset in a way that predetermines how and for what purpose the asset will be used over the period of use is relevant because controlling the key decision-making rights by designing the asset is substantively no different from otherwise controlling the key decision-making rights. Example 3-4 addresses a situation in which the customer has the right to control the use of a solar farm over the period of use because it designed the solar farm and that design predetermined whether, when and how much electricity will be produced by the solar farm.

Example 3-4: How and for what purpose the identified asset (solar farm) will be used is predetermined by customer design

The following example is Case A in *Example 9—Contract for Energy/Power* from ASC 842-10-55-108 to 55-111:

> A utility company (Customer) enters into a contract with a power company (Supplier) to purchase all of the electricity produced by a new solar farm for 20 years. The solar farm is explicitly specified in the contract, and Supplier has no substitution rights. The solar farm is owned by Supplier, and the energy cannot be provided to Customer from another asset. Customer designed the solar farm before it was constructed—Customer hired experts in solar energy to assist in determining the location of the farm and the engineering of the equipment to be used. Supplier is responsible for building the solar farm to Customer's specifications and then operating and maintaining it. There are no decisions to be made about whether, when, or how much electricity will be produced because the design of the asset has predetermined these decisions. Supplier will receive tax credits relating to the construction and ownership of the solar farm, while Customer receives renewable energy credits that accrue from use of the solar farm.
>
> The contract contains a lease. Customer has the right to use the solar farm for 20 years.
>
> There is an identified asset because the solar farm is explicitly specified in the contract, and Supplier does not have the right to substitute the specified solar farm.
>
> Customer has the right to control the use of the solar farm throughout the 20-year period of use because:
>
> a. Customer has the right to obtain substantially all of the economic benefits from use of the solar farm over the 20-year period of use. Customer has exclusive use of the solar farm; it takes all of the electricity produced by the farm over the 20-year period of use as well as the renewable energy credits that are a by-product from use of the solar farm. Although Supplier will be receiving economic benefits from the solar farm in the form of tax credits, those economic benefits relate to the ownership of the solar farm rather than the use of the solar farm and, thus, are not considered in this assessment.
>
> b. Customer has the right to direct the use of the solar farm. Neither Customer nor Supplier decides how and for what purpose the solar farm is used during the period of use because those decisions are predetermined by the design of the asset (that is, the design of the solar farm has, in effect, programmed into the asset any relevant decision-making rights about how and for what purpose the solar farm is used throughout the period of use). Customer does not operate the solar farm; Supplier makes the decisions about the operation of the solar farm. However, Customer's design of the solar farm has given it the right to direct the use of the farm (as described in paragraph 842-10-15-20(b)(2)). Because the design of the solar farm has predetermined how and for what purpose the asset will be used throughout the period of use, Customer's control over that design is substantively no different from Customer controlling those decisions.

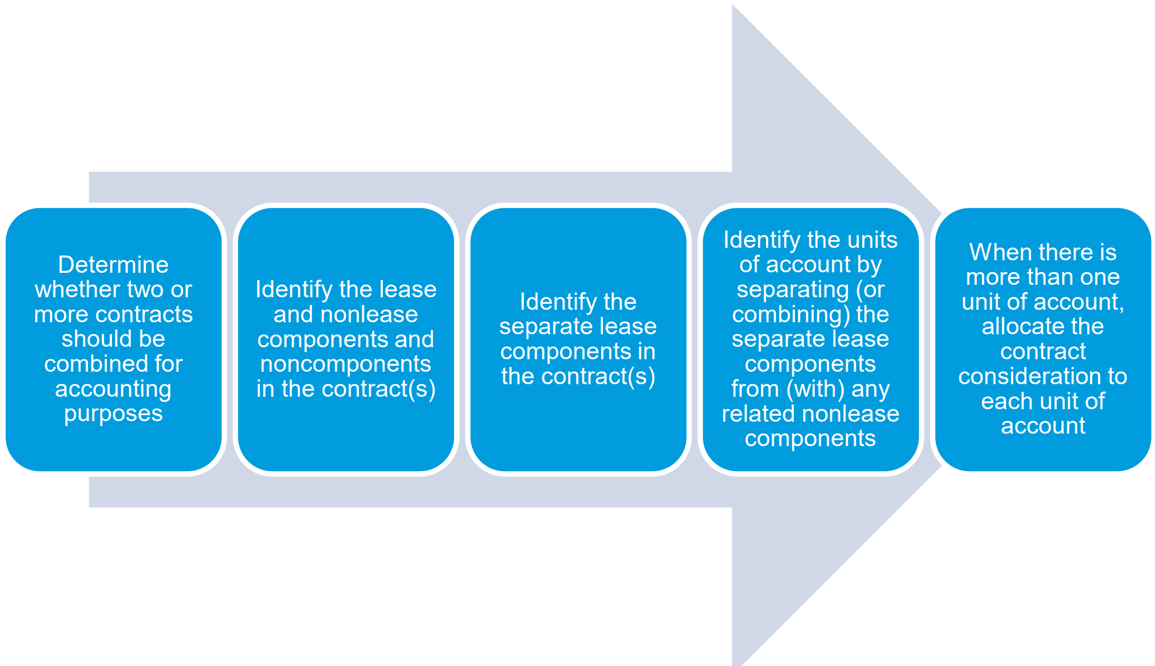
3.7 Reassessment of whether a contract is or includes a lease

Whether a contract is or includes a lease is only reassessed if the contract's terms and conditions are modified (e.g., a change in the contract's scope, consideration or other terms, such as the addition or removal of supplier substitution rights or changes to the parties' decision-making rights). This reassessment requirement applies to both contracts that were previously determined to be or to include a lease and to contracts that were previously determined to not be or to not include a lease. For example, if it was previously determined that a contract for network services was not (or did not include) a lease, and that contract is modified to expand the scope of services, the customer must consider whether that change in scope results in the contract being or including a lease after the modification.

If the modified contract is or includes a lease, the lease modifications guidance in ASC 842 applies (see Section 7.2.5). If the modified contract is not a lease or does not include a lease, other applicable U.S. GAAP should be applied to the modified contract.

4. Determine the unit(s) of account in the contract and allocate the contract consideration

Once the lessee has determined that a contract is or includes a lease, it next determines the units of account present in the contract. When there is more than one unit of account, the lessee allocates the contract consideration to those units of account. The steps involved in doing so include:



4.1 Determine whether two or more contracts should be combined for accounting purposes

A lessee should combine two or more contracts for accounting purposes if the contracts meet all of the following conditions:

- At least one of the contracts is or includes a lease.
- The contracts have the same counterparty or the parties to the contract are related parties.
- The contracts are entered into at or near the same time.
- One of the following criteria is met:
  - The contracts were negotiated as a package and have the same commercial objectives.
  - The price or performance of one contract affects the amount of consideration paid in the other contract(s).
  - Some or all of the rights to use the underlying assets in the contracts do not meet the criteria to be accounted for as separate lease components (see Section 4.3), and as a result, represent a single lease component.

If all of these criteria are not met, the contracts should not be combined for accounting purposes.

While the discussion in this guide focuses on the accounting for a (i.e., one) contract, the same discussion would apply to two or more contracts combined as a result of applying the preceding guidance.

4.2 Identify the lease and nonlease components and noncomponents in the contract

A lease component is the right to use an underlying asset that meets the definition of a lease. A nonlease component transfers a good or service to the lessee that is separate from the right to use the underlying asset. For example, a nonlease component that often arises in a contract with a lease component is maintenance services related to the underlying asset, such as cleaning and providing scheduled and as-needed upkeep and repairs. For another example, a nonlease component that often arises in a contract to lease space in a building is common area maintenance, which involves the lessor providing cleaning services for the common areas, such as the building lobby and parking lot. In addition, utilities for leased office space are also considered a nonlease component. Lease components and nonlease components may be a unit of account, depending on the facts and circumstances.

Spotlight on change: Lessee treatment of maintenance services

There is a difference between how the lessee treats the lessor providing maintenance services related to the underlying asset under ASC 840 compared to ASC 842. Under ASC 840, lessees treat maintenance of the underlying asset as an executory cost, which is considered part of, and included in, the accounting for the lease. For example, common area maintenance provided by the lessor in the lease of building space is considered an executory cost under ASC 840 and included in the lessee's accounting for the lease. However, under ASC 842, maintenance of the underlying asset is considered a nonlease component, and unless the lessee elects the accounting policy to combine a lease component with the related nonlease component(s) (see Section 4.4), the lessee should account for the maintenance services (the nonlease component) separate from the lease.

Warranties provided by the lessor with respect to the performance of the underlying asset or to effectively protect the lessee from obsolescence of the underlying asset are generally not considered nonlease components. However, if the lessor's commitment goes beyond the commitment that would be provided under a typical warranty for the underlying asset, the lessor may be providing an additional service to the lessee that should be treated as a nonlease component.

Noncomponents do not provide an additional good or service to the lessee. Common examples of noncomponents include:

- *Administrative tasks involved in setting up a contract or initiating a lease*. Such tasks do not transfer a good or service to the lessee that is separate from the right to use the underlying asset. Information about the lessee's accounting for initial direct costs is provided in Section 7.1.3.1.
- *Reimbursements of or payments for the lessor's costs*. Such reimbursements and payments do not transfer a good or service to the lessee that is separate from the right to use the underlying asset. For example, reimbursements for the lessor's real estate taxes (which are owed by the lessor regardless of whether it leases the building) and building insurance (which protects the lessor's investment in the building because the lessor will receive the proceeds from any claim) are not considered a component of the contract because they do not transfer a good or service to the lessee that is separate from the right to use the building. Reimbursements of or payments for the lessor's costs are included in lease payments and contract consideration when the amount of the reimbursement or payment is fixed or variable based on an index or rate. When the amount of the reimbursement or payment is variable based on something other than an index or rate, it is not included in lease payments or contract consideration. Additional discussion about fixed and variable lease payments is provided in Sections 5.5.2 and 5.5.3, respectively.
- *Shipping, delivery and installation of the underlying asset*. We believe that when the lessor charges the lessee for any shipping, delivery and (or) installation of the underlying asset, a good or service is not transferred to the lessee that is separate from the right to use the underlying asset. The lessor typically charges a fixed amount for these activities, in which case they are considered part of the

contract consideration and lease payments. If the lessee pays the lessor for these activities prior to the lease's commencement date, the amounts paid are treated as prepaid contract consideration and prepaid lease payments. Section 5.5.1 discusses the treatment of prepaid lease payments.

A noncomponent cannot be a unit of account. As such, no contract consideration is allocated to noncomponents. Example 4-2 illustrates how to identify the units of account when there is a lease component, nonlease component and noncomponents.

4.2.1 Master lease agreements

A master lease agreement is an umbrella agreement under which multiple underlying assets (usually of the same type, such as vehicles or printers) may be leased by the lessee. The master lease agreement typically provides the primary terms of the leases that will fall under its umbrella. Then, when a specific underlying asset is leased under the master lease, other paperwork or schedules with relevant information related to that asset is executed. While neither would likely meet the definition of a lease on its own, together the master lease and the other paperwork or schedules typically combine to include all of the necessary elements of a lease. Specific underlying assets are often leased at varying times over the term of the master lease agreement based on the lessee's needs.

From an accounting perspective, it is important to understand whether a master lease agreement commits or permits the lessee to obtain control over additional underlying assets subject to the right of use.

When the lessee is *committed* to obtaining control of an additional underlying asset under the master lease agreement, it makes the following accounting determinations on the commencement date (see Section 5.1) for the right to use that underlying asset:

- *Whether the additional right of use should be accounted for as a separate lease component (see Section 4.3)*. The types of underlying assets subject to the right of use under a master lease agreement will often result in the right to use those assets meeting the criteria to be accounted for as separate lease components. This is also consistent with those assets often being leased at varying times over the term of the master lease agreement based on the lessee's needs.
- *How the contract consideration should be allocated to the units of account identified in the contract (see Section 4.5.2)*. When the lessee obtains the right to control an additional identified underlying asset subject to the right of use under a master lease agreement, it remeasures and reallocates the contract consideration as appropriate (see Section 4.5.4). However, it is worth noting that if the terms of a master lease agreement are set up to result in the lease of underlying assets at the market rates in place on the commencement date (see Section 5.1), the amounts allocated to previously identified underlying assets that the lessee already has the right to control are unaffected, and the amount allocated to the newly identified underlying asset(s) is based on those market rates.

When the lessee is *permitted* to obtain control of an additional identified underlying asset under the master lease agreement, it should account for obtaining an additional right of use as a modification (see Section 7.2.5). Unless the modification is accounted for as a separate contract, the lessee remeasures and reallocates the contract consideration as appropriate (see Section 4.5.4 and Section 7.2.5.1).

4.3 Identify the separate lease components in the contract

If there is only one right to use an underlying asset in the contract, the contract includes only one lease component. If there is more than one right to use an underlying asset, the lessee must determine whether each right to use an underlying asset represents a separate lease component for accounting purposes. The basis for doing so depends on whether one of the underlying assets is land.

4.3.1 Rights to use land and other assets

If a contract includes the rights to use land and other assets, the right to use land should be accounted for as a separate lease component unless the effects of doing so would be insignificant. Conversely, if the effects of accounting for the right to use the land separately are insignificant, the lessee may account for the rights to use the land and the asset related to the land as one lease component. It is important to note that the right to use land may be explicitly addressed in a contract or it may be an inherent result of entering into the contract to obtain the right to use another asset on the land (see Section 4.3.1.1).

As explained further in paragraph BC147 of ASU 2016-02, the FASB concluded that the right to use land should be accounted for separately (unless the effects of doing so are insignificant) given that its indefinite economic life makes it substantially different from other assets. As a result, a key question when accounting for a contract that includes the rights to use land and other assets is whether the effects of accounting for the right to use the land separately is insignificant.

One situation in which the effects of separately accounting for the right to use land would be considered insignificant is when the ROU asset that would otherwise be recognized under ASC 842 related to the land is insignificant. When that is *not* the case, the lessee should evaluate the effects that treating the right to use land as a separate lease component would have on the classification of each lease component in the contract. Lease classification is used for this purpose because it affects all of the following (which are referred to later as the elements affected by lease classification): (a) the balance-sheet presentation of the related ROU assets and lease liabilities (see Section 9.1), (b) the timing of expense recognition (see Section 7.2.2.1 and Section 7.2.3.1), (c) the classification of the expense on the income statement (see Section 9.2), (d) the classification of the lease payments in the cash flow statement (see Section 9.3) and (e) the disclosure of certain quantitative information, such as lease costs, weighted-average lease term and weighted-average discount rate (see Section 9.4 and Appendix D).

For example, assume a contract includes the right to use land and the right to use the only building located on the land, and each right to use meets the definition of a lease. If the ROU asset that would otherwise be recognized related to the land is insignificant, then the right to use the land does not have to be accounted for separate from the right to use the building. If the ROU asset that would be recognized related to the land is more than insignificant, the lessee next considers how the right to use the land and the right to use the building would each be classified. If separate accounting for the rights to use the land and the building produces the same classification for each (i.e., both are classified as operating or both are classified as finance), the effects of separately accounting for them may be insignificant because all of the elements affected by lease classification would be the same (e.g., the timing of expense recognition and the classification of that expense on the income statement would be the same). Conversely, if separate classification of the rights to use the land and the building produce different classifications (i.e., one is classified as operating and the other is classified as finance), the effects of separately accounting for them may not be insignificant because each of the elements affected by lease classification would be different for each lease (e.g., the timing of expense recognition and the classification of that expense on the income statement would be different for the right to use the land and the right to use the building). Reaching a final conclusion as to whether the effects of separately accounting for the right to use the land and the right to use the building is insignificant compared to accounting for those rights together requires consideration of all the relevant facts and circumstances.

Example 13 in ASC 842-10-55-146 to 55-149 involves the lease of a turbine plant, which includes the right to use the turbine and the building in which it is housed, as well as the land on which the building is located. The example considers whether the effects of accounting for the right to use the land separate from the rights to use the building and the turbine are insignificant.

Spotlight on change: Separation of the right to use land and the right to use another asset

Under ASC 840, the rights to use a building and the related land should be separated from each other for accounting purposes when the fair value of the land is 25% or more of the total fair value of the lease at its inception. In addition, the lease payments allocated to the right to use the land are determined by multiplying the fair value of the land by the lessee's incremental borrowing rate. The difference between the lease payments and the amount allocated to the right to use the land represents the lease payments allocated to the right to use the building. ASC 840 also requires the rights to use equipment and related real estate to be separated from each other for accounting purposes.

Under ASC 842, when a contract includes the right to use land and the right to use another asset (e.g., building, equipment), the right to use the land must be accounted for separately unless there is an insignificant difference between accounting for it separately vs. accounting for it together with the right to use the other asset. In addition, lease payments are allocated to the right to use the land and the right to use the other asset based on their relative standalone prices.

Based on the different guidance in ASC 842 compared to ASC 840, we expect to see more situations in which the right to use land and the right to use another asset will be accounted for separately. In addition, lessees will have to change their processes and internal controls related to the methodology used to allocate the lease payments from a residual method using the fair value of the land multiplied by the lessee's incremental borrowing rate to a relative method using the standalone price of each right to use.

4.3.1.1 Inherent leases of land

When a lessee enters into a contract under which it has the right to use an entire building, it should identify two potential lease components—the right to use the building and the right to use the land on which the building sits. To determine whether each is in fact a lease component, the lessee should determine whether each meets the definition of a lease. Typically, when a lessee has the right to use an entire building, and that right of use meets the definition of a lease, the right to use the land on which the building sits also meets the definition of a lease (that is, the lessee is also inherently leasing the land on which the building sits). When there is a building lease component and a land lease component, the guidance in Section 4.3.1 is applied to determine whether they should be accounted for separately.

When a lessee enters into a contract under which it has the right to use only part of a building, it should evaluate whether there is also an inherent lease of the land related to the part of the building it is leasing. The outcome of the evaluation will likely differ depending on whether the part of the building the lessee has a right to use represents substantially all of the building or if there is otherwise specific land associated with the part of the building being leased by the lessee:

- If the lessee has the right to use substantially all of the building, and that right of use meets the definition of a lease, it is likely that the right to use the land on which the building sits also meets the definition of a lease. In other words, all other things being equal, a lessee should typically reach the same conclusion on whether a land lease component exists regardless of whether it has the right to use an entire building or substantially all of a building.
- If the lessee has the right to use less than substantially all of the building, the lessee should consider whether the part of the building it is leasing has specific land associated with it. For example, if the lessee is leasing one complete wing of a building with three wings, and that right of use meets the definition of a lease, it is possible that the right to use the land on which the wing being leased by the lessee sits also meets the definition of a lease.

- If the lessee has the right to use less than substantially all of the building and there is not specific land associated with the part of the building being leased by the lessee, the lessee typically does not have the right to use a physically distinct part of the land (i.e., the land is not an identified asset) or the lessee would not have the right to control the land on which the building sits (e.g., the entity would not be able to obtain substantially all of the economic benefits related to that land).

Inherent leases of land should be carefully evaluated to determine whether they represent a lease component that should be accounted for separately as discussed in Section 4.3.1.

4.3.2 Separating lease components

The guidance in this section addresses how many lease components exist for accounting purposes in a contract that includes multiple rights to use assets.

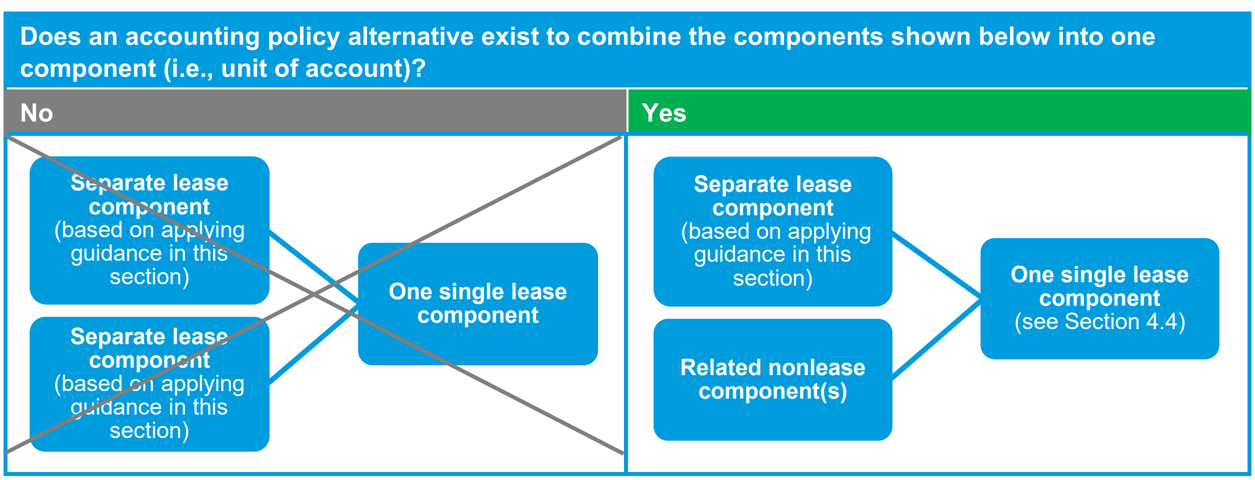
When one of the rights to use an asset in a contract that includes multiple rights to use assets is the right to use land, the guidance in Section 4.3.1 should be applied to determine whether the right to use the land should be accounted for separate from the rights to use the other assets included in the contract. The guidance in Section 4.3.1 is determinative with respect to whether the right to use the land should be accounted for separately.

The right to use an underlying asset that is not land is a separate lease component if both of the following criteria are met:

- The right to use the underlying asset benefits the lessee either on a standalone basis or together with other resources that are readily available to the lessee.
- The right to use the underlying asset and the other right(s) to use underlying asset(s) in the contract are neither highly dependent on nor highly interrelated with each other.

For purposes of the first criterion, resources that are readily available to the lessee include goods or services that a lessor (including the lessor under the contract) or supplier leases or sells separately, as well as those the lessee has already obtained (whether from the contract with the lessor or from other transactions or events). For purposes of the second criterion, one right to use an underlying asset is highly dependent on, or highly interrelated with, another right to use an underlying asset if each right to use significantly affects the other. A key question in determining whether the second criterion is met is whether any lessee would obtain one of the rights to use without also obtaining the other right(s) to use.

There is no accounting policy alternative provided in ASC 842 that allows a lessee to combine lease components that should be separated based on applying the guidance discussed in this section. However, Section 4.4 discusses an accounting policy alternative provided in ASC 842 that allows a lessee to combine a lease component with the related nonlease components.



Example 4-1 illustrates the analysis that must be performed to identify the separate lease components in a contract.

Spotlight on change: Separation of the rights to use assets other than land

Under ASC 840, lessees generally account for the rights to use assets other than land on a combined basis if the assets are interdependent. Under ASC 842, the rights to use assets other than land must be accounted for separately if two specific criteria are met. Based on these criteria and historical practice under ASC 840, we expect there to be more instances of separately accounting for the rights to use multiple underlying assets.

4.4 Identify the units of account by separating (or combining) the separate lease components from (with) any related nonlease components

When a contract includes both lease and nonlease components, the lessee either: (a) treats each separate lease component as a unit of account apart from the nonlease components or (b) elects an accounting policy by class of underlying asset to treat each separate lease component together with the nonlease component(s) related to it as one combined unit of account. If the lessee elects this accounting policy, the combined unit of account is accounted for as a lease component under ASC 842. If the lessee does not elect this accounting policy, the nonlease components are accounted for as one or more unit(s) of account in accordance with other applicable U.S. GAAP.

While electing the accounting policy means the lessee does not separate lease components from nonlease components, it also means that the contract consideration that would otherwise be attributable to the nonlease components is included in determining the lease liability and ROU asset recognized by the lessee. Therefore, electing the accounting policy will typically result in the lessee recognizing a larger ROU asset and lease liability than if it had not elected the accounting policy. Example 4-1 illustrates the effects of adopting the accounting policy to not separate lease components from nonlease components on the identification of the units of account in a contract with multiple lease and nonlease components.

Consider a contract in which the lessee has identified one lease component, one nonlease component related to the lease component and one noncomponent. If the accounting policy is not elected, two units of account would exist—one lease unit of account accounted for under ASC 842 and one nonlease unit of account accounted for under other applicable U.S. GAAP. If the accounting policy is elected, one unit of account would exist and be accounted for under ASC 842.

Spotlight on change: Lessee treatment of services other than maintenance included in a contract with a lease

ASC 840 indicates that substantial services (other than maintenance services) provided by the lessor to the lessee are excluded from its scope, which means that such services are accounted for separate from the lease. ASC 842 also requires lessees to treat services provided by the lessor separate from the lease. However, if the lessee elects the accounting policy to combine a lease component with the related nonlease component(s), the services provided by the lessor related to the lease are accounted for as part of the lease. As a result, there is a difference between how the lessee treats services other than maintenance provided by the lessor to the lessee under ASC 840 compared to ASC 842, but only if the lessee elects the accounting policy under ASC 842 to combine a lease component with the related nonlease component(s).

Lessee treatment of maintenance services provided by the lessor under ASC 840 and ASC 842 is discussed in Section 4.2.

4.5 Allocate the contract consideration to the units of account

4.5.1 Elements of contract consideration

Contract consideration includes all of the following:

Determination of contract consideration	
	Total lease payments used for lease classification purposes (see Section 5.5)
+	Any other fixed payments and in-substance fixed payments not already considered in determining the lease payments used for lease classification purposes (see Sections 5.5.1 and 5.5.2 and Section 5.5.3.1)
–	Any incentives paid or payable not already considered in determining the lease payments used for lease classification purposes (see Section 5.5.4)
+	Any other variable payments based on an index or rate (measured at the index or rate on the commencement date) not already considered in determining the lease payments used for lease classification purposes (see Section 5.5.3.2)
=	Contract consideration

As discussed more fully in Section 5.5.1, lease payments are used for lease classification purposes (see Section 6.5) and for purposes of measuring the lease liabilities and ROU assets recognized by lessees when accounting for their leases (see Section 7.1). While the nature of the lease payments used for these purposes is the same, the amount used for each purpose could differ. For example, fixed lease payments used for lease classification purposes should include those amounts prepaid by the lessee as well as those amounts it has yet to pay over the lease term. In contrast, fixed lease payments for purposes of measuring the lease liability should only include those amounts the lessee has not yet paid. When measuring contract consideration, the objective is to identify the total amount of contract consideration, regardless of whether it has been paid, to facilitate allocating that consideration to the units of account in a contract when there is more than one unit of account. Whether contract consideration has been paid or is payable before, on or after the commencement date comes into play when measuring the lease liability for a unit of account that includes a lease. When measuring a lease liability, the contract consideration allocated to the unit of account should be adjusted, as appropriate and necessary, to exclude amounts paid on or before the commencement date.

The relationship between contract consideration and lease payments is discussed in Section 5.5.12.

4.5.2 Allocation of contract consideration to units of account using relative standalone prices

When a contract includes more than one unit of account, the contract consideration is allocated to the units of account using the relative standalone prices of those units of account.

If observable standalone prices for a unit of account are available, they should be used for allocation purposes. Observable standalone prices are those that the lessor or similar suppliers charge on a standalone basis for a similar unit of account. For example, if a unit of account includes a lease component and the related nonlease components because the lessee elected the accounting policy to combine a separate lease component with the related nonlease components (see Section 4.4), an observable standalone price would be what the lessor or similar suppliers charge on a standalone basis for both the lease component and the related nonlease components. If observable standalone prices are not available for a unit of account, the lessee must estimate the standalone prices. In estimating a standalone price, the lessee must maximize the use of observable information to the extent available. It may be appropriate for a lessee to use a residual estimation approach to the extent the standalone price for a unit of account is highly variable or uncertain.

Example 4-1: Identifying the units of account and allocating contract consideration when there are multiple lease and nonlease components

Lessee enters into a contract with Lessor under which it leases two production printers (Printer X and Printer Y). Printer X is higher speed and provides more finishing options than Printer Y. Printer X will be used in Lessee's Chicago office and Printer Y will be used in its Detroit office. The contract also provides for Lessor to provide regular and as-needed maintenance on the printers in each location. The lease payments are $5,000 per month for Printer X and $3,000 per month for Printer Y. There are no separate maintenance fees charged to Lessee. There are no renewal, termination or purchase options, nor are there any lease incentives. The lease term for both printers is three years. Total payments under the contract are $288,000 ($180,000 for Printer X [$5,000 per month × 12 months × 3 years] + $108,000 for Printer Y [$3,000 per month × 12 months × 3 years]).

Lessee concludes that the right to use each printer represents a separate lease component because Lessee can benefit from the right to use each printer on a standalone basis and because the printers are neither highly dependent on nor highly interrelated with each other.

Assume under Scenario A that Lessee separately accounts for the lease and nonlease components, and under Scenario B that Lessee elects the accounting policy (for its class of underlying assets that includes printers) to not separate each lease component from the nonlease components related to it. The following two tables list the units of account under each scenario, the standalone prices for each unit of account and the contract consideration allocated to each unit of account. The standalone prices were established by Lessee on the basis of observable standalone prices charged by other lessors of the same printers and suppliers of the same maintenance services.

Scenario A

Unit of account	Standalone price	Standalone price relative to total of standalone prices	Allocated contract consideration
Lease of Printer X	$189,000	54% ($189,000 ÷ $350,000)	$155,520 ($288,000 × 54%)
Lease of Printer Y	112,000	32% ($112,000 ÷ $350,000)	92,160 ($288,000 × 32%)
Printer X maintenance services	28,000	8% ($28,000 ÷ $350,000)	23,040 ($288,000 × 8%)
Printer Y maintenance services	21,000	6% ($21,000 ÷ $350,000)	17,280 ($288,000 × 6%)
Total	$350,000	100%	$288,000

Scenario B

Unit of account	Standalone price	Standalone price relative to total of standalone prices	Allocated contract consideration
Lease of Printer X and related maintenance services	$214,200	63% ($214,200 ÷ $340,000)	$181,440 ($288,000 × 63%)
Lease of Printer Y and related maintenance services	125,800	37% ($125,800 ÷ $340,000)	106,560 ($288,000 × 37%)
Total	$340,000	100%	$288,000

Under Scenario A, Lessee accounts for the lease of Printer X and the lease of Printer Y as separate lease components under ASC 842 with lease payments of $155,520 and $92,160, respectively. The payments allocated to the maintenance services for Printer X and Printer Y of $23,040 and $17,280, respectively, are accounted for in accordance with other applicable U.S. GAAP.

Under Scenario B, Lessee accounts for two combined units of account, which include the separate lease component and the related maintenance services, as lease components under ASC 842 with lease payments of $181,440 and $106,560, respectively.

Comparatively, the total amount of lease payments for both lease components that will be used to calculate the lease liabilities under Scenario A of $247,680 ($155,520 + $92,160) is less than the total amount of payments that will be used to calculate the lease liability under Scenario B of $288,000 ($181,440 + $106,560). As discussed earlier, while electing the accounting policy reflected in Scenario B may simplify the accounting for the contract, it typically results in the lessee recognizing a higher lease liability.

Example 4-2: Identifying the units of account and allocating contract consideration when there are lease and nonlease components and noncomponents

Lessee enters into a contract with Lessor under which it will lease five specific floors in a 20-story building for seven years. There are no contract renewal or termination options. Lessor did not give Lessee any lease incentives. Lessee is required to pay $450,000 per year to lease the five floors. In addition, Lessee is required to pay Lessor as follows:

- $90,000 per year for Lessor's property taxes
- $40,000 per year for Lessor's building insurance (for which Lessor is the beneficiary)
- $20,000 per year for common area maintenance

Once the lease was signed, Lessee paid its real estate management director and his staff bonuses totaling $50,000 for negotiating such favorable lease terms.

Lessee concludes the contract meets the definition of a lease and that the lease term is seven years. Lessee also concludes that the contract consideration equals $4,200,000, as follows:

	Annual payment	Total over lease term of 7 years
Fixed lease payment	$450,000	$3,150,000
Property taxes	90,000	630,000
Building insurance	40,000	280,000
Common area maintenance	20,000	140,000
Total contract consideration	$600,000	$4,200,000

Lessee concludes that there are two units of account: (a) the right to use the five floors over seven years (which is a lease component) and (b) common area maintenance (which is a nonlease component). Lessee concludes that the payments to Lessor for building insurance and property taxes are noncomponents as they do not provide a good or service separate from the right to use the five floors in the building. Lessee also concludes that the $50,000 bonus it paid to its real estate management director and his staff meets the definition of an initial direct cost.

Assume under Scenario A that Lessee separately accounts for lease and nonlease components. The following table lists the units of account under Scenario A, the standalone prices for each unit of account and the contract consideration and initial direct costs allocated to each unit of account. The standalone prices were established by Lessee on the basis of observable standalone prices charged by other lessors for similar office space (e.g., same square footage, same general location, similar amenities) and suppliers of similar common area maintenance.

Scenario A				
Unit of account	Standalone price	Standalone price relative to total of standalone prices	Allocated contract consideration	Allocated initial direct costs
Lease (right to use five specific floors in the building)	$3,960,000	90%	$3,780,000	$45,000
Nonlease (common area maintenance)	440,000	10%	420,000	5,000
Total	$4,400,000	100%	$4,200,000	$50,000

The $3,780,000 of contract consideration (i.e., lease payments) and $45,000 of initial direct costs allocated to the lease unit of account are accounted for in accordance with ASC 842. The $420,000 of contract consideration and $5,000 of initial direct costs allocated to the nonlease unit of account are accounted for in accordance with other applicable U.S. GAAP.

Assume under Scenario B that Lessee elects the accounting policy (for its class of assets that includes buildings) to not separate each lease component from the nonlease components related to it. In this scenario, there is only one unit of account, which includes both the right to use five specific floors in the building and the common area maintenance. The $4,200,000 of contract consideration (i.e., lease payments) related to that unit of account and the $50,000 of initial direct costs are accounted for in accordance with ASC 842.

4.5.3 Allocation of variable payments not included in contract consideration

Guidance on how to allocate variable payments in a contract that are not included in the contract consideration (see Section 7.2.2.1 and Section 7.2.3.1) between the contract's units of account is not explicitly provided in ASC 842. However, the lessee in Cases A and B of Example 14 in ASC 842-10-55-150 to 55-154 allocates such payments on the same basis that was used to allocate the contract consideration. For example, if a contract consisted of two units of account—a lease component and a maintenance component—and the contract consideration was allocated by the lessee on a basis of 80% to the lease component and 20% to the maintenance component (based on the related standalone prices), when a variable payment not included in the contract consideration is recognized by the lessee, 80% of that payment is attributed to the lease component and 20% is attributed to the maintenance component. We believe the approach used by the lessee in Cases A and B of Example 14 generally should be applied when allocating variable lease payments not included in contract consideration to lease and nonlease components. We believe that once the variability is eliminated and the amounts become known, the lessee should allocate those amounts to the lease and nonlease components on the same basis as was used to perform previous allocations of contract consideration.

Example 4-3: Allocating variable consideration based on printer usage

Lessee enters into a contract with Lessor under which it leases one production printer. The contract also provides for Lessor to provide regular and as-needed maintenance on the printer. The lease payments are $5,000 per month and there are no separate maintenance fees charged to Lessee. There are no renewal, termination or purchase options, nor are there any lease incentives. The lease term is three years. Total fixed payments under the contract are $180,000 ($5,000 per month × 12 months × 3 years).

The contract also requires Lessee to make an additional payment of $10,000 each year in which the number of pages printed exceeds 100,000. As such, Lessee could pay up to $30,000 of additional consideration to Lessor over the lease term ($10,000 per year × 3-year lease term).

The $30,000 of potential additional contract consideration is variable based on other than an index or rate (i.e., it is variable based on usage). As a result, the potential variable payments are not included in the contract consideration initially allocated at lease commencement (see Section 4.5.1) or the lease payments used for classification or measurement purposes at least commencement (see Section 5.5.3.3). Instead, such amounts are recognized in the period in which the obligation to make the payments is incurred, which is when it becomes probable that the printed pages threshold will be achieved (see Section 7.2.2.1 and Section 7.2.3.1).

Assume under Scenario A that Lessee separately accounts for the lease and nonlease component, and under Scenario B that Lessee elects the accounting policy (for its class of underlying assets that includes printers) to not separate each lease component from the nonlease components related to it.

The following table lists the units of account under Scenario A, the standalone prices for each unit of account and the contract consideration allocated to each unit of account. The standalone prices were established by Lessee on the basis of observable standalone prices charged by other lessors of the same printer and suppliers of the same maintenance services.

Scenario A

Unit of account	Standalone price	Standalone price relative to total of standalone prices	Allocated contract consideration
Lease of printer	$170,000	85% ($170,000 ÷ $200,000)	$153,000 ($180,000 × 85%)
Printer maintenance services	30,000	15% ($30,000 ÷ $200,000)	27,000 ($180,000 × 15%)
Total	$200,000	100%	$180,000

Under Scenario A, Lessee accounts for the lease of the printer as a separate unit of account with lease payments of $153,000. The payments allocated to the maintenance services for the printer of $27,000 are accounted for in accordance with other applicable U.S. GAAP.

Under Scenario B, Lessee has only one unit of account, which includes the lease component and the related maintenance services. This unit of account is accounted for as a lease component under ASC 842 with lease payments of $180,000.

During the first year of the lease, Lessee concludes it is probable that the printed pages threshold will be met. As such, Lessee must accrue $10,000 of additional costs related to the printer. In making that accrual, Lessee must determine how much of the $10,000 should be considered lease costs under Scenario A and how much should be considered nonlease costs. To make this determination, Lessee allocates the $10,000 variable lease payment in the same manner it allocated the contract consideration at lease commencement. As such, Lessee allocates $8,500 ($10,000 × 85%) to lease costs and $1,500 to nonlease costs ($10,000 × 15%).

Under Scenario B, the entire $10,000 would be considered lease costs given that there is only one unit of account in that scenario and it is accounted for under ASC 842.

The variable lease costs recognized in Scenario A and B are subject to the presentation and disclosure requirements in ASC 842 (see Section 9.2 and Section 9.4).

4.5.4 Remeasuring and reallocating contract consideration

Contract consideration should be remeasured and reallocated to the contract's units of account only if: (a) the lease liability is remeasured as otherwise required by ASC 842 (see Section 7.2.1.1) or (b) there is a contract modification that is not accounted for as a separate contract (see Section 7.2.5.1). Current standalone prices should be used for each unit of account for reallocation purposes.

5. Key inputs to classifying and accounting for a lease

5.1 Commencement date

The commencement date is the date the lessor makes the underlying asset available to the lessee for its use.

The commencement date is the date on which a number of important determinations and measurements are made related to the accounting for a lease (e.g., lease term, lease classification, lease payments). It is also the date on which the lease liability and ROU asset are recognized for a lease unless the short-term lease accounting policy has been elected (see Section 7.1.1).

If the contractual terms of a lease indicate that the lessor will make the underlying asset available for the lessee to use on a specific date, but the lessor makes the asset available for the lessee's use before or after that date, the lessee should understand the reason(s) for the difference between those dates. If the difference between the dates is attributable to:

- *The lessor making the underlying asset available to the lessee early for purposes of the lessee building out leasehold improvements*, the lessee must understand who will ultimately own those leasehold improvements—the lessee or the lessor. If the lessee ultimately owns the leasehold improvements, the date the lessor made the underlying asset available for the lessee's use to build those leasehold improvements is the commencement date for the lease. Conversely, if the lessor ultimately owns the leasehold improvements, the commencement date is the date the lessor makes the underlying asset available to the lessee for its intended use (including the completed leasehold improvements).
- *Something other than the lessor making the underlying asset available to the lessee early for purposes of the lessee building out leasehold improvements,* the commencement date is the date the asset was made available to the lessee for its intended use.

A lease's commencement date may be before or after the lessee has begun operations. In addition, a lease's commencement date may be before or after the lessee is required to make payments under the lease.

A master lease agreement (see Section 4.2.1) may give rise to multiple commencement dates. For example, if a lessee is committed to lease a fleet of trucks under a master lease agreement and the lessor will make those trucks available to the lessee on a staggered basis over the first year of the lease, multiple commencement dates will exist.

Spotlight on change: Lease commencement vs. lease inception

The following table indicates when the classification, recognition and initial measurement of a lease should occur under ASC 840 and ASC 842:

	ASC 840	ASC 842
Classification	Inception	Commencement
Recognition	Commencement	Commencement
Initial measurement	Inception	Commencement

Under ASC 842, a lease is classified, recognized and initially measured on the commencement date of the lease. While a lease is also recognized on the commencement date of the lease under ASC 840, the lease is classified and measured under ASC 840 as of the lease's inception date, which is the earlier of the date of the lease agreement or the commitment date. The inception date of a lease typically occurs before its commencement date. Using different dates for classification and initial measurement purposes means that the lessee could reach different classification conclusions and recognize different amounts under ASC 840 and ASC 842. For example, if the discount rate changes between the inception date of the lease and its commencement date, a lessee could reach a different classification conclusion under ASC 840 compared to ASC 842 and (or) could initially measure a capital lease obligation under ASC 840 and a lease liability under ASC 842 at different amounts, all other things being equal.

Example 5-1: Determining the commencement date in a ground lease

Lessor enters into a ground lease with Lessee under which Lessee will build a restaurant on Lessor's land. Lessee will own the building. Lessor makes its land available to Lessee on March 1, 20X6. Lessee is not expected to complete construction of the restaurant until September 1, 20X6, which is also the date Lessee is required to start making lease payments.

The commencement date for the lease is March 1, 20X6, because that is the date Lessor makes its land available to Lessee for its use, which includes the construction of a building that Lessee will own. The fact that there is a construction period causing Lessee not to commence operations or make lease payments until September 1, 20X6 does not affect the determination of the commencement date. Lessee begins recognizing lease costs related to the ground lease on the commencement date. Other applicable U.S. GAAP is applied to determine whether those lease costs are expensed or capitalized as part of the construction project.

Example 5-2: Determining the commencement date when the lessor constructs the underlying asset

On March 1, 20X6, Lessor enters into a lease with Lessee under which Lessor will construct an office building for Lessee's use. Lessor will own the office building. Lessor begins construction on March 2, 20X6. Lessor is not expected to complete construction of the office building until April 1, 20X7, which is also when the office building will be made available to Lessee for its use. Lessee plans to spend three months installing leasehold improvements before moving into the office building on July 1, 20X7. Lessee will own these leasehold improvements. Lessee is required to start making lease payments on July 1, 20X7.

The commencement date for the lease is April 1, 20X7, because that is the date Lessor makes the office building available to Lessee to build leasehold improvements that Lessee will own. The fact that there is a three-month delay in Lessee moving into the office building to allow for the installation of these leasehold improvements does not affect the determination of the commencement date. The timing of lease payments also has no bearing on the commencement date. Lessee begins recognizing lease costs on the commencement date. Other applicable U.S. GAAP is applied to determine whether those lease costs are expensed or capitalized as part of the leasehold improvements.

5.1.1 Costs incurred before the commencement date

A lessee may incur costs related to a lease before the lease's commencement date. For example, a lessee may incur costs to have the underlying asset delivered to its facilities and (or) installed at its facilities. A key question in accounting for these costs is whether the activities are performed by the lessor or a third-party.

As discussed in Section 4.2, shipping, delivery and (or) installation activities performed by the lessor with respect to the underlying asset are noncomponents (i.e., they do not represent a unit of account in and of themselves). As a result, any amounts paid by the lessee to the lessor before the commencement date related to shipping, delivering and (or) installing the underlying asset should be treated as prepaid contract consideration.

We believe costs incurred with third parties to ship, deliver and (or) install an underlying asset should not be accounted for as initial direct costs (see Section 7.1.3.1) because they do not relate to the lessee obtaining the lease with the lessor, but instead to the lessee obtaining services from a third party related to the underlying asset. As we discuss in more detail in Section 7.1.4, when the costs incurred with third parties to ship, deliver and (or) install an underlying asset are within the scope of a specific ASC topic or subtopic, the guidance in that topic or subtopic should be applied. When there is no directly applicable ASC topic or subtopic for these costs, we believe a lessee has an accounting policy choice to either: (a) expense the costs as incurred or (b) capitalize the costs by analogy to ASC 360-10-30-1 and 30-2, together with ASC 835-20-05-1, because the costs are incurred to bring the underlying asset (and by extension, the ROU asset) to the point at which it can be used by the lessee as intended. The accounting policy elected should be consistently applied and appropriately disclosed.

5.2 Discount rate

The discount rate used by a lessee is the rate implicit in the lease (see Section 5.2.1), if that rate is readily determinable. If that rate is not readily determinable, the lessee's incremental borrowing rate (see Section 5.2.2) should be used. Lessees that are not public business entities may elect an accounting policy to use the risk-free rate for a period comparable to the lease term (see Section 5.2.3) if the rate implicit in the lease is not readily determinable. This policy may be elected on a class-of-asset basis.

5.2.1 Rate implicit in the lease

The rate implicit in the lease is defined in the Master Glossary of the ASC as:

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

In most cases, the rate implicit in the lease is not readily determinable by the lessee because it requires knowledge of lessor-specific information that the lessee may not have access to or insight about, such as the investment tax credits earned by the lessor, the amount of investment tax credits the lessor expects to retain and realize and the amount of initial direct costs deferred by the lessor. As a result, lessees typically use their incremental borrowing rate as the discount rate, unless the lessee is not a public business entity and has elected the accounting policy to use the risk-free rate on a class-of-asset basis for a period comparable to the lease term.

Spotlight on change: Rate implicit in the lease

The lessee is required to use the rate implicit in the lease as the discount rate under ASC 840 if it is practicable to do so and under ASC 842 if it is readily determinable. However, when it is practicable to use the rate implicit in the lease under ASC 840, but that rate is more than the lessee's incremental borrowing rate, the lessee's incremental borrowing rate should be used as the discount rate. ASC 842 does not include the same exception related to use of the rate implicit in the lease if it is readily determinable.

5.2.2 Incremental borrowing rate

The lessee's incremental borrowing rate for ASC 842 purposes is the interest rate the lessee would be charged for a loan that: (a) is collateralized (i.e., secured by the lessee's aggregate collateral), (b) has a term similar to the lease term, (c) is for an amount equal to the lease payments and (d) occurs in a similar economic environment. Determining the incremental borrowing rate requires the lessee to determine the borrowing rate it would be charged for a hypothetical loan with terms that are similar to the lease's terms.

Questions the lessee should consider in identifying its incremental borrowing rate for purposes of ASC 842 include the following:

- *What are the payment terms of the lease?* The hypothetical loan on which the incremental borrowing rate is based should reflect payment terms that are consistent with those of the lease. For example, if the lease requires the same recurring monthly payment over a five-year period (i.e., an amortizing loan), the hypothetical loan should reflect the same recurring monthly payment over the same term. In other words, it would not be appropriate in this situation for the hypothetical loan to require monthly interest payments and a balloon principal payment at the end of five years (i.e., a bullet loan).
- *Could the significance of the lease payments affect the lessee's incremental borrowing rate?* A lessee should consider whether the amount of the lease payments that should be reflected in the hypothetical loan could have a significant effect on the lessee's capital structure such that it would change the lessee's credit-risk profile, which would in turn affect the lessee's incremental borrowing rate.
- *Has the lessee's debt been rated by a credit agency?* A key determinant in the rate a lessee would be charged on the hypothetical loan is its creditworthiness. As such, if the lessee's debt has been rated by a credit agency, that rating should factor into determining the lessee's incremental borrowing rate. Even if the lessee's debt has not been rated by a credit agency, the lessee should consider whether it would be possible to develop a synthetic credit rating through qualitative and quantitative analysis, with the objective of identifying what the lessee's credit rating would be if it had been rated by a credit rating agency.
- *Is the lessee a consolidated subsidiary whose parent entity acts as the treasury function for all of its subsidiaries or acts as a guarantor on all of its subsidiaries' debt obligations?* In some consolidated entities, the parent entity acts as the treasury function for all of its subsidiaries, which includes functioning as the source of financing for the subsidiaries. In other cases, the parent entity acts as the guarantor on all of its subsidiaries' debt obligations. When either of these circumstances is the case, it may be appropriate, depending on other facts and circumstances, to consider the parent entity's incremental borrowing rate under ASC 842 for purposes of determining the consolidated subsidiary's incremental borrowing rate under ASC 842.
- *Are third parties unwilling to enter into a loan with the lessee?* The lessee's incremental borrowing rate is what third parties would charge the lessee for the hypothetical loan. This concept assumes that third parties would be willing to enter into a loan with the lessee, which is not always the case. In situations in which third parties are not willing to enter into a loan with the lessee, the lessee's incremental borrowing rate should be measured at the interest rate for the lowest grade of similar debt currently available in the marketplace as of the lease commencement date.
- *Is it sufficient to base the incremental borrowing rate on the effective interest rate of a borrowing facility recently entered into by the lessee?* The answer to this question would only be yes if the terms of the borrowing facility matched the terms of the lease, and the borrowing facility was entered into in a similar economic environment and timeframe (such that the lessee's creditworthiness has not

changed or would otherwise not be affected). If the terms of the borrowing facility do not possess the attributes necessary to make it similar to the lease terms, the effective interest rate charged on the borrowing facility is a data point that should be considered in determining the incremental borrowing rate, but is not itself determinative of the incremental borrowing rate.

- *Is a lender's quote for a loan with terms similar to the lease sufficient evidence to support the incremental borrowing rate?* Whether a lender's quote for a loan with terms similar to the lease is sufficient evidence in and of itself to support the incremental borrowing rate depends on the facts and circumstances. One of the key questions that should be considered in this regard is whether the lender's quote is binding, because a binding lender's quote presumably would provide better evidence of the lessee's incremental borrowing rate than a nonbinding lender's quote. To the extent a lender's quote for a loan with terms similar to the lease is not sufficient evidence in and of itself to support the lessee's incremental borrowing rate, it may still represent a relevant data point that should be considered along with all other relevant data points in determining that rate.
- *Was the lease entered into in a foreign jurisdiction or entered into by a foreign subsidiary?* To the extent the lease was entered into in a foreign jurisdiction, the risk profile of the hypothetical loan should reflect the economic environment of that jurisdiction. To the extent the lease was entered into by a foreign subsidiary, the relevant sovereign credit risk should be considered in determining the incremental borrowing rate. In addition, if the lease was entered into in a foreign jurisdiction or by a foreign subsidiary, consideration should be given to whether the lease payments are denominated in the local currency, which is typically the case. When the lease is denominated in the local foreign currency, the lessee should make sure the incremental borrowing rate for the lease incorporates the risks associated with that currency, such as inflation risk.

Based on this list of questions, it is clear that the degree of complexity associated with determining the appropriate incremental borrowing rate that a lessee should use in applying ASC 842 depends on the facts and circumstances. To the extent a lessee faces a high degree of complexity in making this determination, it should consider working with specialists on the topic. For additional information, refer to our white paper, ASC 842: Calculating the incremental borrowing rate as a lessee.

A lessee should ensure it is approaching the determination of its incremental borrowing rate in a consistent manner each time it is required to make that determination. Depending on the extent of a lessee's leasing activity, determining its incremental borrowing rate could be more than an occasional exercise. To the extent the lessee has significant ongoing leasing activities, it should have a process in place to identify changes in the factors that affect its incremental borrowing rate so that those changes are appropriately considered when it next has to determine its incremental borrowing rate.

Spotlight on change: Lessee's incremental borrowing rate

The basis on which the lessee's incremental borrowing rate is calculated under ASC 842 compared to ASC 840 differs primarily due to ASC 842 requiring the lessee's incremental borrowing rate to be determined on a secured basis, which is not required under ASC 840. Instead, ASC 840 requires the lessee's incremental borrowing rate to be determined based on the rate it would be charged by lenders to borrow the funds necessary to purchase the underlying asset. As such, if the lessee could (and would) have entered into an unsecured loan to borrow the necessary funds, the incremental borrowing rate would be determined on an unsecured basis under ASC 840.

5.2.3 Risk-free rate

A lessee that is not a public business entity is permitted to make an accounting policy election to use the risk-free rate as the discount rate if the rate implicit in the lease is not readily determinable. In the U.S., the risk-free rate is the rate of a zero coupon U.S. Treasury instrument for the same period of time as the lease term. The risk-free rate should not be less than zero.

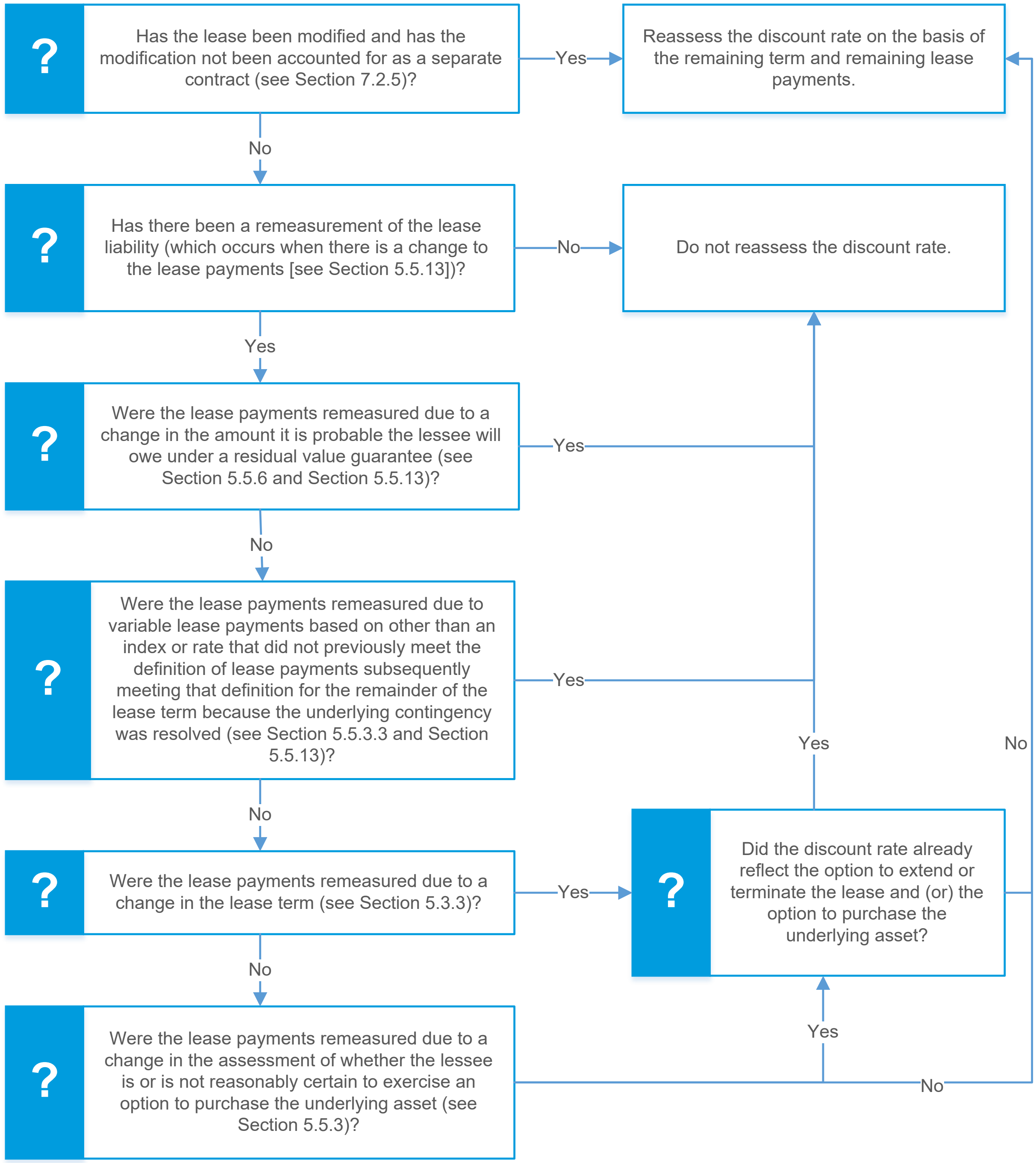
If a lessee elects the accounting policy to use the risk-free rate, it may do so on a class-of-asset basis, and it must disclose the election of the accounting policy and the class(es) of assets to which it was applied in the notes to the financial statements.

5.2.4 Determining the discount rate on a portfolio basis

Depending on the facts and circumstances, it may be appropriate to determine the discount rate using a portfolio approach when the lessee enters into a large number of similar leases in the same timeframe. Key factors that should generally be present to utilize the portfolio approach are: (a) similar lease terms (e.g., durations, lease payments), (b) a stable interest rate environment and (c) the lessee maintains a stable credit rating. Additional information about applying some or all of ASC 842 on a portfolio basis is discussed in Section 2.7.

5.2.5 Reassessing the discount rate

The discount rate should be reassessed when the lease has been modified and the modification is accounted for as a separate contract (see Section 7.2.5.1). In addition, the discount rate is reassessed when the lease liability has been remeasured (see Section 7.2.1.1), with certain exceptions. The lease liability is remeasured when the lease payments have been changed (see Section 5.5.13). The following flowchart indicates the circumstances under which the discount rate should be reassessed.



If the discount rate changes as a result of a reassessment, the accounting for that change should not result in the balance of the ROU asset going below zero. The amount that would otherwise cause the ROU asset to go below zero should be recognized in the income statement.

5.3 Lease term

5.3.1 General information

The lease term begins at the commencement date (see Section 5.1) and is based on the noncancellable period for which a lessee has the right to use an underlying asset, which should include any rent-free periods. In addition, the lease term may also need to reflect periods covered by an option to extend or terminate a lease (see Section 5.3.2).

The noncancellable period for which a lessee has the right to use an underlying asset is the period over which the lessee's right is enforceable. If *both* the lessee and lessor have the right to unilaterally terminate the lease without incurring more than an insignificant penalty, the lease is not enforceable. If only the lessee *or* lessor have the right to terminate the lease, that right is considered an option to terminate the lease and is taken into consideration in determining the lease term as discussed in Section 5.3.2.

5.3.2 Termination and renewal options

Absent the existence of a fiscal funding clause (see Section 5.3.3), whether termination and renewal options should affect the lease term depends on whether the option rests with the lessee, lessor or both. If the termination or renewal option rests solely with the lessee, the lease term is affected as follows:

- The period covered by a renewal option is included in the lease term if the lessee is reasonably certain to exercise the option.
- The period covered by a termination option is included in the lease term if the lessee is reasonably certain not to exercise the option.

In contrast, if the termination or renewal option rests solely with the lessor, the periods covered by the option should be included in the lease term regardless of the likelihood of the lessor exercising the option. ASC 842 assumes: (a) a lessor will exercise a renewal option and (b) a lessor will not exercise a termination option. In essence, ASC 842 assumes the lessor action that results in the longer lease term.

If the renewal option rests with both the lessee and lessor, the period covered by the option is included in the lease term regardless of the likelihood of either party exercising the option.

If the termination option rests with both the lessee and lessor, the lessee considers whether exercising the termination option results in more than an insignificant penalty. If any penalty is not more than insignificant, and the option can be exercised at any time, the lease is not enforceable and the lessee would likely account for the lease on a month-to-month basis (see Section 5.3.4.1). If any penalty is not more than insignificant, and the option can only be exercised at a stated future date, the period covered by the termination option is not included in the lease term because the lease would be considered unenforceable after that date. Conversely, if the penalty is more than insignificant, the period covered by the termination option is included in the lease term if the lessee is reasonably certain to not exercise the option.

In summary, following is how a termination or renewal option should affect the lease term absent the existence of a fiscal funding clause (see Section 5.3.3):

Option rests solely with lessee	Option rests solely with lessor	Option rests with both lessee and lessor
Termination options		
The period(s) covered by the option should be included in the lease term if the lessee is	The period(s) covered by the option should be included in the lease term regardless of the	If exercising the option results in a penalty that is more than insignificant, the period covered

Option rests solely with lessee	Option rests solely with lessor	Option rests with both lessee and lessor
reasonably certain not to exercise the option.	likelihood of the lessor exercising the option (i.e., ASC 842 assumes a lessor will not exercise a termination option).	by the option should be included in the lease term if the lessee is reasonably certain to not exercise the option. If exercising the option results in a penalty that is not more than insignificant and: • The option can be exercised at any time, the lease is not enforceable and the lessee would likely account for the lease on a month-to-month basis (see Section 5.3.4.1) • The option can only be exercised at a stated future date, the period covered by the option is not included in the lease term because the lease would be considered unenforceable after that date.
Renewal options		
The period(s) covered by the option should be included in the lease term if the lessee is reasonably certain to exercise the option.	The period(s) covered by the option should be included in the lease term regardless of the likelihood of the lessor exercising the option (i.e., ASC 842 assumes a lessor will exercise a renewal option).	The period covered by the option should be included in the lease term regardless of the likelihood of either party exercising the option.

The factors that should be considered in determining whether a lessee is reasonably certain to exercise a renewal option, or reasonably certain not to exercise a termination option, are those that may have economic consequences on the lessee as it relates to the lease. These factors may be contract-based, asset-based, entity-based and (or) market-based. In general, the longer the time period between the commencement date and the exercise date of an option, the greater the difficulty in determining whether a lessee is reasonably certain to exercise a renewal option or to not exercise a termination option.

Examples of factors to be considered when assessing whether a lessee is reasonably certain to exercise a renewal option or not exercise a termination option, and what those factors may indicate depending on the facts and circumstance, include the following:

Factor	Indicator that the lessee is reasonably certain to not exercise a termination option	Indicator that the lessee is reasonably certain to exercise a renewal option
Historical conclusions about the likelihood of the lessee exercising the option under ASC 840	When not exercising the option was historically deemed reasonably assured under ASC 840	When exercising the option was historically deemed reasonably assured under ASC 840

Factor	Indicator that the lessee is reasonably certain to not exercise a termination option	Indicator that the lessee is reasonably certain to exercise a renewal option
History related to the lessee's exercise of similar options	When similar termination options have not been exercised in the past	When similar renewal options have been exercised in the past
Option's exercise price (or penalty for not exercising the option) compared to the lease payments for the period covered by the option	When the exercise price (i.e., termination penalty) is substantive compared to the lease payments for the period covered by the option	When there is a penalty for not exercising the option and that penalty is substantive compared to the lease payments for the period covered by the option
Contractual rates for the period covered by the option compared to market rates for the same period	When contractual rates are favorable compared to market rates (e.g., contractual rates for the period covered by the termination option are less than the market rates for that period)	When contractual rates are favorable compared to market rates (e.g., contractual rates for the renewal period are less than the market rates for that period)
Costs to enter into a new lease for a replacement asset (Note 1)	When exercising the option would result in the lessee incurring significant costs to enter into a new lease	When exercising the option would result in the lessee not incurring significant costs to enter into a new lease (e.g., costs to negotiate and execute the new lease) until after the end of the renewal period
Costs to return the asset or restore the underlying asset to its prior specified condition	When exercising the option would result in the lessee incurring significant costs of this nature	When exercising the option would result in the lessee not incurring significant costs of this nature until after the end of the renewal period
Degree of specific design and customization of the underlying asset	When the underlying asset required a significant degree of design and customization	When the underlying asset required a significant degree of design and customization
Importance of the underlying asset to the lessee's operations	When the underlying asset is critical to the lessee's operations	When the underlying asset is critical to the lessee's operations
When the underlying asset is a building or part of a building, the extent of leasehold improvements and their remaining economic life compared to the period covered by the option	When there are significant leasehold improvements with a remaining economic life that extends into or past the period covered by the option	When there are significant leasehold improvements with a remaining economic life that extends into or past the period covered by the option
When the underlying asset has been subleased, the period covered by the sublease compared to the period covered by the option	When the period covered by the sublease extends into or past the period covered by the option	When the period covered by the sublease extends into or past the period covered by the option

Factor	Indicator that the lessee is reasonably certain to not exercise a termination option	Indicator that the lessee is reasonably certain to exercise a renewal option
Guaranteed residual value	When exercising the option triggers payment of a significant guaranteed residual value	When exercising the option reduces or removes a significant guaranteed residual value payment or defers payment of a significant guaranteed residual value until after the renewal period ends
Length of the lease term compared to the length of time the underlying asset could be used and is expected to be needed by the lessee	When exercising the option would result in a shorter lease term than the period of time the underlying asset could be used and is expected to be needed by the lessee	When not exercising the option would result in a shorter lease term than the period of time the underlying asset could be used and is expected to be needed by the lessee

Note 1: Examples of the costs that may be incurred to enter into a new lease include exploratory costs to identify another underlying asset that will work in the lessee's environment, costs to negotiate a new lease, relocation costs and installation costs.

These are examples of factors that should be considered and not an all-inclusive list. Whether the indicators in these examples rise to the level of reasonably certain depends on the specific facts and circumstances. In addition, no one factor is determinative on its own. All of the relevant factors should be considered in each set of specific facts and circumstances to determine whether, on balance, the lessee is reasonably certain to exercise a renewal option or not to exercise a termination option.

Example 5-3: Determining the lease term when renewal or termination options exist

Lessee enters into a lease with Lessor that provides Lessee with the right to use a piece of equipment from February 1, 20X6 to January 31, 20Y0. Lessor makes the equipment available for Lessee's use on February 1, 20X6. The following table provides the lease term for several different scenarios involving this lease and renewal or termination options.

Scenario	Lease term
Only Lessee has the option to renew the lease for two years and Lessee is reasonably certain to exercise the option.	Six years
Only Lessee has the option to renew the lease for two years and Lessee is not reasonably certain to exercise the option.	Four years
Only Lessee has the option to terminate the lease after three years and Lessee is reasonably certain not to exercise the option.	Four years
Only Lessee has the option to terminate the lease after three years and Lessee is not reasonably certain to not exercise the option (i.e., the likelihood of Lessee not exercising the option is less than reasonably certain).	Three years
Only Lessor has the option to renew the lease for two years (regardless of the likelihood of Lessor exercising its option).	Six years
Only Lessor has the option to terminate the lease after three years (regardless of the likelihood of Lessor exercising the option).	Four years

Scenario	Lease term
Both Lessee and Lessor have the option to renew the lease for two years and Lessee is not reasonably certain to exercise the option (regardless of the likelihood of Lessor exercising the option).	Six years
Both Lessee and Lessor have the option to terminate the lease after three years in exchange for an insignificant penalty (regardless of the likelihood of Lessee or Lessor exercising the option).	Three years
Both Lessee and Lessor have the option to terminate the lease at any time in exchange for an insignificant penalty (regardless of the likelihood of Lessee or Lessor exercising the option).	Unenforceable lease
Both Lessee and Lessor have the option to terminate the lease after three years in exchange for more than an insignificant penalty and Lessee is less than reasonably certain to not terminate the lease (regardless of the likelihood of Lessor exercising the option).	Three years
Both Lessee and Lessor have the option to terminate the lease after three years in exchange for more than an insignificant penalty and Lessee is reasonably certain to not terminate the lease (regardless of the likelihood of Lessor exercising the option).	Four years
Only Lessor has the option to renew the lease for two years and there is a fiscal funding clause (see Section 5.3.3) for which the likelihood of exercise is remote.	Six years
Only Lessor has the option to renew the lease for two years and there is a fiscal funding clause (see Section 5.3.3) for which: (a) the likelihood of exercise is more than remote and (b) funding is only reasonably certain for the first two years of the lease.	Two years

5.3.3 Fiscal funding clauses

A fiscal funding clause in a lease makes the lease cancellable if a legislature or other funding authority does not make the necessary funds available to the lessee such that the lessee can fulfill its obligations under the lease. When such a clause is included in the lease, the lessee must determine if the likelihood of cancellation of the lease via exercise of the clause is more than remote. If so, the lease term should only reflect the periods for which the necessary funding is reasonably certain. If the likelihood of lease cancellation via exercise of the clause is less than remote, the fiscal funding clause does not affect the determination of the lease term.

In some cases, a penalty may be assessed if the fiscal funding clause is exercised. The significance of that penalty should be considered in determining whether the exercise of the fiscal funding clause is more than remote.

5.3.4 Calculation of the lease term

The lease term is calculated as follows:

Determination of the lease term (subject to two guardrails)	
	Noncancellable lease term (including any rent-free periods) (see Section 5.3.1)
+	Period(s) covered by any renewal or termination option(s) that rest solely with the lessor (see Section 5.3.2)
+	Period(s) covered by any renewal option(s) that rest solely with the lessee and that the lessee is reasonably certain to exercise (see Section 5.3.2)
+	Period(s) covered by any renewal option(s) that rest with both the lessee and lessor (see Section 5.3.2)
+	Period(s) covered by any termination option(s) that rest solely with the lessee and that the lessee is reasonably certain to not exercise (see Section 5.3.2)
+	Period(s) covered by any termination option(s) that rest with both the lessee and lessor when both: (a) any termination penalty is more than insignificant (see Section 5.3.2) and (b) the lessee is reasonably certain to not exercise the option (see Section 5.3.2)
=	Lease term (subject to two guardrails)

One of the two guardrails the lease term is subject to involves fiscal funding clauses when the likelihood of their exercise is more than remote. As discussed in Section 5.3.3, when this is the case, the lease term should only reflect the periods for which the necessary funding is reasonably certain.

The other guardrail involves purchase options that the lessee is reasonably certain to exercise (see Section 5.4). When such an option exists, the lease term should not extend beyond the date the purchase option becomes exercisable.

5.3.4.1 No stated term, evergreen and month-to-month leases

Some leases may not have a stated term, but continue on until the lessee opts to terminate the lease. The lessee's option to terminate the lease may or may not be explicitly stated in the lease. This type of lease is commonly referred to as an evergreen lease. The terms of such a lease will state that the payments are to be made by the lessee for as long as the underlying asset is made available to the lessee.

In a month-to-month lease, the lessee typically has the option to renew the lease on a monthly basis for either a specific or indeterminate period of time. A lessee should evaluate the explicit or implicit renewal or termination options that exist in these situations in the same way it evaluates such options when there is a stated term that could be affected by the exercise of an explicitly defined termination or renewal option.

Consider a situation in which a lessee enters into a lease for a specific vehicle, and the lease provides rates that the lessee will be charged for each day the vehicle is available to the lessee for its use. To determine the lease term in this situation, the lessee should determine the period of time it is reasonably certain to implicitly renew the lease through continuing to retain control of the vehicle.

5.3.5 Reassessment of the lease term

The lessee reassesses the lease term only under the following circumstances:

- The lessee's assessment about whether it is reasonably certain to exercise a renewal option or purchase option (see Section 5.4), or not exercise a termination option, changes directly as a result of a significant event or significant change in circumstances that was within the lessee's control (see Section 5.3.5.1).

- The contract requires the lessee to either exercise or not exercise an option to extend or terminate the lease when a specific event occurs and that event has occurred.
- The lessee exercises a renewal, termination or purchase option (see Section 5.3.2 and Section 5.4) when it had previously concluded it was not reasonably certain to do so.
- The lessee does not exercise a renewal, termination or purchase option (see Section 5.3.2 and Section 5.4) when it had previously concluded it was reasonably certain to do so.

The lessee should not reassess the lease term due solely to a change in market-based factors, such as changes in the market rate to enter into a comparable lease or to buy a comparable asset.

It is important for lessees to have an ongoing process in place to identify the circumstances under which a lease term reassessment is required as those circumstances occur.

To the extent a lessee reassesses whether it is reasonably certain to exercise a renewal option or not exercise a termination option and changes its previous conclusion reflected in the accounting for the lease, the lessee needs to consider the effects of that change on the lease's classification (see Section 6.7), lease payments (see Section 5.5.13) and discount rate (see Section 5.2.5).

Example 5-4 illustrates the effects of reassessing the lease term.

5.3.5.1 Events or significant changes within the lessee's control

As discussed in Section 5.3.5, one of the circumstances under which the lease term should be reassessed is when the lessee's assessment about whether it is reasonably certain to exercise a renewal option, or not exercise a termination option, changes directly as a result of a significant event or significant change in circumstances that was within the lessee's control. There are any number of events or changes in circumstances within the lessee's control that could change the lessee's conclusion with respect to whether it is reasonably certain to exercise or not to exercise a renewal or termination option. Examples of such events or changes in circumstances include the following:

- The lessee of a building constructs significant leasehold improvements (which were not planned at the lease commencement date) that will have significant economic value to the lessee over the period covered by the option.
- The lessee significantly modifies or customizes the underlying asset (which was not expected at the lease commencement date) and those modifications or customizations will have significant economic value to the lessee during the period covered by the option. In addition, if the asset were replaced, costs would be incurred to modify or customize the replacement asset.
- The lessee has subleased the underlying asset (which was not contemplated at the lease commencement date) and the term of the sublease extends past the option exercise date and into the period covered by the option.
- The lessee has extended the lease of another asset (which was not expected at the lease commencement date) that makes the underlying asset more or less important to the lessee's operations. For example, extending the lease of a complementary asset may make the underlying asset more important to the lessee's operations, while extending the lease of a replacement asset may make the underlying asset less important to the lessee's operations.
- The lessee has sold assets (which was not expected at the lease commencement date) that make the underlying asset more or less important to the lessee's operations. For example, selling assets that are alternatives for the underlying asset may make that asset more important to the lessee's

operations. Conversely, selling assets that are complementary to the underlying asset may make that asset less important to the lessee's operations.

Examples of events or circumstances that would *not* be in the lessee's control include those related to changes in market-based factors, such as changes in the rates to lease or the price to purchase a comparable asset in the current market. While these factors would be considered if reassessment of the lease term was triggered by one of the circumstances discussed in Section 5.3.5, they do not themselves trigger the need for reassessment of the lease term.

5.4 Purchase options

5.4.1 General information

Purchase options provide the lessee with the option to purchase the underlying asset. How a purchase option affects the accounting for a lease depends on whether the lessee is reasonably certain to exercise the option. If the lessee is reasonably certain to exercise the option, the lease is classified as a finance lease (see Section 6.3), the option's exercise price is included in lease payments (see Section 5.5.2), and the lease term extends only to the exercise date for the purchase option (see Section 5.3.4). If the lessee is not reasonably certain to exercise the option, the classification of the lease depends on the outcome of assessing the other lease classification criteria, the option's exercise price is not included in lease payments, and the lease term is unaffected by the option.

In paragraph BC218 of ASU 2016-02, the FASB pointed out that an option to purchase an underlying asset is economically similar to an option to extend the lease term for the remaining economic life of the underlying asset. This is the basis for a lease containing a purchase option that the lessee is reasonably certain to exercise being classified as a finance lease by the lessee (see Section 6.3).

The factors that should be considered in determining whether a lessee is reasonably certain to exercise a purchase option are those that may have economic consequences on the lessee as it relates to the lease. These factors may be contract-based, asset-based, entity-based and (or) market-based.

Examples of factors to be considered when assessing whether a lessee is reasonably certain to exercise a purchase option, and what those factors may indicate depending on the facts and circumstances, include the following:

Factor	Indicator that the lessee is reasonably certain to exercise a purchase option
Historical conclusions about the likelihood of the lessee exercising the option under ASC 840	When exercising the option was historically deemed reasonably assured under ASC 840
History related to the lessee's exercise of similar options	When similar purchase options have been exercised in the past
Option's exercise price compared to the expected market value of the underlying asset on the option's exercise date	When the exercise price is specified and fixed and also less than the expected market value of the underlying asset on the option's exercise date
Costs to enter into a new lease (Note 1) compared to the option's exercise price	When exercising the option would eliminate the lessee incurring the costs to enter into a new lease and those costs are significant relative to the option's exercise price
Degree of specific design and customization of the underlying asset	When the underlying asset required a significant degree of design and customization

Factor	Indicator that the lessee is reasonably certain to exercise a purchase option
Importance of the underlying asset to the lessee's operations	When the underlying asset is critical to the lessee's operations
When the underlying asset is a building or part of a building, the extent of leasehold improvements and their expected remaining economic life at what would otherwise be the end of the lease term	When there are significant leasehold improvements with a remaining economic life that extends past what would otherwise be the end of the lease term by more than an insignificant period of time
When the underlying asset has been subleased (see Section 7.5), the end of the sublease's lease term compared to what would otherwise be the end of the head lease's lease term	When the sublease's lease term extends past what would otherwise be the end of the head lease's lease term

Note 1: Examples of the costs that may be incurred to enter into a new lease include exploratory costs to identify another underlying asset that will work in the lessee's environment, costs to negotiate a new lease, relocation costs and installation costs.

These are examples of factors that should be considered and not an all-inclusive list. Whether the indicators in these examples rise to the level of reasonably certain depends on the specific facts and circumstances. All of the relevant factors should be considered in each set of specific facts and circumstances to determine whether, on balance, the lessee is reasonably certain to exercise a purchase option.

Example 23 in ASC 842-10-55-211 to 55-217 and Example 24 in ASC 842-10-55-218 to 55-224 illustrate how a lessee should account for purchase options included in leases.

5.4.2 Reassessment of purchase option exercise

The lessee reassesses whether it is reasonably certain to exercise a purchase option only under the following circumstances:

- The lessee's assessment about whether it is reasonably certain to exercise the purchase option changes directly as a result of a significant event or significant change in circumstances that was within the lessee's control (see Section 5.4.2.1).
- The lessee exercises the purchase option when it had previously concluded it was not reasonably certain to do so.
- The lessee does not exercise the purchase option when it had previously concluded it was reasonably certain to do so.

The lessee should not reassess whether it is reasonably certain to exercise a purchase option due solely to a change in market-based factors, such as a change in the market rate to buy a comparable asset.

It is important for lessees to have an ongoing process in place to identify the circumstances under which the reassessment of whether the exercise of a purchase option is reasonably certain is required as those circumstances occur.

To the extent a lessee reassesses whether it is reasonably certain to exercise a purchase option and changes its previous conclusion reflected in the accounting for the lease, the lessee needs to consider the effects of that change on the lease's classification (see Section 6.7), lease payments (see Section 5.5.13) and lease term (see Section 5.3.5).

5.4.2.1 Events or significant changes within the lessee's control

As discussed in Section 5.4.2, one of the circumstances under which the lessee reassesses whether it is reasonably certain to exercise a purchase option is when there is a significant event or significant change in circumstances that was within the lessee's control that could affect whether the lessee is reasonably certain to exercise a purchase option. There are any number of events or changes in circumstances within the lessee's control that could change the lessee's conclusion with respect to whether it is reasonably certain to exercise a purchase option. Examples of such events or changes in circumstances include the following:

- The lessee of a building constructs significant leasehold improvements (which was not expected at the lease commencement date) that will have significant economic value to the lessee beyond what would otherwise be the end of the lease term.
- The lessee significantly modifies or customizes the underlying asset (which was not expected at the lease commencement date) and those modifications or customizations will have significant economic value beyond what would otherwise be the end of the lease term.
- The lessee subleases the underlying asset (which was not contemplated at the lease commencement date) and the term of the sublease extends beyond what would otherwise be the end of the lease term.
- The lessee extends the lease of another asset (which was not expected at the lease commencement date) that makes the underlying asset for which it has a purchase option more or less important to the lessee's operations. For example, extending the lease of a complementary asset may make the underlying asset more important to the lessee's operations, while extending the lease of a replacement asset may make the underlying asset less important to the lessee's operations.
- The lessee sells assets (which was not expected at the lease commencement date) that make the underlying asset more or less important to the lessee's operations. For example, selling assets that are alternatives for the underlying asset may make that asset more important to the lessee's operations. Conversely, selling assets that are complementary to the underlying asset may make that asset less important to the lessee's operations.

Examples of events or circumstances that would *not* be in the lessee's control include those related to changes in market-based factors, such as changes in the expected market value of the asset at the option exercise date. While this factor would be considered if reassessment of the purchase option's exercise was otherwise triggered by one of the circumstances discussed in Section 5.4.2, it does not itself cause the need for reassessment of the purchase option's exercise.

5.5 Lease payments

5.5.1 Classification vs. measurement

Lease payments are used for lease classification purposes (see Section 6.5) and for purposes of measuring the lease liabilities and ROU assets recognized by lessees when accounting for their leases (see Section 7.1). While the nature of the lease payments used for these purposes is the same, the amount used for each purpose could differ. For example, fixed lease payments used for lease classification purposes should include those amounts prepaid by the lessee as well as those amounts it has yet to pay over the lease term. In contrast, fixed lease payments for purposes of measuring the lease liability should only include those amounts the lessee has not yet paid (see Section 7.1.2), while for purposes of measuring the ROU asset, prepaid rent should be added back to the lease liability (see Section 7.1.3). For another example, as discussed in Section 5.5.4, the amount of lease incentives other than rent abatements (i.e., free rent) reflected in lease payments depends on whether the lease payments are being used for purposes of lease classification or measurement, and if for measurement, whether they have been paid or payable at lease commencement.

When evaluating whether a payment that is or may be required under the lease should be included in lease payments, the lessee should keep in mind that the amount that should be used for lease classification purposes could differ from the amount that should be used for lease liability measurement purposes.

5.5.2 Nature of payments included and excluded from lease payments

Lease payments for lessees include (i.e., the lease payments are either increased or decreased by) and exclude (i.e., lease payments are unaffected by) the following:

Nature of payment	Include in or exclude from lease payments?	Additional discussion in Section
Fixed payments, including payments for insurance or taxes that are fixed	Include	4.2, Example 4-2
Variable payments, including payments for insurance or taxes that are variable (e.g., the payment amounts are based on the lessor's actual cost)	Include when they are in-substance fixed payments or when they vary after the commencement date based on an index or rate Exclude when they vary after the commencement date based on other than an index or rate	5.5.3
Lease incentives	Include when they are paid or payable to the lessee (as appropriate) and when they are losses incurred by the lessor for assuming the lessee's preexisting lease Exclude when they are rent abatements	5.5.4
Exercise price for the option to purchase the underlying asset	Include when it is reasonably certain that the lessee will exercise the purchase option Exclude when it is *not* reasonably certain that the lessee will exercise the purchase option	5.4.1
Termination penalty	Include when the lease term reflects the lessee exercising the termination option (i.e., the lease term does not include the period covered by the option) and the penalty is fixed or variable based on an index or rate Exclude when the lease term reflects the lessee exercising the termination option and the penalty is variable based on other than an index or rate Exclude when the lease term does not reflect the lessee exercising the termination option (i.e., the lease term includes the period covered by the option) regardless of whether the penalty is variable or fixed	5.3.2 5.5.5
Renewal fee	Include when the lease term reflects the lessee exercising the renewal option (i.e., the lease term includes the period covered by the option) and the fee is fixed or variable based on an index or rate	5.3.2

Nature of payment	Include in or exclude from lease payments?	Additional discussion in Section
	Exclude when the lease term reflects the lessee exercising the renewal option and the fee is variable based on other than an index or rate Exclude when the lease term does not reflect the lessee exercising the renewal option (i.e., the lease term does not include the period covered by the option) regardless of whether the renewal fee is variable or fixed	
Fees paid by the lessee to the owners of a special-purpose entity for structuring the transaction	Include (see ASC 842-10-30-5(e) and ASC 958-810-55-14)	
Residual value guarantees	Include the amount of the guarantee probable of being owed Exclude the amount of the guarantee not probable of being owed	5.5.6
Stated purchase price in a lessor put option	Include the stated purchase price for the underlying asset	5.5.7
Maintenance deposits	Exclude those deposits (or portions thereof) that are substantively and contractually related to maintenance of the underlying asset and: • When it is not probable that the deposits will be refunded to the lessee, treat those deposits as variable lease expense (see Section 5.5.3) • When it is probable that the deposit will be refunded to the lessee, recognize a deposit asset Include those nonrefundable deposits (or portions thereof) that are not substantively and contractually related to maintenance of the underlying asset Exclude those refundable deposits (or portions thereof) that are not substantively and contractually related to maintenance of the underlying asset and treat those deposits as variable lease payments (see Section 5.5.3)	5.5.8
Security deposit paid on or before lease commencement	Include when the security deposit is not refundable Exclude when the security deposit is refundable	
Payments to dismantle and remove an underlying asset	Generally, treat as a lease payment and: (a) include when the payment is fixed or when it is variable based on an index or rate or (b) exclude when the payment is variable based on other than an index or rate	5.5.9

Nature of payment	Include in or exclude from lease payments?	Additional discussion in Section
Payments to return an underlying asset to its pre-lease condition (i.e., prior to any lessee modifications to the underlying asset)	Generally, exclude from lease payments and treat as an asset retirement obligation under ASC 410-20	5.5.10
Payments related to the lessee's guarantee of the lessor's debt	Generally, exclude and account for in accordance with ASC 460 (as applicable). However, in limited circumstances, we believe the lessee's guarantee of the lessor's debt is an in-substance residual value guarantee (see Section 5.5.6) and should be reflected in lease payments as such. For those limited circumstances to exist, we believe the lessee's guarantee of the lessor's debt must be in place until the end of the lease term. In addition, we believe the debt must be nonrecourse to the borrower (i.e., lessor) and (or) the underlying asset must be the only significant asset held by the lessor. For purposes of measuring the amount of any in-substance residual value guarantee that may exist in the limited circumstances noted (and including that amount in lease payments), the lessee should use the probable difference between the following two amounts as expected at the end of the lease term: (a) the amount of the lessor's outstanding debt and (b) the value of the residual asset. Section 5.5.6 discusses the change made by ASC 842 to only include in lease payments the amount of a residual value guarantee that is probable of being paid. When the lessee's guarantee of the lessor's debt is accounted for in accordance with ASC 460, and a guarantee liability is recognized as a result, we believe the lessee must choose one of the following as its accounting policy with respect to the offsetting debit: (a) include the debit in the ROU asset related to the lease, (b) recognize a separate asset, but amortize that asset in a manner that is consistent with the amortization of the ROU asset related to the lease, or (c) expense the debit when the guarantee liability is recognized. We believe including the debit in the ROU asset related to the lease is less complex than recognizing a separate asset. The accounting policy elected should be consistently applied and appropriately disclosed. When the lessee makes a nonrecourse loan to the lessor, we believe the lessee should consider whether an in-substance residual value guarantee	

Nature of payment	Include in or exclude from lease payments?	Additional discussion in Section
	exists. To do so, we believe the lessee should consider the preceding guidance on when the lessee's guarantee of the lessor's debt gives rise to an in-substance residual value guarantee. We do not believe an in-substance residual value guarantee exists when the lessee makes a loan to the lessor and has recourse to assets of the lessor beyond the leased asset.	
Payments related to indemnification of the lessor	Exclude when indemnification is for adverse tax consequences resulting from a change in tax laws Exclude when indemnification is for environmental contamination Inclusion or exclusion of other indemnifications depends on the facts and circumstances	5.5.11
Contract consideration allocated to unit(s) of account including only nonlease component(s)	Exclude	5.5.12
Contract consideration allocated to unit(s) of account that is (are) lease component(s)	Final determination of lease payments for a unit of account.	5.5.12

Spotlight on change: Lessee treatment of payments to the lessor for property taxes and insurance

Under ASC 840, fixed payments to the lessor for property taxes and insurance are excluded from the minimum rental payments for lease classification purposes. The accounting for such payments under ASC 840 may vary depending on whether the lease is classified as a capital or operating lease. For a capital lease, such payments are excluded from the accounting for the lease. For an operating lease, there is diversity in practice with respect to whether fixed payments for property taxes and insurance are included in minimum rental payments.

Under ASC 842, fixed payments to the lessor for property taxes and insurance are treated the same as any other fixed payments—they are included in lease payments and contract consideration. For example, if the contract includes only a single lease component, fixed payments to the lessor for property taxes and insurance are included in lease payments for both lease classification and accounting purposes. For another example, if the contract includes a lease component and a related nonlease component (such as maintenance), fixed payments to the lessor for property taxes and insurance are included in the contract consideration that is allocated to the lease component and the related nonlease component, resulting in some of the payments being treated as lease payments. However, if the lessee elects the accounting policy to account for the lease and the related nonlease component as a combined lease component (see Section 4.4), the fixed payments for property taxes and insurance are treated entirely as lease payments.

Based on the different approaches taken to account for fixed payments to the lessor for property taxes and insurance under ASC 840 and ASC 842 and the diversity in practice under ASC 840, when such payments are involved, the amount of lease payments under ASC 842 could be different from the amount of minimum rental payments under ASC 840. Which one is higher than the other will depend on factors such as: (a) the classification of the lease under ASC 840, and if the lease is classified as an operating lease, how the lessee treats payments for property taxes and insurance, and (b) whether there are nonlease components in the contract, and if so, whether the lessee has elected the accounting policy under ASC 842 to account for a lease component and the related nonlease component(s) as a combined lease component.

Variable payments to the lessor for property taxes and insurance when the amount paid ultimately depends on the lessor's actual property taxes and insurance costs are excluded from the minimum rental payments under ASC 840 and are excluded from lease payments used for classification or measurement purposes under ASC 842 (see Section 5.5.3.3).

5.5.3 Variable lease payments

The accounting for variable lease payments depends on whether they are in-substance fixed payments (see Section 5.5.3.1) or whether they are variable based on an index or rate (see Section 5.5.3.2) or based on other than an index or rate (see Section 5.5.3.3). Payments that vary solely based on the passage of time are not considered variable lease payments.

5.5.3.1 In-substance fixed payments

A lease agreement may describe a payment as a variable payment, but upon closer look it is apparent there is an amount that must be paid (e.g., a minimum amount that cannot be avoided) or there is an amount that will be paid because the variability lacks economic substance. These types of variable lease payments are in-substance fixed payments and are treated as fixed payments when determining lease payments.

An example of a variable lease payment that includes an in-substance fixed payment is when a lease requires a lessee to pay percentage rent equal to 1% of its sales, subject to a minimum sales figure of $5 million. The in-substance fixed payment is the minimum amount the lessee will be required to pay of $50,000 ($5 million × 1%), which should be included in lease payments on the commencement date. Any potential payments above the minimum amount are based on the lessee's sales and should be accounted for as variable lease payments based on other than an index or rate (see Section 5.5.3.3). Another way that this payment term could be worded in the lease agreement, but still result in the same outcome, would be if the lessee was required to make a payment of $50,000 or 1% of its sales, whichever is greater. In this situation, there is an in-substance fixed payment of $50,000 that will be required of the lessee.

5.5.3.2 Variable lease payments based on an index or rate

Variable lease payments that depend on an index or rate are initially measured and included in lease payments by reference to the index or rate at the commencement date. In addition, any additional lease costs arising from subsequent changes to the index or rate are recognized in the period those costs are incurred (i.e., similar to variable lease payments based on other than an index or rate [see Section 5.5.3.3]). However, if the variable lease payments are based on a multiple of an index and a cap, the lessee must consider whether the combination of the multiplier and the cap was designed to ensure that the cap is always reached. If so, the variable payment is an in-substance fixed payment (see Section 5.5.3.1). If not, the lessee must next consider whether the guidance in ASC 815-15 would result in a portion of the variable payment being separated from the host contract and accounted for as a derivative. The lessee evaluates the portion of the variable payment not accounted for as a derivative as it would evaluate any other variable payment based on an index or rate—initially measure and include it in lease payments by reference to the index or rate at the commencement date and subsequently recognize the effects of any changes in the index or rate in lease costs in the period those costs are incurred.

The FASB explains the basis for including in lease payments those variable lease payments based on an index or rate in paragraph BC211 of ASU 2016-02. While the amount of the payment may vary, the FASB notes that the payment itself cannot be avoided, and as such, the obligation to make the payment should be included in the lessee's lease liability. The FASB also notes that the variability in the amount of the obligation affects the measurement of the lease liability, not its recognition. In other words, the FASB did not think the obligation to make variable lease payments based on an index or rate should not be recognized due to the measurement uncertainty caused by the potential changes in the index or rate after the commencement date.

Common examples of indexes and rates on which variable lease payments are or have been based include:

- Consumer price index (CPI)
- Benchmark interest rates, such as the London Interbank Offered Rate (LIBOR) or the Secured Overnight Financing Rate (SOFR) (see Section 7.2.5.5 for discussion of the phase out of LIBOR)
- Prime interest rate
- Interest rates on direct Treasury obligations of the U.S. government (with or without a spread)
- Market rental rates

Example 5-4: Variable lease payments based on an index or rate

Facts at lease commencement

Lessee is a private company with a calendar year end. Lessee enters into a lease with Lessor on January 1, 20X6, which is also the lease's commencement date. The noncancellable term of the lease is three years. Lessee must pay Lessor $100,000 on January 1, 20X7. The lease payments on January 1, 20X8 and 20X9 are $100,000 adjusted for the cumulative increase in the Consumer Price Index (CPI) since January 1, 20X7. No refunds are provided if the CPI decreases. Lessee has the option to extend the lease for one year with a lease payment of $100,000 on January 1, 20Y0 adjusted for the cumulative increase in the CPI since January 1, 20X7. On January 1, 20X6, Lessee concluded it was not reasonably certain to exercise the option to extend the lease. As a result, at lease commencement, the lease term is three years.

Analysis at lease commencement

There is a fixed lease payment of $100,000 per year paid in arrears. The amount of the variable lease payment that should be included in the lease payments used in classifying the lease and measuring the related lease liability and ROU asset should be determined initially by reference to the CPI at the commencement date. Given that the variable lease payment is based on the increase in the CPI after January 1, 20X7, the variable lease payment on that date is zero. As such, the amount of lease payments used in the classification and measurement of the lease on January 1, 20X6 is $300,000 (annual payments of $100,000 over the lease term of three years).

Facts after lease commencement

The increase in the CPI and the payments made by Lessee on January 1, 20X8 are as follows:

Increase in the CPI from January 1, 20X7 to December 31, 20X7	2.0%
Payment due on January 1, 20X8 ($100,000 + [$100,000 × 2%])	$102,000

On June 30, 20X8, there is a significant change in circumstances under Lessee's control that requires Lessee to reassess the lease term. As a result of doing so, Lessee concludes it is reasonably certain to exercise the option to extend the lease, which increases the total lease term from three years to four years.

Analysis after lease commencement

Lessee should recognize the variable lease costs included in the lease payment it makes on January 1, 20X8 in the period in which those costs are incurred, which is 20X7. As a result, Lessee includes additional lease costs of $2,000 in its financial statements for the year ending December 31, 20X7.

Reassessment of the lease term on June 30, 20X8 triggers remeasurement of the lease payments on that date. When remeasuring lease payments, any variable lease payments based on an index or rate are remeasured using the index or rate on the remeasurement date. Accordingly, Lessee concludes the lease liability and ROU asset should be remeasured using a lease payment of $102,000 for January 1, 20X9 and 20Y0. If the increase in the CPI from January 1, 20X7 to December 31, 20X8 is 3.5%, Lessee includes additional lease costs of $1,500 ($103,500 payment on January 1, 20X9 less $102,000 payment included in the remeasurement of the lease liability and ROU asset) in its financial statements for the year ending December 31, 20X8.

5.5.3.3 Variable lease payments based on other than an index or rate

Variable lease payments that vary after the commencement date for reasons other than a change in an index or rate (e.g., lease payments that vary based on the sales of a retail location) are not included in the lease payments used for classification or measurement purposes. As illustrated in Example 5-6, when the only payments in a lease are variable based on other than an index or rate, there are no lease payments on which to base the recognition and measurement of a lease liability and ROU asset.

In some cases, variable lease payments may become fixed lease payments after the commencement date. For example, consider a situation in which the fixed annual lease payment in a lease increases from $40,000 to $50,000 if the number of units produced by the leased equipment surpasses a specified cumulative production level. Upon lease commencement, only the $40,000 is included in lease payments. As discussed in Section 5.5.13, if the number of units produced using the leased equipment surpasses the specified cumulative production level during the lease term, lease payments are remeasured to reflect the $50,000 annual lease payment.

Additional guidance about the accounting for variable lease payments that are not included in the lease payments used for classification or measurement purposes is provided in Section 7.2.2.1 and Section 7.2.3.1. The following example illustrates the accounting for a variable lease payment based on sales, which includes illustrating the application of this additional guidance.

Example 5-5: Variable lease payments based on sales

Lessee is a private company with a calendar year end and has no interim financial reporting requirements. Lessee enters into a lease for the exclusive right to use specifically identified retail space in one of Lessor's shopping centers. Lessor does not have the right to substitute Lessee's retail space. The lease is entered into on July 1, 20X6, which is also the lease's commencement date. The noncancellable term of the lease is five years. There are no purchase, renewal or termination options. Lessee must pay Lessor a fixed rental fee of $25,000 per month and a variable rental fee based on a rate of 2% of Lessee's annual net sales generated by the retail space.

The fixed payments of $25,000 per month are included in lease payments, which serves as the basis for recognizing the lease liability and ROU asset. The annual variable lease payment based on Lessee's sales is not included in the lease payments used for classification or measurement purposes because it is not based on an index or rate. Instead, such lease payments are included in lease costs in the period in which the obligation to make the payments is incurred.

Even though Lessee pays the variable rental fee to Lessor on an annual basis, it incurs the obligation to make those payments each day the retail space in Lessor's shopping center generates net sales. As a result, for its year ending December 31, 20X6, Lessee should recognize the lease costs for the variable rental fees it became obligated to pay as net sales were generated by the retail space from July 1, 20X6 to December 31, 20X6. For example, if the retail space generated $2.4 million in net sales from July 1, 20X6 to December 31, 20X6, Lessee should recognize a liability and lease costs in the amount of $48,000 ($2,400,000 × 2%) in its 20X6 financial statements.

Example 5-6: Only payments in the lease are variable lease payments based on usage

Lessee is a private company with a calendar year end and has no interim financial reporting requirements. Lessee enters into a lease for the exclusive right to use a specifically identified production printer. Lessor does not have substantive substitution rights related to the production printer. The lease is entered into on July 1, 20X6, which is also the lease's commencement date. The noncancellable term of the lease is three years. There are no purchase, renewal or termination options. On a monthly basis, Lessee must pay Lessor $0.10 per page printed by the production printer in the previous month. For example, in August 20X6, Lessee pays Lessor $0.10 per page printed by the production printer in July 20X6.

The only payments required under the lease are variable lease payments based on other than an index or rate. As a result, there are no lease payments that give rise to recognition of a lease liability or ROU asset. The variable lease payments are included in lease costs as the printer is used. For example, if Lessee used the production printer to print 2,720 pages in July 20X6, it should recognize lease costs of $272 for that month.

5.5.4 Lease incentives

Lease incentives include payments made to or on behalf of the lessee. Lease incentives also include the assumption by the lessor of a lessee's preexisting lease with a third party. In those situations, the lessee should estimate the losses the lessor will incur as a result of assuming that preexisting lease and include that estimate in lease incentives. In estimating the lessor's loss, the lessee could consider market rental rates charged by other lessors for similar underlying assets, or the market rental rate charged by the same lessor for the same or similar underlying asset when it does not assume a preexisting lease. While rent abatements are a type of lease incentive as that term is generally used, they are not considered a lease incentive for accounting purposes. In addition, lease payments should not be grossed up for rent abatements.

ASC 842-10-30-5 addresses what lease payments should consist of at the lease's commencement date. ASC 842-10-30-5(a), in particular, states the following should be included in lease payments: "Fixed payments, including in substance fixed payments, less any lease incentives paid or payable to the lessee." We believe this guidance applies when determining the lease payments that should be used for purposes of assessing the classification of a lease (see Section 6.5).

ASC 842-20-30-1(a) indicates that the lease liability is measured "at the present value of the lease payments not yet paid." As such, for purposes of measuring the lease liability on the commencement date, we believe incentives paid on or before the commencement date should not reduce lease payments, while incentives payable on or after the commencement date (but not yet paid on that date) should reduce lease payments for purposes of measuring the lease liability.

ASC 842-20-30-5 indicates that the ROU asset is measured on the commencement date by starting with the lease liability and adding to it the lessee's initial direct costs incurred, as well as: "Any lease payments made to the lessor at or before the commencement date, minus any lease incentives received." For purposes of measuring the ROU asset on the commencement date, based on how we believe the lease incentives should affect the lease liability, we believe the ROU asset will already reflect incentives payable (but not yet paid) on or after the commencement date because the starting point for measuring the asset is the lease liability, which is based on lease payments from which those lease incentives payable have already been deducted. Only where the incentive is paid on or prior to the commencement date would the lessee need to make an adjustment to the lease liability in measuring the ROU asset.

The following summarizes the treatment of lease incentives other than rent abatements under ASC 842:

- For classification purposes, incentives paid or payable before, on or after the commencement date should be deducted from total lease payments.
- For measurement purposes:
  - Incentives paid on or before the commencement date should not reduce lease payments for purposes of measuring the lease liability, but should reduce the lease liability for purposes of measuring the ROU asset.
  - Incentives payable (but not yet paid) on or after the commencement date should reduce lease payments for purposes of measuring the lease liability, but will only affect the ROU asset on the commencement date in that the measurement of that asset starts with the lease liability.

The following example illustrates and compares the accounting for a lease incentive when it is received on or before the commencement date vs. after the commencement date.

Example 5-7: Accounting for lease incentives

Lessee and Lessor entered into a lease on January 1, 20X6. The terms of the lease and other facts pertinent to the accounting for the lease include the following:

- The underlying asset is a large piece of specifically identified industrial equipment.
- Lessor makes the equipment available to Lessee for its use on January 1, 20X6.
- Lessee has the right to use the equipment for a noncancellable term of three years. There are no extension, termination or purchase options.
- Fixed lease payments in year one of the lease are $100,000 and increase by $5,000 per year over the noncancellable term.
- Lease payments are made annually in arrears.
- There are no variable lease payments or initial direct costs.
- Lessee's incremental borrowing rate is 8% (the rate implicit in the lease is not readily determinable).
- The useful life of the equipment is four years.

In Scenario A, Lessor pays a $20,000 lease incentive to Lessee on January 1, 20X6. In Scenario B, Lessor pays a $20,000 lease incentive to Lessee on January 1, 20X7.

Total lease payments for classification purposes is $295,000 for both Scenario A and B—the total annual fixed lease payments of $315,000 less the lease incentive of $20,000. Total lease payments for lease liability measurement purposes under Scenario A is $315,000 (the total annual fixed lease payments), while total lease payments for lease liability measurement purposes under Scenario B is $295,000 (the total annual fixed lease payments of $315,000 less the $20,000 lease incentive not yet paid).

For Scenario A, based on the annual lease payments in arrears of $100,000 for 20X6, $105,000 for 20X7 and $110,000 for 20X8, a lease term of three years and a discount rate of 8%, the present value of the annual lease payments not yet paid is $269,935. The beginning balance of the ROU asset is $249,935, calculated by starting with the beginning balance of the lease liability of $269,935 and reducing it for the lease incentive of $20,000 paid on the commencement date.

For Scenario B, based on the annual lease payments in arrears of $100,000 for 20X6, $105,000 for 20X7 and $110,000 for 20X8, the lease incentive of $20,000 received on January 1, 20X7, a lease term of three years and a discount rate of 8%, the present value of the annual lease payments not yet paid net of the lease incentive not yet received is $251,416, which is also the beginning balance of the ROU asset.

Lessee records the following journal entry on lease commencement for each scenario:

	Scenario A		Scenario B	
	Debit	**Credit**	**Debit**	**Credit**
ROU asset	$249,935		$251,416	
Cash	20,000			
Lease liability		$269,935		$251,416

The difference between the ROU asset recognized on the commencement date under Scenarios A and B of $1,481 ($249,935 – $251,416) is attributed to the time value of money for the lease incentive of $20,000 paid on the commencement date in Scenario A, while it is paid one year later in Scenario B. (The present value on the commencement date of the $20,000 incentive paid one year after the commencement date under Scenario B is $18,519 [$20,000 – $1,481].) In essence, the lease incentive is more valuable in Scenario A because it is paid sooner, which results in a greater reduction to the ROU asset under Scenario A.

The difference between the lease liability recognized on the commencement date under Scenarios A and B of $18,519 is attributed to the present value of the $20,000 incentive paid one year after the commencement date under Scenario B. The lease liability under Scenario B is lower than the lease liability under Scenario A because Lessee's net cash outflows under the lease after the commencement date are lower under Scenario B.

The subsequent accounting for a lease with an incentive paid on the commencement date (similar to Scenario A) is illustrated in detail in Example 7-2. The subsequent accounting mechanics for a lease with an incentive paid one year after the commencement date (Scenario B) would be similar to those with an incentive paid on the commencement date, with the exception being the net cash outflows in the first year after the commencement date being $100,000 under Scenario A and $80,000 under Scenario B.

Example 5-8: Accounting for lease incentive in which lessor assumes lessee's preexisting lease

Lessee and Lessor entered into a lease on January 1, 20X6. The terms of the lease and other facts pertinent to the accounting for the lease include the following:

- The underlying asset is an office building.
- Lessor makes the building available to Lessee for its use on January 1, 20X6.
- Lessee has the right to use the building for a noncancellable term of five years. There are no extension, termination or purchase options.
- Fixed lease payments in year one of the lease are $240,000 and increase by $10,000 per year over the noncancellable term.
- Lease payments are made annually in arrears.

- There are no variable lease payments or initial direct costs.
- Lessee's incremental borrowing rate is 8% (the rate implicit in the lease is not readily determinable).
- The useful life of the building is seven years.

In addition, to incent Lessee to enter into the lease for the office building, Lessor agrees to assume Lessee's preexisting lease for office space with an unrelated third-party lessor, which results in Lessee being released from its obligations under the preexisting lease. Considering market rental rates for the office space Lessee will be vacating and the terms of the preexisting lease, Lessee estimates that a loss of $50,000 would be incurred upon abandoning the lease on January 1, 20X6, absent Lessor assuming the lease. The amount was determined by considering the present value of the amount of remaining lease payments and the amount of payments expected upon subleasing the space. As a result, the lease incentive that should be reflected in Lessee's accounting for the new lease is $50,000. The carrying amount of the lease liability and ROU asset for the preexisting lease being assumed by Lessor on January 1, 20X6 are $100,000 and $85,000, respectively.

Total lease payments for classification purposes is $1,250,000—the total annual fixed lease payments of $1,300,000 ($240,000 for 20X6 + $250,000 for 20X7 + $260,000 for 20X8 + $270,000 for 20X9 + $280,000 for 20Y0) less the lease incentive of $50,000. Total lease payments for lease liability measurement purposes is $1,300,000.

Based on the annual lease payments in arrears of $240,000 for 20X7, $250,000 for 20X7, $260,000 for 20X8, $270,000 for 20X9 and $280,000 for 20Y0, a lease term of five years and a discount rate of 8%, the present value of the annual lease payments not yet paid is $1,031,975. The beginning balance of the ROU asset is $981,975, calculated by starting with the beginning balance of the lease liability of $1,031,975 and reducing it for the lease incentive of $50,000.

Lessee records the following journal entry on the lease commencement date:

	Debit	Credit
ROU asset (for new lease)	$981,975	
Lease liability (for preexisting lease assumed by Lessor)	100,000	
Loss on lease abandonment (Note 1)	35,000	
Lease liability (for new lease)		$1,031,975
ROU asset (for preexisting lease assumed by Lessor)		85,000

Note 1: The loss on lease abandonment is the difference between the $50,000 lease incentive resulting from Lessor assuming the lease and the $15,000 net difference between the carrying amounts of the lease liability and ROU asset for the preexisting lease on January 1, 20X6.

5.5.5 Termination penalties, including lessee guarantee of lessor's return upon termination

Whether a termination penalty is included in lease payments depends first on whether the lease term reflects the lessee exercising the termination option (see Section 5.3.2). When the lease term does not reflect the lessee exercising the termination option (i.e., the lease term includes the period covered by the option), any termination penalty is excluded from lease payments, regardless of whether the penalty is variable or fixed.

When the lease term reflects the lessee exercising the termination option (i.e., the lease term does not include the period covered by the option), whether any termination penalty is included in lease payments depends on whether the penalty is fixed or variable. If the termination penalty is fixed, it is included in lease payments. If the termination penalty is variable, it is treated like any other variable payment (see Section 5.5.3). If it is variable based on an index or rate, it is included in lease payments and measured at the index or rate at the commencement date (see Section 5.5.3.2). If it is variable based on other than an index or rate, it is not included in lease payments used for classification or measurement purposes (see Section 5.5.3.3).

While termination penalties are typically fixed, an example of a termination penalty that could be variable is when a lease agreement requires the lessee, upon its termination of the lease, to make a payment to the lessor, or perhaps even one of the lessor's lenders, that guarantees a return on the underlying asset. In this situation, if the lease term does not reflect the lessee exercising the termination option, the guarantee does not affect lease payments. Conversely, if the lease term does reflect the lessee exercising the termination option, the guarantee affects lease payments when the return is fixed, or when the return is variable based on an index or rate. When the return is variable based on something other than an index or rate, it does not affect lease payments.

5.5.6 Residual value guarantees

A residual value guarantee assures the lessor that when it gets back the underlying asset at the end of the lease term, its value will be at or above a specified amount. Payments under residual value guarantees that are probable of being owed by the lessee are included in lease payments. Depending on the terms of the residual value guarantee, the amount the lessee believes is probable of being owed under the guarantee may not be the maximum potential amount that could be paid under the guarantee.

For purposes of ASC 842, a residual value guarantee does not include the lessee promising to make a payment to the lessor to address a residual value shortfall caused by damage, abnormal wear and tear or too much use. Depending on the facts and circumstances, the promise to make such a payment may need to be accounted for as a variable lease payment under ASC 842 (see Section 5.5.3), or it may need to be accounted for in accordance with other applicable U.S. GAAP (e.g., as an asset retirement obligation under ASC 410-20 [see Section 5.5.10]).

When a lessee obtains a residual value guarantee from an unrelated third party for the benefit of the lessor, the cost of doing so is only included in lease payments if the lessee is released from all obligations having to do with the residual value guarantee; otherwise, the cost of doing so is treated as an executory cost. If the lessee is still obligated to honor the residual value guarantee if the third-party guarantor defaults, it has not been released from all obligations having to do with the residual value guarantee.

Spotlight on change: Residual value guarantees included in lease payments

Under ASC 840, minimum rental payments include the full amount of a residual value guarantee. Under ASC 842, lease payments include only the amount of a residual value guarantee that is probable of being paid. As a result, all other things being equal, a lease liability measured under ASC 842 will be less than a capital lease obligation measured under ASC 840 when the lease includes a residual value guarantee under which the amount probable of being paid is less than the full amount.

5.5.7 Payment in connection with lessor put option

When the lessor has the right to require the lessee to purchase the underlying asset by the end of the lease term for a stated purchase price, that right is referred to as a put option. The stated purchase price should be included in lease payments because the FASB believes that amount is essentially a residual value guarantee the lessee must pay based on circumstances not within its control.

5.5.8 Maintenance deposits

One of the key issues with respect to maintenance deposits is whether some or all of the deposits truly represent a deposit that will be returned to the lessee for reimbursement of costs to maintain the underlying asset. To address this issue, the lessee must consider whether payments to the lessor for maintenance deposits, in whole or in part, are substantively and contractually related to maintenance of the underlying asset.

Deposits (or the portion thereof) paid to the lessor that are not substantively and contractually related to maintenance of the underlying asset should not be accounted for as maintenance deposits. Instead, when the deposit (or portion thereof) is not refundable, it should be evaluated as a fixed lease payment; and when the deposit (or portion thereof) is refundable, it should be evaluated as a variable lease payment (see Section 5.5.3).

Deposits (or portions thereof) paid to the lessor that are substantively and contractually related to maintenance of the underlying asset (i.e., actual maintenance deposits) should be recognized as deposit assets. The lessee must next consider the probability of some or all of the deposit assets being returned to the lessee for reimbursement of costs to maintain the underlying asset. The portion of a maintenance deposit that is probable (as of the commencement date) of being returned to the lessee for reimbursement of costs to maintain the underlying asset is accounted for as a deposit asset (i.e., it is not included in lease payments). The portion of a deposit asset not probable (as of the commencement date) of being returned to the lessee for reimbursement of costs to maintain the underlying asset should be accounted for in the same manner as a variable lease expense (see Section 5.5.3). For these purposes, *probable* means likely to occur.

When the lessee performs the maintenance, it should account for the cost in accordance with its established accounting policy for such costs. For example, if the underlying asset is a building, the lessee should account for any related maintenance costs using the accounting policy it has in place for building maintenance costs.

5.5.9 Payments to dismantle and remove an underlying asset

Payments to be made in accordance with lease provisions obligating the lessee to dismantle and remove an underlying asset at the end of the lease term should generally be included in lease payments if they are fixed or variable based on an index or rate, depending on the facts and circumstances. If the payment to be made by the lessee is variable based on other than an index or rate, it is not included in lease payments used for classification or measurement purposes, but is treated the same as other lease payments that are variable based on other than index or rate (see Section 5.5.3.3).

5.5.10 Payments to return an underlying asset to its pre-lease condition

Payments to be made in accordance with lease provisions obligating the lessee to return an underlying asset to the condition it was in before the lessee made modifications to it (i.e., the underlying asset's pre-lease condition) include payments to remove leasehold improvements installed by the lessee. Such payments generally do not meet the definition of lease payments or variable lease payments in the Master Glossary of the ASC (see Sections 5.5.2 and 5.5.3). When that is the case, the payments should be accounted for as asset retirement obligations under ASC 410-20. In the unlikely event that payments to be made in accordance with lease provisions obligating the lessee to return an underlying asset to its pre-lease condition meet the definition of lease payments or variable lease payments, they should be accounted for in accordance with ASC 842.

5.5.11 Payments related to indemnification of the lessor

Lease agreements may require that the lessee indemnify the lessor for certain adverse events or circumstances that may arise in the future related to the lessee's use of the underlying asset. ASC 842 specifically addresses the following types of indemnifications:

- *Tax indemnifications*. The following guidance is provided in ASC 460 and ASC 842 related to the accounting for tax-related indemnifications:
  - ASC 460-10-15-7(c) provides a scope exception for contracts that have the characteristics of a guarantee, but are accounted for as variable lease payments.
  - ASC 460-10-55-13(b) addresses whether two types of indemnifications for adverse tax consequences provided by the lessee to the lessor are within the scope of ASC 460. One is an

indemnification for *a future change in tax laws*, which is within the scope of ASC 460 (notwithstanding the scope exceptions in ASC 460-10-15-7) because the lessee has no control over making changes to tax laws. The other is an indemnification for *the lessee's acts, omissions or misrepresentations*, which does not fall within the scope of ASC 460 because the lessee is essentially guaranteeing its own future performance.

- ASC 460-10-55-23A indicates that a tax indemnification provided by the lessee to the lessor within the scope of ASC 460 should result in the recognition of a liability by the lessee at lease inception (see ASC 460-10-25-4) that is measured at the fair value of the tax indemnification (see ASC 460-10-30-2).
- ASC 842-10-55-38 indicates that while potential payments from the lessee to the lessor in connection with the lessee indemnifying the lessor for any adverse tax consequences that may arise from *a future change in tax laws* "may appear to meet the definition of variable lease payments, those payments are not of the nature normally expected to arise under variable lease payment provisions." ASC 842-10-55-39 goes on to indicate that such potential indemnification payments should not change lease classification.

Based on the guidance cited, a lessee indemnification of the lessor for any adverse tax consequences that may arise from *a future change in tax laws* should be accounted for in accordance with ASC 460 and does not affect lease classification. Conversely, a lessee indemnification of the lessor for any adverse tax consequences that may arise from the lessee's acts, omissions or misrepresentations should not be accounted for in accordance with ASC 460.

- *Environmental contamination*. ASC 842-10-55-15 indicates that the potential payments from the lessee to the lessor in connection with the lessee indemnifying the lessor for any environmental contamination should not affect the classification of the lease.

5.5.12 Contract consideration allocated to lease and nonlease components

As discussed in more detail in Section 4.4, when a contract includes both lease and nonlease components, the lessee either: (a) treats each separate lease component as a unit of account apart from the nonlease components or (b) elects an accounting policy by class of underlying asset to treat each separate lease component together with the nonlease component(s) related to it as one combined unit of account. If the lessee elects this accounting policy, the combined unit of account is accounted for as a lease component under ASC 842, which means the contract consideration allocated to that unit of account should be considered its lease payments. If the lessee does not elect this accounting policy, the nonlease components are accounted for as one or more unit(s) of account in accordance with other applicable U.S. GAAP, which means the contract consideration allocated to that (or those) unit(s) of account should *not* be considered lease payments.

As discussed in more detail in Section 4.5.1, the contract consideration allocated to the units of account in a contract includes lease payments. So, when a contract includes more than one unit of account, the lessee determines the lease payments and uses that as an input to determine the contract consideration. The amount of contract consideration allocated to a unit of account that should be accounted for as a lease component under ASC 842 is the final determination of the lease payments for that unit of account.

Examples 4-1 and 4-2 illustrate the determination of lease payments when the contract includes lease and nonlease components.

5.5.13 Remeasurement of lease payments

The lessee remeasures lease payments only under the following circumstances:

- *The lessee modifies the lease and the modification is not accounted for as a separate contract*. Accounting for lease modifications is discussed in detail in Section 7.2.5.

- *Variable lease payments based on other than an index or rate that did not previously meet the definition of lease payments (because they were based on other than an index or rate [see Section 5.5.3.3]) subsequently meet the definition of lease payments for the remainder of the lease term because the underlying contingency has been resolved.* For example, if the lease requires the lessee to make incremental payments to the lessor once a usage milestone is reached, lease payments are remeasured to include those payments if and when the lessee reaches the usage milestone.
- *There is a change in the lease term (see Section 5.3.5), in which case the lease payments are remeasured to reflect the revised lease term.* For example, if a lessee changes its assessment from it not being reasonably certain to exercise a renewal option to it being reasonably certain to exercise the renewal option because of the installation of significant leasehold improvements (which was not expected at the lease commencement date) with an economic life that extends into the renewal period, the lessee reassesses the lease term to include the period covered by the renewal option. At the same time, the lessee remeasures lease payments to include the lease payments for the period covered by the renewal option, as well as any fee related to exercising the renewal option.
- *There is a change to the expectations about whether the lessee is reasonably certain to exercise a purchase option (see Section 5.4.2), in which case the lease payments are revised for that change in expectations.* For example, if a lessee changes its assessment from it not being reasonably certain to exercise a purchase option to it being reasonably certain to exercise the purchase option because of the increased importance of the underlying asset to the lessee's business due to strategic changes in the lessee's product mix (which were not expected at the lease commencement date), the lessee remeasures lease payments to include the exercise price of the purchase option. In addition, if the change in expectations with respect to exercising the purchase option changes the lease term, the corresponding effects on lease payments should be reflected in their remeasurement.
- *There is a change in the probable amount expected to be owed by the lessee under a residual value guarantee (see Section 5.5.6), in which case the lease payments are revised to reflect that change in expectations.* For example, if a lessee determines that the probable amount expected to be owed by the lessee under a residual value guarantee changes from $10,000 to $8,000, the lessee remeasures the lease payments to reduce them by $2,000.

When one of the foregoing circumstances occurs and the lessee remeasures its lease payments as a result, it should also remeasure any variable lease payments based on an index or rate by using the index or rate on the remeasurement date.

Example 5-4 illustrates the effects of remeasuring lease payments, including a variable lease payment based on an index or rate, as a result of a change in the lease term.

6. Classify the lease

At the commencement date, lessees classify their leases (more specifically, the units of account that should be accounted for as leases [see Section 4.3 and Section 4.4]) as either finance or operating leases. There are special considerations involved when the lessee is leasing facilities owned by a government unit or authority, such as facilities at an airport, port or bus terminal, which are discussed in Section 6.1. When the lessee is not leasing facilities owned by a government unit or authority, there are five criteria that lessees must consider in evaluating whether a lease should be classified as a finance or operating lease:

- Ownership of the underlying asset transfers to the lessee by the end of the lease term (see Section 6.2).
- An option exists under which the lessee may purchase the underlying asset and exercise of that option is reasonably certain (see Section 6.3).

- The lease term makes up a major part of the underlying asset's remaining economic life (see Section 6.4). (This criterion is not applicable if the lease term commences at or near the end of the underlying asset's economic life.)
- The sum of the present value of the lease payments and any residual value guaranteed by the lessee that is not already included in the lease payments is equal to or exceeds substantially all of the underlying asset's fair value (see Section 6.5).
- 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 (see Section 6.6).

If one or more of these lease classification criteria are met at lease commencement, the lessee should classify the lease as a finance lease. If none of these lease classification criteria are met, the lessee should classify the lease as an operating lease. The circumstances under which a lease's classification is reassessed are discussed in Section 6.7.

If the lessee indemnifies the lessor for environmental contamination, the classification of the lease should not be affected, regardless of whether the indemnification relates to preexisting environmental contamination or environmental contamination caused by the lessee. Additional discussion about the lessee's indemnification of the lessor for environmental contamination is provided in Section 5.5.11.

Examples 7-3 to 7-5, Example 8-2 and Example 8-3 illustrate the application of the lease classification criteria to specific facts and circumstances.

Spotlight on change: Lease classification

Under ASC 840, there are four lease classification criteria and certain of those criteria include bright lines. Under ASC 842, there are five lease classification criteria, four of which are similar to those in ASC 840, but without any bright lines. The two criteria affected by the removal of the bright lines are the following:

- *Lease term compared to remaining economic life.* Both ASC 840 and ASC 842 have a lease classification criterion focused on comparing the lease term to the underlying asset's remaining economic life. ASC 840 indicates that a lease should be classified as a capital lease if the lease term represents *75% or more* of the underlying asset's remaining economic life, and ASC 842 indicates that a lease should be classified as a finance lease if the lease term represents a *major part* of the underlying asset's remaining economic life. While there is not a bright line in the ASC 842 criterion, the implementation guidance in ASC 842 indicates that one reasonable approach to defining *major part* is 75% or more. In addition, ASC 840 indicates that this criterion should not be applied if the beginning of the lease term falls within the *last 25%* of the underlying asset's total economic life, and ASC 842 indicates that this criterion should not be applied if the commencement date is *at or near the end* of the underlying asset's total economic life. While there is not a bright line in the ASC 842 criterion, the implementation guidance in ASC 842 indicates that one reasonable approach to defining *at or near the end* of the underlying asset's economic life is 25% or less of the underlying asset's total economic life.
- *Present value amount compared to the underlying asset's fair value*. Both ASC 840 and ASC 842 have a lease classification criterion focused on comparing the fair value of the underlying asset to a present value amount based predominantly on the minimum rental payments under ASC 840 (which includes the full amount of a residual value guarantee) or the lease payments under ASC 842 along with any part of a residual value guarantee not already included in the lease payments. ASC 840 indicates that if the present value amount is *90% or more* of the underlying asset's fair value, the lease should be classified as a capital lease, and ASC 842 indicates that if the present value amount represents *substantially all* of the underlying asset's fair value, the lease should be classified as a finance lease. While there is not a bright line in the ASC 842 criterion, the

implementation guidance in ASC 842 indicates that one reasonable approach to defining *substantially all* is 90% or more.

While the bright lines were removed from these two criteria in ASC 842, we do not expect the criteria to be applied much differently in practice based on the implementation guidance provided in ASC 842. As such, we do not expect the changes made to these two criteria to have a significant effect on the classification of a lease.

The new criterion under ASC 842 indicates that if the underlying asset is of such a specialized nature that it is not expected to have an alternative use to the lessor at the end of the lease term, the lease should be classified as a finance lease. We believe this criterion will most likely only be met if one of the other four lease classification criteria in ASC 842 is also met. As a result, we believe it will be very uncommon for this criterion to result in the classification of a lease as a finance lease under ASC 842 when that lease would have been classified as an operating lease under ASC 840.

In addition to these changes, the incremental guidance in ASC 840 related to the classification of a lease involving both land and a building and a lease involving only part of a building was not incorporated into ASC 842. While this change could affect the classification of a lease involving land and a building or a lease involving only part of a building, we do not believe those effects will be pervasive.

6.1 Lease of facilities owned by a government unit or authority

When the lessee is leasing facilities owned by a government unit or authority, such as facilities at an airport, port or bus terminal, ASC 842 provides a separate set of criteria that should be applied first with respect to the lease's classification. If all of the following criteria are met the lease should be classified as an operating lease:

- A governmental unit or authority owns the underlying asset.
- The underlying asset is part of a larger facility operated by the lessor or on the lessor's behalf.
- Either the underlying asset or facility is a permanent structure, and given that permanence, the underlying asset could not typically be moved to a different location.
- The lessor or a higher governmental authority has the right to terminate the lease at any time because such right is explicitly granted either by the lease or by laws and regulations applicable to the underlying asset.
- Ownership of the underlying asset does not transfer to the lessee.
- The lessee is not permitted to own the underlying asset, by purchase or otherwise.
- The lessee cannot purchase or lease the underlying asset (or an equivalent asset in the same service area) from a nongovernmental unit or authority. (The determining factors in whether there is an equivalent asset in the same service area are: (a) the asset must continue to perform essentially the same service or activity as the underlying asset and (b) using the asset must not result in any appreciable difference in the lessee's economic performance.)
- It is impracticable for the lessee to determine the fair value of the underlying asset.

If one or more of these criteria are not met, the same lease classification criteria applied to leases not involving government-owned property apply to the classification of the lease.

6.2 Ownership transfer to the lessee

If ownership of the underlying asset transfers to the lessee by the end of the lease term, the lease should be classified as a finance lease. This criterion is met if the lessee's performance in accordance with the terms of the lease obligate the lessor to both: (a) execute and deliver the documents necessary to release the underlying asset from the lease and (b) transfer ownership of the underlying asset to the lessee. If the lease contains a requirement that the lessee pay no more than a nominal fee when ownership is transferred (e.g., a statutory transfer fee), such a requirement would not preclude this criterion from having been met.

If the lease provides the lessee with an option to not pay a fee (nominal or otherwise), which, if elected, would result in the lessee not obtaining ownership of the underlying asset, this criterion is not met. Instead, an option to purchase the underlying asset exists, which may affect the classification of the lease in a different manner, as discussed in Section 6.3.

6.3 Lessee purchase option reasonably certain of exercise

A lease should be classified as a finance lease if it includes an option under which the lessee may purchase the underlying asset and the lessee is reasonably certain to exercise that option. Additional information about purchase options, including the factors that should be considered in determining whether their exercise by the lessee is reasonably certain, is provided in Section 5.4.

6.4 Lease term makes up a major part of the underlying asset's remaining economic life

The lease classification criterion focused on in this section is based on whether the lease term makes up a major part of the underlying asset's remaining economic life. However, this criterion only applies to situations in which the lease's commencement date is not at or near the end of the underlying asset's economic life. For purposes of determining whether this criterion is met, one reasonable approach to assessing whether the lease term makes up a major part of the underlying asset's remaining economic life would be to consider whether the lease term makes up 75% or more of the underlying asset's economic life. If so, this criterion has been met (and the lease should be classified as a finance lease). If not, this criterion has not been met.

For purposes of determining whether this criterion applies in a particular situation, one reasonable approach to assessing whether the lease's commencement date is at or near the end of the underlying asset's economic life would be to consider whether the lease's commencement date falls within 25% or less of the underlying asset's economic life. If so, this criterion does not apply. If not, this criterion does apply, and the lessee considers whether the lease term makes up a major part of the underlying asset's remaining economic life.

The difference between an asset's economic life and useful life is discussed in Section 6.4.1.

When a unit of account includes more than one lease component because the lease components were not separated for accounting purposes (see Section 4.3), the remaining economic life of the predominant underlying asset is used when applying this criterion. Example 13 in ASC 842-10-55-146 to 55-149 illustrates how to identify the predominant underlying asset in a unit of account that includes rights to use a turbine, a building and land. To determine which of those assets represents the predominant underlying asset in the unit of account, the lessee considered what its primary purpose was for entering into the lease. Based on the following, the lessee concluded the predominant asset for purposes of applying this criterion was the turbine: (a) the lessee would most likely have not entered into the lease without the power-generation capabilities of the turbine and (b) the building and land have little to no value to the lessee separate and apart from the turbine.

While a threshold of 25% or less is a reasonable approach for determining whether the lease's commencement date is not *at or near the end* of the underlying asset's economic life, and a threshold of 75% or more is a reasonable approach for determining whether a lease term makes up a *major part* of the underlying asset's remaining economic life, those are not the only approaches lessees may use.

However, if those approaches are not used, lessees will need to adopt and consistently apply a reasonable accounting policy related to their application of this criterion.

6.4.1 Economic life vs. useful life of an asset

An asset's economic life is defined as follows in the Master Glossary of the ASC: "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." Conversely, an asset’s useful life is defined as follows in the Master Glossary of the ASC: “The period over which an asset is expected to contribute directly or indirectly to future cash flows.” One of the key differences between an asset’s economic life and its useful life is that the useful life is determined from an entity-specific perspective, while the economic life is determined from the perspective of all potential users of the asset. For example, if an entity purchases a new truck, the useful life of that truck to the entity may be five years because the entity typically uses new trucks for five years and then sells them to other parties who buy and operate used trucks (instead of new trucks) until the end of their economic lives, which would be when the used trucks’ only value comes from being used or sold for parts. In general, the economic life of a truck is either equal to or longer than the useful life of a truck.

6.5 Present value of lease payments and residual value guarantee equals or exceeds substantially all of the asset’s fair value

When the sum of the present value of the lease payments and any residual value guaranteed by the lessee that is not already included in the lease payments is equal to or exceeds substantially all of the underlying asset’s fair value, the lease should be classified as a finance lease. The same discount rate should be used for both classification and measurement purposes (see Section 5.2).

What should and should not be included in lease payments used for purposes of this lease classification criterion, and how the amount of lease payments used for this purpose may be different from the lease payments used for purposes of measuring the lease liability, are discussed in Sections 5.5.1 and 5.5.2.

As discussed in Section 5.5.6, when the lease includes a residual value guarantee related to the underlying asset, the lessee determines how much of that guarantee is probable of being paid, and that amount is included in lease payments for purposes of measuring the lease liability. ASC 842 includes the entire residual value guarantee in lease payments for purposes of evaluating this lease classification criterion. As a result, when applying this criterion, if the lessee:

- Did not include any of the residual value guarantee in lease payments because no amount of the guarantee was probable of being paid, the entire residual value guarantee is added to lease payments.
- Only included part of the residual value guarantee in lease payments because only that part of the guarantee was probable of being paid, the other part of the residual value guarantee is added to lease payments.
- Included the entire residual value guarantee in lease payments because the entire guarantee was probable of being paid, no incremental amount related to the residual value guarantee is added to lease payments.

The residual value guaranteed by the lessee for a portfolio of underlying assets (and not individual underlying assets) is not considered when evaluating this criterion.

The fair value of the underlying asset should be measured in accordance with ASC 820. While any related investment tax credits retained, and expected to be realized, by the lessor should reduce the fair value of the underlying asset, any fees paid by the lessee to the owners of a special-purpose entity for structuring the transaction (see ASC 842-10-30-5(e) and ASC 958-810-55-14) should not be included in the fair value of the underlying asset. In situations where it is impracticable for the lessee to estimate the fair value of the underlying asset, this criterion should be disregarded. Estimating the fair value of the underlying asset is impracticable if a reasonable estimate cannot be made without expending undue cost and effort.

For purposes of determining what represents substantially all of the underlying asset's fair value, one reasonable approach would be to consider whether the sum of the present value of the lease payments and any residual value guaranteed by the lessee that is not already included in the lease payments is 90% or more than the underlying asset's fair value. If so, the lease is classified as a finance lease. While a 90% or more threshold is a reasonable approach for determining whether this criterion is met, it is not the only approach lessees may use. However, if this approach is not used, lessees will need to adopt and consistently apply a reasonable accounting policy related to their application of this criterion.

6.6 Asset of a specialized nature and with no alternative use

When the underlying asset is of a specialized nature, which is expected to result in it not having an alternative use to the lessor at the end of the lease term, the lease is classified as a finance lease. In situations in which this criterion is met, we would typically expect one of the other lease classification criteria to also be met. In other words, we generally do not expect this criterion to be the only one met by a lease. As explained in paragraph BC71(e) of ASU 2016-02, "it is expected that lessors would lease specialized assets that have no alternative use to them at the end of the lease term only under terms that would transfer substantially all the benefits (and risks) of the asset to the lessee," which would typically trigger one of the other lease classification criteria to be met (see Section 6.4 and Section 6.5).

When assessing whether this criterion has been met, the lessee must consider whether there are any contractual restrictions or practical limitations on the lessor's ability to redirect the use of the underlying asset at the end of the lease term (e.g., sell it, lease it to another entity). However, only *substantive* contractual restrictions affect whether the underlying asset has an alternative use to the lessor at the end of the lease term. For a contractual restriction to be substantive, it must be enforceable.

If the lessor redirecting the use of the underlying asset at the end of the lease term would result in the lessor incurring significant economic losses, the underlying asset does not have an alternative use to the lessor at the end of the lease term. Significant economic losses may be caused by: (a) the lessor needing to incur significant costs to rework the underlying asset so that it will function in another environment and (or) (b) the lessor only being able to sell or re-lease the underlying asset at a significant loss.

The possibility of contract termination is not a relevant consideration in assessing the lessor's ability to redirect the use of the underlying asset.

6.7 Reassessment of a lease's classification

A lessee reassesses classification of a lease only in the following three situations: (a) the contract is modified and the modification is not accounted for as a separate contract (see Section 7.2.5.1), (b) the lease term changes (see Section 5.3.5) or (c) the assessment related to whether the lessee is expected to exercise a purchase option becomes reasonably certain or is no longer reasonably certain (see Section 5.4.2). When one of these situations occurs, the lessee performs the reassessment based on the lease's terms and conditions and relevant facts and circumstances as of the reassessment date. For example, if a lessee reassesses a lease's classification because the lease was modified and the modification was not accounted for as a separate contract, the lessee uses the lease's terms and conditions as modified and the relevant facts and circumstances as of the modification date when reapplying the lease classification criteria. For another example, if the assessment related to whether the lessee is reasonably certain to exercise a renewal option changes, the lessee uses the lease's terms and conditions and relevant facts and circumstances as of the date the lease term was changed when reapplying the lease classification criteria. In both examples, this means lease payments, the lease term and the underlying asset's fair value and remaining economic life would all be determined as of the modification or reassessment date.

7. Apply the appropriate accounting model

7.1 Initial accounting

On the commencement date, lessees are required to recognize ROU assets and lease liabilities for all leases other than those for which it has elected the short-term lease accounting policy (see Section 7.1.1). Example 7-2 and Example 7-3 illustrate the lessee's initial accounting for a lease when the short-term lease accounting policy discussed in Section 7.1.1 is not elected.

Spotlight on change: Recognition of lease liabilities and ROU assets for operating leases

The most significant change under ASC 842 is the recognition of ROU assets and lease liabilities by lessees for all leases, other than those for which the lessee has elected the short-term lease accounting policy (see Section 7.1.1). This change will result in lessees recognizing ROU assets and lease liabilities for most leases classified as operating leases under ASC 842, which is not the case under ASC 840 (i.e., neither a lease liability nor a lease asset is recognized under ASC 840 for operating leases).

7.1.1 Short-term leases

By definition, a short-term lease is one in which: (a) the lease term is 12 months or less and (b) there is not an option to purchase the underlying asset that the lessee is reasonably certain to exercise. For short-term leases, lessees may elect an accounting policy by class of underlying asset under which the ROU assets and lease liabilities are not recognized and: (a) lease payments are recognized as lease costs over the lease term on a straight-line basis and (b) variable lease payments based on other than an index or rate are recognized as lease costs in the period in which they are incurred, which is consistent with how such payments are recognized when the short-term lease accounting policy is not elected (see Section 7.2.2.1 and Section 7.2.3.1).

If a lease initially meets the definition of a short-term lease, but either of the following circumstances subsequently arise, the lease no longer meets the definition of a short-term lease:

- The lease term is reassessed (see Section 5.3.5) and the remaining lease term is more than 12 months from the end of the previously determined lease term. (Note that the 12 months is measured from the end of the previously determined lease term, not from the reassessment date.)
- Exercise of a purchase option by the lessee becomes reasonably certain.

If the lease no longer meets the definition of a short-term lease because one of these circumstances arises, the lessee should classify the lease and begin applying the appropriate accounting model (which will result in the recognition of a ROU asset and lease liability) as of the date the change in circumstances occurred (which would be considered the commencement date for accounting purposes).

Example 7-1: Reassessment of the lease term for a short-term lease

Lessee enters into a lease with Lessor on January 1, 20X6. The noncancellable term of the lease is one year and Lessee has an option to renew the lease for an additional year. On January 1, 20X6, Lessee appropriately concludes it is not reasonably certain to exercise the option to renew the lease. Accordingly, Lessee concludes the lease term is one year. Lessee elects the accounting policy under which ROU assets and lease liabilities are not recognized for short-term leases. As a result, Lessee recognizes the lease payments as lease costs over the one-year lease term.

A significant change in circumstances under Lessee's control occurs on September 1, 20X6, which requires Lessee to reassess the lease term. In doing so, Lessee appropriately concludes it is reasonably certain to exercise the option to renew the lease through December 31, 20X7. While the remaining lease term is more than 12 months from the date the lease term is reassessed, it is not more

> than 12 months from the end of the previously determined lease term (December 31, 20X6). As a result, Lessee continues to account for the lease as a short-term lease.

7.1.2 Lease liability

For the initial measurement of the lease liability, regardless of the lease's classification, the lessee discounts the lease payments not yet paid (see Section 5.5) over the lease term (see Section 5.3) using the discount rate (see Section 5.2) as of the commencement date (see Section 5.1).

7.1.3 ROU asset

For the initial measurement of the ROU asset, regardless of the lease's classification, the lessee starts with the amount of the lease liability (see Section 7.1.2) and adjusts it as follows:

Determination of the initial balance of the ROU asset	
	Initial balance of the lease liability
+	Any lease payments already made to the lessor on or before the commencement date
+	Any initial direct costs incurred by the lessee (see Section 7.1.3.1)
–	Any lease incentives received from the lessor on or before the commencement date (see Section 5.5.4)
=	Initial balance of the ROU asset

Incentives payable on or after the commencement date (but not yet paid on that date) should not be subtracted from the lease liability to arrive at the ROU asset. This is because the ROU asset already reflects those lease incentives given that the starting point for measuring the ROU asset is the lease liability, which is based on lease payments from which those lease incentives have already been deducted.

7.1.3.1 Initial direct costs

Only incremental costs to obtain a lease that a lessee would not have incurred if the lease had not been entered into should be considered initial direct costs of the lessee. For example, a commission due to an employee of the lessee only after the lease has been executed meets the definition of an initial direct cost.

In general, any costs incurred prior to signing a lease with the lessor are not considered initial direct costs. As a result, internal and external costs associated with negotiating lease terms, vetting the tax implications of a lease and preparing and processing lease documents are not considered initial direct costs of a lease. In addition, fixed costs (including the fixed salaries of employees responsible for negotiating and entering into leases) and general overheads are not considered initial direct costs of a lease.

To the extent there is more than one unit of account (see Section 4.4), the initial direct costs are allocated between the units of account on the same basis as the contract consideration was allocated to the units of account (see Section 4.5). Example 4-2 illustrates the allocation of initial direct costs when there is more than one unit of account.

> **Spotlight on change: Definition of initial direct costs**
>
> The definition of initial direct costs under ASC 842 is much narrower than the definition of such costs under ASC 840. Under ASC 842, initial direct costs include only those incremental costs to obtain a lease that a lessee would not have incurred if the lease had not been entered into. Under ASC 840, initial direct costs include incremental costs to obtain a lease, regardless of whether they would have been incurred if the lease had not been entered into, and certain of the lessee's internal costs directly related to entering into the lease. Provided below are examples of costs a lessee typically incurs when

it enters into a lease and an indication as to whether the cost meets the definition of an initial direct cost under ASC 840 and (or) ASC 842.

	Initial direct cost under ASC 840?	Initial direct cost under ASC 842?
Commission paid to an employee only after the lease is entered into	Yes	Yes
Fees for legal assistance related to entering into the lease	Yes	No
Allocated portion of the salary and benefits paid to the employee primarily responsible for negotiating the lease (where the allocated portion is based on the amount of time spent by the employee negotiating the specific lease)	Yes	No
Allocated portion of depreciation costs related to the office and equipment used by the employee primarily responsible for negotiating the lease (where the allocated portion is based on the amount of time spent by the employee negotiating the specific lease)	No	No

7.1.4 Costs incurred to place a leased asset into use

A lessee may incur costs to place a leased asset into use. These costs may include costs to ship the asset to the lessee's premises or install the asset at the lessee's premises. While ASC 842 provides guidance on the accounting implications of incurring these costs with the lessor (see Section 4.2), it does not provide guidance on the accounting implications of incurring these costs with third parties. As such, we believe costs incurred with a third party to place a leased asset into use are not within the scope of ASC 842.

The accounting for shipping and installation costs incurred by a lessee with a third party was addressed in an SEC staff speech (Pidgeon 2018), in which the SEC staff indicated that if the cost is within the scope of a specific ASC topic or subtopic (e.g., ASC 340-40 or ASC 360), that guidance should be applied. When the shipping and installation costs do not fall within the scope of a specific ASC topic or subtopic, the SEC staff indicated that the lessee could elect an accounting policy to either: (a) recognize the costs as an expense in the period in which they are incurred or (b) analogize to the accounting for property, plant and equipment in ASC 360 and capitalize the costs incurred to place a leased asset into service. The accounting policy elected should be consistently applied and appropriately disclosed.

We believe the approach captured in the SEC staff speech (Pidgeon 2018) related to accounting for costs incurred with a third party to place a leased asset into service should be followed by all entities (and not just public entities) when applying ASC 842.

7.2 Subsequent accounting

The subsequent accounting for a lease depends, in large part, on its classification as either a finance lease or an operating lease. Examples 7-2 to 7-5 illustrate the lessee's subsequent accounting for a lease when the short-term lease accounting policy discussed in Section 7.1.1 is not elected.

7.2.1 Lease liability for both operating and finance leases

The subsequent accounting for the lease liability is the same for both finance and operating leases. Measurement of the lease liability at the end of any given period in which lease payments are not remeasured (see Section 5.5.13 and Section 7.2.1.1) is based on the following:

Determination of ending balance in lease liability when there is not a remeasurement during the period	
	Beginning balance of the lease liability
+	Accretion of the lease liability for the period
–	Lease payments made during the period
=	Ending balance of the lease liability

One of the differences between the finance and operating lease accounting models is how the accretion of the lease liability is treated from a cost perspective. As discussed in Section 7.2.2.1 and Section 7.2.3.1, the accretion of the lease liability is treated as an interest cost under the finance lease accounting model, while it is treated as part of total lease costs under the operating lease accounting model.

The accretion of the liability for the period should produce a constant periodic discount rate on the lease liability's remaining balance. The constant periodic discount rate could change on a going-forward basis as a result of a reassessment of the discount rate (see Section 5.2.5).

At the end of each period, the balance of the lease liability should be equal to the present value of the lease payments not yet paid less the present value of lease incentives not yet received, with those present values determined using the appropriate discount rate (i.e., the commencement date discount rate or the most recent discount rate resulting from a reassessment, if applicable).

7.2.1.1 Remeasurement of the lease liability

When lease payments are remeasured (see Section 5.5.13), the lease liability should be remeasured. In addition, when the lease liability is remeasured, the lessee may also be required to remeasure the discount rate. The circumstances under which the discount rate must be remeasured are discussed in Section 5.2.5.

Measurement of the lease liability at the end of any given period in which lease payments are remeasured (see Sections 5.5.13) is based on the following:

Determination of ending balance in lease liability when there is a remeasurement during the period	
	Beginning balance of the lease liability
+	Accretion of the lease liability for the period
+/–	Remeasurement adjustment
–	Lease payments made during the period
=	Ending balance of the lease liability

When the lease liability is remeasured to reflect the remeasurement of lease payments, the adjustment to the lease liability should also be recognized as an adjustment to the ROU asset, which is done explicitly in the case of a finance lease (see Section 7.2.2.2) and implicitly in the case of an operating lease (see Section 7.2.3.2). However, when the adjustment would reduce the carrying amount of the ROU asset to less than zero, the amount of the adjustment in excess of the carrying amount of the ROU asset should be recognized in profit or loss.

7.2.2 Finance lease

7.2.2.1 Costs associated with the lease

The lessee recognizes the following costs associated with a finance lease in each reporting period:

- *Amortization of the ROU asset*. The ROU asset should be amortized on a straight-line basis, unless there is another systematic basis that better represents the pattern in which the lessee expects to consume the ROU asset's future economic benefits. Under ASC 842, the right to control the use of the underlying asset is equivalent to physical use. Therefore, amortization of the ROU asset should not be affected by how much or when the lessee uses the underlying asset. The ROU asset's amortization period starts with the commencement date. If ownership of the underlying asset transfers to the lessee or if the lessee is reasonably certain to exercise an option to purchase the underlying asset, the amortization period spans the underlying asset's useful life. Otherwise, the amortization period spans the shorter of: (a) the lease term and (b) the useful life of the underlying asset. If the ROU asset is adjusted as a result of the lease liability being remeasured (see Section 7.2.1.1), amortization of the ROU asset is adjusted prospectively from the remeasurement date. If the ROU asset is adjusted as a result of an impairment (see Section 7.3), the amortization period for the post-impairment ROU asset starts with the impairment date and spans the shorter of: (a) the remaining lease term and (b) the remaining useful life of the ROU asset.
- *Interest costs*. The amount of interest costs recognized for the period is equal to the accretion of the lease liability (see Section 7.2.1).
- *Variable lease payments*. Variable lease payments that have not been included in lease payments because they depend on something other than an index or rate (see Section 5.5.3.3) are recognized in the period in which the obligation to make the payments is incurred. The obligation has been incurred in the period in which it becomes probable that the specified target that triggers the variable lease payments will be achieved. Once these variable lease payments have been recognized, they should only be reversed when it becomes probable that the specified target will not be achieved. Variable lease payments that depend on an index or rate are initially measured and included in lease payments by reference to the index or rate at the commencement date. In addition, any additional lease costs arising from changes in the index or rate are recognized in the period those costs are incurred (see Section 5.5.3.2).
- *Impairment of the ROU asset.* Any impairment of the ROU asset is recognized during the period in accordance with ASC 360-10-35 (see Section 7.3).

These costs are included in net income for the period unless they are capitalized in accordance with other applicable U.S. GAAP. For example, if the lease costs relate to equipment being used in the construction of a building (e.g., a crane), it may be appropriate to capitalize some or all of those costs as part of the cost of the building, depending on the facts and circumstances. Additional information about the presentation of these costs on the income statement is provided in Section 9.2.

7.2.2.2 ROU asset

The net carrying amount of the ROU asset refers to the gross amount of the ROU asset less accumulated amortization and accumulated impairment losses (if any). The net carrying amount of the ROU asset at the end of any given period in which lease payments are not remeasured is based on the following:

Determination of ending balance of net ROU asset when lease payments are not remeasured	
	Beginning balance of the net ROU asset
–	Amortization of the ROU asset for the period
–	Impairment losses recognized during the period (if any)
=	Ending balance of the net ROU asset

The net carrying amount of the ROU asset at the end of any given period in which lease payments are remeasured is based on the following:

Determination of ending balance of net ROU asset when lease payments are remeasured	
	Beginning balance of the net ROU asset
–	Amortization of the ROU asset for the period
+/–	Remeasurement adjustment (see Section 7.2.1.1)
–	Impairment losses recognized during the period (if any)
=	Ending balance of the net ROU asset

7.2.3 Operating lease

7.2.3.1 Lease costs

Costs recognized in any given period for an operating lease include the following:

- *Single lease cost*. Determination of the single lease cost for an operating lease in any given period depends on whether the ROU asset was impaired in a prior period (see Section 7.3).
  - *No ROU asset impairment recognized in a prior period*. When the ROU asset has not been impaired, the single lease cost for a period is based on amortizing the remaining lease costs over the remaining lease term on a straight-line basis (or another systematic basis that better represents the pattern of benefit to be derived from the right to use the underlying asset). Because the right to control the use of the underlying asset is equivalent to physical use, amortization of the remaining lease costs should not be affected by how much or when the lessee uses the underlying asset. Remaining lease costs and the single lease cost for the period are determined as follows when the remaining lease costs are amortized on a straight-line basis over the lease term:

Determination of remaining lease costs and single lease cost for the period	
	Total lease payments (paid and unpaid) (see Section 5.5) (as adjusted for the remeasurement of lease payments [see Section 5.5.13] or a lease modification not accounted for as a separate contract [see Section 7.2.5.1])
+	Initial direct costs of the lease (see Section 7.1.3.1)
–	Periodic lease costs recognized in prior periods
=	Remaining lease costs
÷	Remaining lease term
=	Single lease cost for the period

    When the straight-line amortization method is used to recognize remaining lease costs, if there are no lease modifications and no remeasurements of lease payments over the lease term, the single lease cost is the same in each period and is calculated by taking total lease costs (total lease payments [paid and unpaid] plus initial direct costs of the lease) and dividing it by the lease term.
  - *ROU asset impairment recognized in a prior period*. The single lease cost for a period is the sum of the following: (a) periodic amortization of the remaining ROU asset over the shorter of the remaining lease term and the ROU asset's remaining useful life on a straight-line basis or another systematic basis that better represents the pattern of benefit to be derived from the remaining ROU asset and (b) periodic accretion of the lease liability by an amount that produces a constant periodic discount rate on the liability's remaining balance (see Section 7.1.2). The sum of the two amounts is considered the single lease cost for the period. If none of the single lease cost should

be capitalized, the single lease cost is included as one amount in the income statement (see Section 9.2) and not split between amortization expense and interest expense.

- *Variable lease payments*. Variable lease payments that have not been included in lease payments because they depend on something other than an index or rate (see Section 5.5.3.3) are included in the lease costs for a period if the obligation to make the payments is incurred in that period. The obligation has been incurred when it becomes probable that the specified target that triggers the variable lease payments will be achieved. Once these variable lease payments have been recognized, they should only be reversed when it becomes probable that the specified target will not be achieved. Variable lease payments that depend on an index or rate are initially measured and included in lease payments by reference to the index or rate at the commencement date. In addition, any additional lease costs arising from subsequent changes in the index or rate are recognized in the period those costs are incurred (see Section 5.5.3.2).
- *Impairment of the ROU asset.* Any impairment of the ROU asset is recognized during the period in accordance with ASC 360-10-35 (see Section 7.3).

Lease costs (i.e., single lease costs and variable lease costs) are included in the income statement unless they are capitalized in accordance with other applicable U.S. GAAP. For example, lease costs related to equipment being used in the construction of a building (e.g., a crane) may be capitalized as part of the cost of the building depending on the facts and circumstances. Additional information about the presentation of these costs in the income statement is provided in Section 9.2.

7.2.3.2 ROU asset

At the end of each period, the balance of the ROU asset should equal the following when the straight-line amortization method is used to recognize remaining lease costs and the ROU asset was not impaired in a prior period:

Determination of ending balance of ROU asset when not impaired in a prior period	
	Balance of the lease liability
+/–	Plus prepaid lease payments or minus accrued lease payments (see next table)
–	Unamortized lease incentives (i.e., the portion of lease incentives not recognized as part of the single lease cost in the current or prior periods)
+	Unamortized initial direct costs (i.e., the portion of initial direct costs not recognized as part of the single lease cost in the current or prior periods)
–	Impairment of the ROU asset recognized in the current period (if any)
=	ROU asset at the end of the period

Calculation of ending balance of prepaid or accrued lease payments	
	Total lease payments to be paid to the lessor that will be reflected in the single lease cost over the lease term
x	Fraction of lease term that has passed by the end of the period (assuming the straight-line amortization method is used to recognize remaining lease costs)
=	Cumulative amount of total lease payments to be paid to the lessor that have been reflected in the single lease cost through the end of the period
–	Cumulative lease payments paid to the lessor through the end of the period
=	Ending balance in prepaid (negative amount) or accrued (positive amount) lease payments

When there has not been an impairment of the ROU asset in the current or prior periods and there has not been a remeasurement of the lease liability during the current period (see Section 7.2.1.1), the amortization of the ROU asset (i.e., net decrease in the ROU asset) should be equal to the difference between the single lease cost for the period (see Section 7.2.3.1) and the accretion of the lease liability (see Section 7.2.1).

Any remeasurement of the lease liability during the current period is incorporated into the ROU asset by the determination of the ending balance in the ROU asset starting with the ending balance in the lease liability. However, as discussed further in Section 7.2.1.1, a remeasurement of the lease liability should not result in a negative ROU asset.

If the ROU asset was impaired in a prior period, the balance of the ROU asset at the end of each subsequent period should equal (a) its carrying amount immediately after recognition of the impairment less (b) the cumulative amortization of the remaining ROU asset included in the single lease cost recognized in periods since the impairment was recognized.

Example 7-2: Illustration and comparison of finance and operating lease accounting

Lessee (a private company) and Lessor entered into a lease on January 1, 20X6. The terms of the lease and other facts pertinent to the accounting for the lease include the following:

- The underlying asset is a large piece of specifically identified industrial equipment.
- Lessor makes the equipment available to Lessee for its use on January 1, 20X6.
- Lessee has the right to use the equipment for a noncancellable term of three years. There are no extension, termination or purchase options.
- Fixed lease payments in year one of the lease are $100,000 and increase by $5,000 per year over the noncancellable term.
- Lease payments are made annually in arrears.
- If use of the industrial equipment exceeds 3,500 hours in any year of the lease, Lessee must pay Lessor an additional $20,000 in that year. Lessee only exceeds the limit in the second year of the lease.
- Lessee paid a $5,000 bonus to its employee in connection with entering into the lease.
- Lessor paid a $20,000 lease incentive to Lessee on January 1, 20X6.
- Lessee cannot determine the rate implicit in the lease, and its incremental borrowing rate on January 1, 20X6 is 8%. Lessee does not elect the practical expedient to use the risk-free rate for the relevant asset class.
- The useful life of the equipment is more than three years.
- There are no remeasurement events, modifications or impairments over the lease term.

For illustration purposes, the analysis that follows in this example discusses the accounting for this lease as if it were classified as a finance lease, as well as if it were classified as an operating lease. In reality, Lessee would need to obtain additional information and evaluate the lease classification criteria to determine whether the lease should be classified as a finance lease or an operating lease. In other words, Lessee does not have a choice when it comes to the accounting model it should apply to this lease.

Initial accounting regardless of lease classification

Based on the annual lease payments in arrears of $100,000 for 20X6, $105,000 for 20X7 and $110,000 for 20X9, a lease term of three years and a discount rate of 8%, the present value of the annual lease payments not yet paid is $269,935. The beginning balance of the ROU asset is $254,935, calculated by starting with the beginning balance of the lease liability ($269,935), reducing it for the lease incentive paid on the commencement date ($20,000) and increasing it for the initial direct costs ($5,000 bonus to employee). Lessee records the following journal entry on January 1, 20X6, regardless of the lease's classification:

	Debit	Credit
ROU asset	$254,935	
Cash receipt (lease incentive)	20,000	
Lease liability		$269,935
Cash payment (bonus to employee)		5,000

Subsequent accounting for the lease liability

The balance in Lessee's lease liability over the lease term is the same, regardless of the lease's classification:

Lease liability	20X6	20X7	20X8
Beginning balance	$269,935	$191,530	$101,852
Plus accretion (beginning balance × 8%)	21,595	15,322	8,148
Minus lease payment	100,000	105,000	110,000
Ending balance	$191,530	$101,852	$ -

One of the differences between the accounting models for a finance lease and an operating lease is the characterization of the accretion of the lease liability. For a finance lease, the accretion is an interest cost. For an operating lease, it is part of the lease cost. This will become more apparent later in the example.

Subsequent accounting for the ROU asset when the lease is a finance lease

Under the finance lease accounting model, Lessee amortizes the ROU asset over the lease term of three years because it is shorter than the equipment's useful life. In addition, Lessee uses the straight-line method for amortization purposes because there is not another systematic basis that better represents the pattern in which Lessee expects to consume the ROU asset's future economic benefits. As a result, annual amortization of the ROU asset is $84,978 ($254,935 ÷ 3 years). The balance of Lessee's net ROU asset over the lease term when the lease is classified as a finance lease is determined as follows:

Net ROU asset	20X6	20X7	20X8
Beginning balance	$254,935	$169,957	$84,979
Minus amortization	84,978	84,978	84,979
Ending balance	$169,957	$84,979	$ -

Subsequent accounting for the ROU asset when the lease is an operating lease

Under the operating lease accounting model, Lessee first determines its total lease cost on an annual basis to calculate the adjustment to the ROU asset each period. Lessee determines that its total lease costs over the term of the lease are $300,000, which is the total lease payments of $315,000 ($100,000 for 20X6, $105,000 for 20X7 and $110,000 for 20X8) reduced by the $20,000 lease incentive and increased by the initial direct costs of $5,000. Lessee recognizes the total lease costs over the lease term of three years because it is shorter than the equipment's useful life. In addition, Lessee uses the straight-line method for purposes of recognizing the lease costs because there is not another systematic basis that better represents the pattern in which Lessee expects to derive benefit from the right to use the underlying asset. As a result, Lessee's annual lease costs are $100,000 per year

($300,000 ÷ 3 years). Because the lease liability has not been remeasured and the ROU asset has not been impaired, the amount of the annual lease cost that is reflected as amortization of the ROU asset is the difference between the annual lease cost and the accretion of the lease liability:

Net ROU asset	**20X6**	**20X7**	**20X8**
Beginning balance	$254,935	$176,530	$91,852
Minus amortization (Note 1)	78,405	84,678	91,852
Ending balance	$176,530	$91,852	$ -

Note 1: Calculated by taking the difference between the annual lease cost of $100,000 and the accretion of the lease liability each year, which is $21,595 in 20X6, $15,322 in 20X7 and $8,148 in 20X8.

The components of the ending balance of the net ROU asset are as follows:

Net ROU asset	**20X6**	**20X7**
Ending balance of the lease liability	$191,530	$101,852
Minus accrued lease payments (see next table)	5,000	5,000
Minus unamortized lease incentive ($20,000 × 2/3 in 20X6 and 1/3 in 20X7)	13,333	6,667
Plus unamortized initial direct costs ($5,000 × 2/3 in 20X6 and 1/3 in 20X7)	3,333	1,667
Ending balance	$176,530	$91,852

Calculation of accrued lease payments at year end	**20X6**	**20X7**
Total lease payments to be paid to Lessor that will be reflected in the single lease cost over the lease term ($100,000 in 20X6, $105,000 in 20X7 and $110,000 in 20X8)	$315,000	$315,000
Multiplied by: Fraction of the lease term that has passed by the end of the year	1/3	2/3
Cumulative amount of total lease payments to be paid to Lessor that have been reflected in the single lease cost through the end of the year	105,000	210,000
Less: Cumulative lease payments paid to Lessor through the end of the year	100,000	205,000
Accrued lease payments	$5,000	$5,000

Comparison of finance lease and operating lease accounting models

Based on the information provided in this example, the following represents the journal entries that Lessee would record each year after the initial recognition of the ROU asset and lease liability, depending on the classification of the lease:

	Finance lease		**Operating lease**	
20X6	**Debit**	**Credit**	**Debit**	**Credit**
Lease liability	$78,405		$78,405	
Amortization expense (Note 1)	84,978			
Interest expense (Note 1)	21,595			
Lease expense (Note 1)			100,000	
Cash		$100,000		$100,000
ROU asset		84,978		78,405

	Finance lease		Operating lease	
20X7	**Debit**	**Credit**	**Debit**	**Credit**
Lease liability	$89,678		$89,678	
Amortization expense (Note 1)	84,978			
Interest expense (Note 1)	15,322			
Lease expense (Notes 1 and 2)	20,000		120,000	
Cash (Note 2)		$125,000		$125,000
ROU asset		84,978		84,678
20X8				
Lease liability	$101,852		$101,852	
Amortization expense (Note 1)	84,979			
Interest expense (Note 1)	8,148			
Lease expense (Note 1)			100,000	
Cash		$110,000		$110,000
ROU asset		84,979		91,852

Note 1: Lessee includes these costs in net income for the period because they should not be capitalized in accordance with other applicable U.S. GAAP. With respect to the classification of these expenses on the income statement, refer to Section 9.2.
Note 2: Lessee is obligated to make an additional lease payment of $20,000 in the second year of the lease because it used the equipment over 3,500 hours. Lessee recognizes the variable lease payment as lease expense regardless of the lease's classification.

The following table compares the balance of the net ROU asset and the income statement effects for each year under the finance lease and operating lease accounting models:

	Finance	Operating
Net ROU asset:		
20X6	$169,957	$176,530
20X7	84,979	91,852
20X8	-	-
Income statement effects:		
20X6	$106,573	$100,000
20X7	120,300	120,000
20X8	93,127	100,000
Total	$320,000	$320,000

This example illustrates one of the primary differences between the finance lease and operating lease accounting models in that the income statement effects of a finance lease are typically greater than those of an operating lease early in the lease term, with the opposite being true later in the lease term.

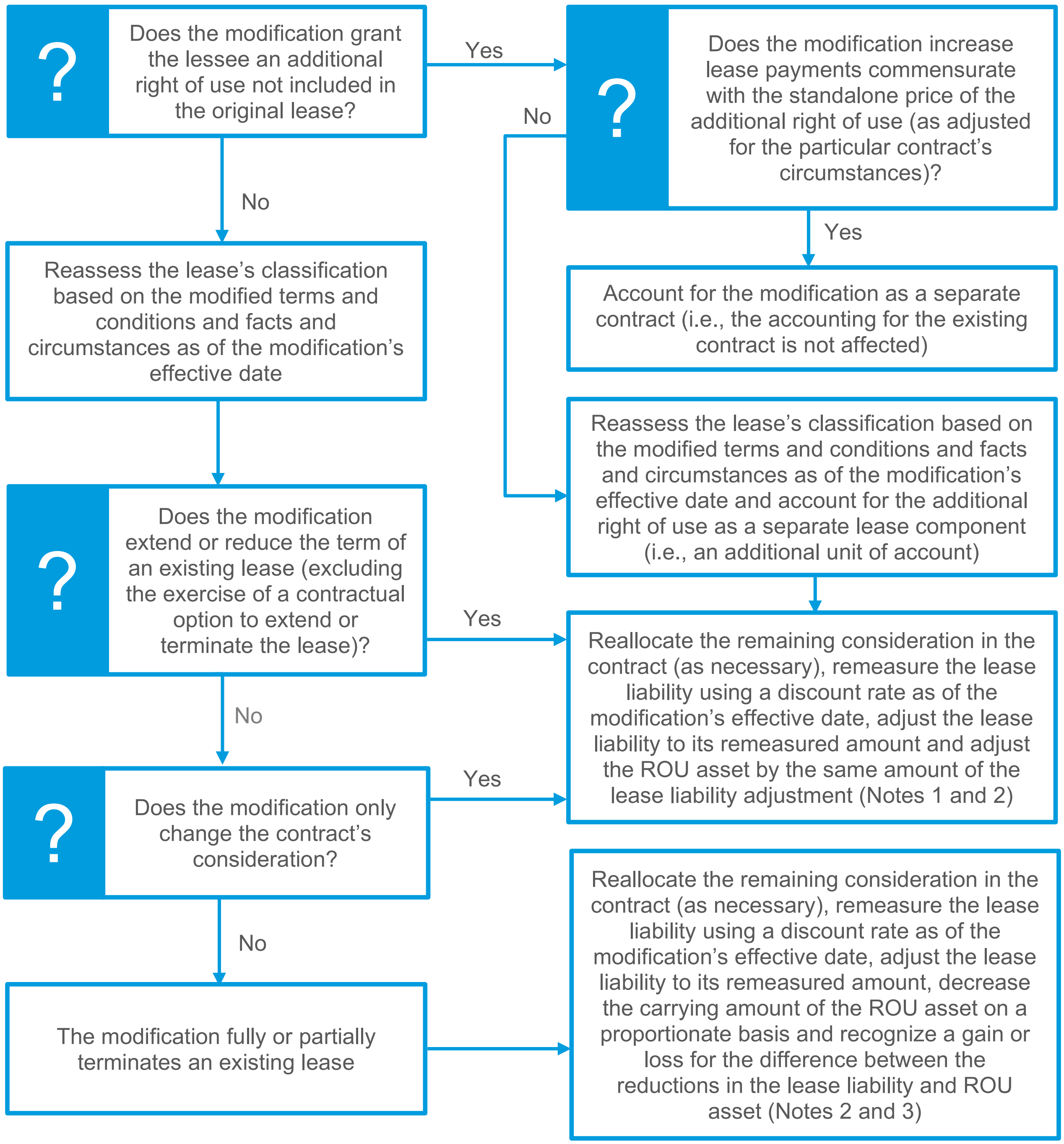
7.2.4 Amortization of leasehold improvements

In any of the following circumstances, the amortization period for leasehold improvements should be their useful life: (a) ownership of the underlying asset transfers to the lessee, (b) the lessee is reasonably certain to exercise an option to purchase the underlying asset or (c) the useful life of the leasehold improvements is shorter than the remaining lease term. Otherwise, the amortization period for those improvements is the remaining lease term. Information about the amortization period used for leasehold improvements acquired in a business combination is provided in Section 7.7.6.

7.2.5 Lease modifications

7.2.5.1 Determining factors and accounting consequences

Changes to a lease that are considered modifications for accounting purposes are those that change the lease's scope or consideration. The numerous factors considered in determining how to account for modifications to an existing lease, as well as the various accounting consequences for different types of modifications, are captured in the flowchart on the next page.



Note 1: When a new separate lease component results from the modification, the related lease liability should be measured using the appropriate discount rate as of the commencement date for that lease component.

Note 2: If the modification results in reclassifying a lease from finance to operating, any difference between the adjusted carrying amount of the ROU asset and the carrying amount that would result from applying the initial measurement guidance for a ROU asset in an operating lease (ASC 842-20-30-5) to the modified lease should be accounted for similar to a rent prepayment or a lease incentive.

Note 3: Example 18 in ASC 842-10-55-177 to 55-185 illustrates two acceptable approaches that could be used to remeasure the ROU asset. One is based on the proportionate change in the lease liability and the other is based on the proportionate change in the remaining right of use.

Example 7-3: Lease is modified to extend the lease term and lease classification does not change

[Note: This example is built off the facts of *Case A—No Change in Lease Classification* in *Example 16—Modification That Increases the Lease Term* from ASC 842-10-55-162 to 55-165.]

Pre-modification facts

Lessee (a private company) and Lessor enter into a lease on January 1, 20X6. The lease provides Lessee with the exclusive right to use the entire fourth floor of a building (which is 10,000 square feet of office space). The terms of the lease and other information pertinent to the accounting for the lease are as follows:

- The lease term is January 1, 20X6 through December 31, 20Y5.
- The remaining economic life of the building is 50 years.
- Annual payments of $100,000 are made in arrears on December 31 of each year.
- Lessee cannot determine the rate implicit in the lease, and its incremental borrowing rate on January 1, 20X6 is 6%. Lessee does not elect the practical expedient to use the risk-free rate for the relevant asset class.
- The lease does not include any of the following: (a) an option to purchase the underlying asset or extend or terminate the lease, (b) a residual value guarantee, (c) variable lease payments, (d) lease incentives or (e) nonlease components.
- The fair value of the office space is $1.5 million.

For ease of illustration, Lessee did not incur any initial direct costs related to the lease.

Lessee and Lessor agree to modify the lease on January 1, 20Y1.

Pre-modification analysis

Lessee determines its lease should be accounted for as an operating lease because:

- Ownership of the office space does not transfer to Lessee.
- The lease does not include a purchase option.
- The lease term of 10 years does not make up a major part of the remaining economic life of the building (i.e., 50 years).
- The sum of the present value of the lease payments ($100,000 annually in arrears for 10 years discounted at 6% equals $736,009) does not equal or exceed substantially all of the fair value of the office space ($1.5 million).
- The office space is not of a specialized nature.

Lessee recognizes a lease liability and ROU asset for $736,009. The ROU asset is measured at the same amount as the lease liability because Lessee did not: (a) make any lease payments, or receive any lease incentives, on or before January 1, 20X6 or (b) incur any initial direct costs related to the lease. Lessee records the following journal entry on January 1, 20X6:

	Debit	Credit
ROU asset	$736,009	
Lease liability		$736,009

The balance in Lessee's lease liability at the end of each year leading up to the modification on January 1, 20Y1, is as follows:

Lease liability	20X6	20X7	20X8	20X9	20Y0
Beginning balance	$736,009	$680,169	$620,979	$558,238	$491,732
Plus accretion (beginning balance × 6%)	44,160	40,810	37,259	33,494	29,504
Minus lease payment	100,000	100,000	100,000	100,000	100,000
Ending balance	$680,169	$620,979	$558,238	$491,732	$421,236

Lessee determines its total lease costs on an annual basis and uses that amount to calculate the adjustment to the ROU asset each period. Lessee determines that its total lease costs over the term of the lease are $1 million ($100,000 annual lease payment × 10-year lease term). Lessee recognizes the total lease costs over the lease term of 10 years because the lease term is shorter than the useful life of the office space. In addition, Lessee amortizes the total lease costs over the lease term on a straight-line basis because there is not another systematic and rational basis that better represents the pattern in which Lessee expects to derive benefits from the right to use the office space. As a result, Lessee's annual lease costs are $100,000 per year. The amount of the annual lease cost that is reflected as amortization of the ROU asset is the difference between the annual lease cost and the accretion of the lease liability.

Because the annual lease cost ($100,000) is the same as the annual lease payment ($100,000) and Lessee did not incur any initial direct costs or receive any lease incentives related to the lease or recognize any impairment on the ROU asset: (a) the amortization of the ROU asset is the same as the net change in the lease liability and (b) the ending balance in the net ROU asset is the same as the ending balance in the lease liability. These outcomes will continue to be the case over the lease term provided there are no impairments to the ROU asset and no lease modifications.

Modification facts

Lessee and Lessor agree to modify the lease on January 1, 20Y1. The changes made to the terms of the lease and other information pertinent to the accounting for the lease modification are as follows:

- The lease term is extended to December 31, 20Z0.
- Annual lease payments are increased from $100,000 to $110,000 on a prospective basis.
- Lessee cannot determine the rate implicit in the lease, and its incremental borrowing rate on January 1, 20Y1 is 7%.
- The remaining economic life of the building is 45 years.
- The fair value of the office space is $1.7 million.

For ease of illustration, Lessee did not incur any initial direct costs related to the lease modification, nor did Lessee receive any lease incentives.

Modification analysis

The modification extends the term of the existing lease for an additional five years and increases the annual lease payments by $10,000. The modification does not: (a) grant Lessee an additional right of use that was not included in the original lease, (b) *only* change the contract consideration (e.g., lease payments) or (c) fully or partially terminate the existing lease. As a result, Lessee accounts for the modification by:

- Reassessing the lease's classification based on the modified terms and conditions and facts and circumstances on the modification date

- Remeasuring the lease liability using its incremental borrowing rate as of the modification date
- Adjusting the lease liability and ROU asset by the appropriate amount (which depends, in part, on the classification of the modified lease)

Lessee concludes the modified lease should be classified as an operating lease because:

- Ownership of the office space does not transfer to Lessee.
- The lease does not include a purchase option.
- The lease term of 10 years does not make up a major part of the remaining economic life of the building (i.e., 45 years).
- The sum of the present value of the lease payments ($110,000 paid annually in arrears for 10 years discounted at 7% equals $772,594) does not equal or exceed substantially all of the fair value of the office space ($1.7 million).
- The office space is not of a specialized nature.

Lessee adjusts the lease liability to $772,594 from its carrying amount right before the modification of $421,236. The same adjustment is made to the ROU asset because the modified lease continues to be classified as an operating lease. As a result, Lessee records the following journal entry on January 1, 20Y1:

	Debit	**Credit**
ROU asset	$351,358	
Lease liability ($772,594 – $421,236)		$351,358

The following table calculates the balance in Lessee's lease liability at the end of each year through the end of the modified lease term, provided there are no further modifications made to the lease:

Lease liability	**20Y1**	**20Y2**	**20Y3**	**20Y4**	**20Y5**
Beginning balance	$421,236	$716,676	$656,843	$592,822	$524,320
Plus modification adjustment	351,358	-	-	-	-
Adjusted beginning balance	772,594	716,676	656,843	592,822	524,320
Plus accretion (adjusted beginning balance × 7%)	54,082	50,167	45,979	41,498	36,702
Minus lease payment	110,000	110,000	110,000	110,000	110,000
Ending balance	$716,676	$656,843	$592,822	$524,320	$451,022
	20Y6	**20Y7**	**20Y8**	**20Y9**	**20Z0**
Beginning balance	$451,022	$372,594	$288,675	$198,882	$102,804
Plus accretion (beginning balance × 7%)	31,572	26,081	20,207	13,922	7,196
Minus lease payment	110,000	110,000	110,000	110,000	110,000
Ending balance	$372,594	$288,675	$198,882	$102,804	$ -

Lessee determines its total lease costs on an annual basis and uses that amount to calculate the adjustment to the ROU asset each period. Lessee determines that its total lease costs over the term of the modified lease are $1.1 million ($110,000 annual lease payment × 10-year lease term). Lessee recognizes the total lease costs over the lease term of 10 years because the lease term is shorter than the useful life of the office space. In addition, Lessee amortizes the total lease costs over the lease term on a straight-line basis because there is not another systematic and rational basis that better represents the pattern in which Lessee expects to derive benefits from the right to use the office space. As a result, Lessee's annual lease costs are $110,000 per year ($1.1 million ÷ 10 years). The amount of the annual lease cost that is reflected as amortization of the ROU asset is the difference between the annual lease cost and the accretion of the lease liability.

Because the annual lease cost ($110,000) is the same as the annual lease payment ($110,000) and Lessee did not incur any initial direct costs or receive any lease incentives related to the original or modified lease or recognize any impairment on the ROU asset: (a) the amortization of the ROU asset is the same as the net change in the lease liability and (b) the ending balance in the net ROU asset is the same as the ending balance in the lease liability. These outcomes will continue to be the case over the lease term provided there are no impairments to the ROU asset and no further lease modifications.

Example 7-4: Lease is modified to extend the lease term and lease classification changes

[Note: This example is built off the facts of *Case B—Change in Lease Classification* in *Example 16—Modification That Increases the Lease Term* from ASC 842-10-55-166 to 55-167.]

Pre-modification facts

Assume the same pre-modification facts as in Example 7-3, except for the following:

- The underlying asset is a piece of equipment (instead of office space).
- The remaining economic life of the equipment is 17 years.
- The fair value of the equipment is $1 million.

Pre-modification analysis

Lessee determines its lease should be accounted for as an operating lease because:

- Ownership of the equipment does not transfer to Lessee.
- The lease does not include a purchase option.
- The lease term of 10 years does not make up a major part of the remaining economic life of the equipment (i.e., 17 years).
- The sum of the present value of the lease payments ($100,000 annually in arrears for 10 years discounted at 6% equals $736,009) does not equal or exceed substantially all of the fair value of the equipment ($1 million).
- The equipment is not of a specialized nature.

Given that the classification of the lease prior to the modification in this example is the same as the classification of the lease prior to the modification in Example 7-3, and the facts used in recognizing and measuring the ROU asset and lease liability in Example 7-3 were not changed for this example, the pre-modification accounting for the ROU asset and lease liability through the modification date of January 1, 20Y1 in this example is the same as the pre-modification accounting in Example 7-3.

Modification facts

Assume the same modification facts in Example 7-3, except that the underlying asset is a piece of equipment with a remaining economic life of 12 years and a fair value of $800,000.

Modification analysis

The modification extends the term of the existing lease for an additional five years and increases the annual lease payments by $10,000. The modification does not: (a) grant Lessee an additional right of use that was not included in the original lease, (b) *only* change the contract consideration (e.g., lease payments) or (c) fully or partially terminate the existing lease. As a result, Lessee accounts for the modification by:

- Reassessing the lease's classification based on the modified terms and conditions and facts and circumstances on the modification date
- Remeasuring the lease liability using its incremental borrowing rate as of the modification date
- Adjusting the lease liability and ROU asset by the appropriate amount (which depends, in part, on the classification of the modified lease)

In reassessing the lease's classification, Lessee concludes the modified lease should be accounted for as a finance lease because: (a) the lease does not commence at or near the end of the equipment's economic life and (b) the lease term of 10 years makes up over 80% (i.e., a major part) of the remaining economic life of the equipment (12 years).

Lessee determines the lease liability on January 1, 20Y1 should be $772,594 ($110,000 paid annually in arrears for 10 years discounted at 7%). Lessee adjusts the lease liability to $772,594 from its carrying amount right before the modification of $421,236 (an increase of $351,358). If the same adjustment is made to the ROU asset, its adjusted carrying amount would be $772,594 ($421,236 carrying amount right before the modification plus the adjustment of $351,358). Because the modified lease is classified as a finance lease, Lessee needs to apply the initial measurement guidance for a ROU asset to the modified lease terms as of the modification date to determine whether the amount calculated in accordance with that guidance is different from $772,594. Applying the initial measurement guidance for a ROU asset to the modified lease terms as of the modification date results in an amount of $772,594 (i.e., the same amount as the lease liability) because: (a) there are no prepaid or accrued lease payments related to the lease, (b) Lessee did not receive any lease incentives in connection with the original or modified lease, (c) Lessee did not incur any initial direct costs related to the original or modified lease and (d) Lessee has not recorded any impairments related to the ROU asset. As a result, Lessee records the following journal entry on January 1, 20Y1:

	Debit	Credit
ROU asset	$351,358	
Lease liability		$351,358

The subsequent accounting for the adjusted lease liability is the same as Example 7-3 because the accounting for the lease liability does not depend on the classification of the lease.

The subsequent accounting for the adjusted ROU asset is different than that in Example 7-3 because the modified lease in this example is a finance lease, while the modified lease in Example 7-3 is an operating lease. Under the finance lease accounting model, Lessee amortizes the ROU asset over the lease term of 10 years because it is shorter than the equipment's useful life and the lease does not include a purchase option. In addition, Lessee amortizes the ROU asset on a straight-line basis because there is not another systematic basis that better represents the pattern in which Lessee expects to consume the ROU asset's future economic benefits. As a result, annual amortization of the ROU asset is $77,259 ($772,594 ÷ 10 years). The balance of Lessee's net ROU asset over the lease term provided there are no further modifications to the lease and no impairment of the ROU asset is determined as follows:

Net ROU asset	20Y1	20Y2	20Y3	20Y4	20Y5
Beginning balance	$421,236	$695,335	$618,075	$540,816	$463,556
Plus modification adjustment	351,358	-	-	-	-
Adjusted beginning balance	772,594	695,335	618,075	540,816	463,556
Minus amortization (Note 1)	77,259	77,260	77,259	77,260	77,259
Ending balance	$695,335	$618,075	$540,816	$463,556	$386,297

	20Y6	20Y7	20Y8	20Y9	20Z0
Beginning balance	$386,297	$309,037	$231,778	$154,518	$77,259
Minus amortization (Note 1)	77,260	77,259	77,260	77,259	77,259
Ending balance	$309,037	$231,778	$154,518	$77,259	$ -

Note 1: For rounding purposes, amortization in the odd years and in 20Z0 is reflected as $77,259 and amortization in the even years (except for 20Z0) is reflected as $77,260.

Total lease costs over the lease term provided there are no further modifications of the lease and no impairment of the ROU asset are:

Total lease costs	20Y1	20Y2	20Y3	20Y4	20Y5
Interest (Note 1)	$54,082	$50,167	$45,979	$41,498	$36,702
Amortization	77,259	77,260	77,259	77,260	77,259
Total (Note 2)	$131,341	$127,427	$123,238	$118,758	$113,961
	20Y6	**20Y7**	**20Y8**	**20Y9**	**20Z0**
Interest (Note 1)	$31,572	$26,081	$20,207	$13,922	$7,196
Amortization	77,260	77,259	77,260	77,259	77,259
Total (Note 2)	$108,832	$103,340	$97,467	$91,181	$84,455

Note 1: The interest is equal to the accretion of the liability, which is shown in the lease liability table for the modified lease in Example 7-3.
Note 2: Refer to Section 9.2 for information about the income statement classification of these lease costs.

Example 7-5: Lease is modified to add an additional right of use

[Note: This example is built off the facts of *Example 17—Modification That Grants an Additional Right to Use* from ASC 842-10-55-168 to 55-176.]

Pre-modification facts and analysis

Assume the same pre-modification facts and analysis as Example 7-3.

Modification facts

Lessee and Lessor agree to modify the lease on January 1, 20Y1. The changes made to the terms of the lease and other information pertinent to the accounting for the lease modification are as follows:

- Lessor provides Lessee with the exclusive right to use the entire fifth floor of the building (which is an additional 10,000 square feet of office space) for the period January 1, 20Y2 through December 31, 20Y5 (i.e., the last four years of the original lease term).
- Annual lease payments increase from $100,000 to $150,000 on January 1, 20Y2.
- Lessee cannot determine the rate implicit in the lease and its incremental borrowing rates on January 1, 20Y1 and 20Y2 are 7% and 7.5%, respectively.
- The remaining economic life of the building is 45 years on January 1, 20Y1 and 44 years on January 1, 20Y2.
- The fair value of the office space on the fourth floor is $1.7 million on January 1, 20Y1 and the fair value of the office space on the fifth floor is $1.75 million on January 1, 20Y2.

- The standalone prices of the rights to use the fourth floor and fifth floor on January 1, 20Y1 for a 10-year period is $100,000 per floor per year.

For ease of illustration, Lessee did not incur any initial direct costs related to the lease modification, nor did Lessee receive any lease incentives.

Modification analysis

The lease modification grants Lessee an additional right of use that was not included in the original lease. Lessee must determine whether the lease modification increased the lease payments commensurate with the standalone price of the additional right of use (as adjusted for the lease's particular circumstances). While lease payments increased by $50,000 per year (or 50%), the square feet of office space that Lessee has the right to use under the modified lease increased by 10,000 square feet (or 100%). In addition, while the standalone price of the additional right of use is $100,000 per year, the increase in annual lease payments is only $50,000. As a result, Lessee concludes: (a) the lease payments did not increase commensurate with the standalone price of the additional right of use and (b) the lack of correlation between the increase in the annual lease payments and the standalone price of the additional right of use cannot be attributed solely to the circumstances of the lease. As a result, Lessee does not account for the modification as a separate contract. Instead, Lessee accounts for the additional right of use as a separate lease component. To do so, Lessee accounts for the modification by:

- Allocating the remaining consideration in the lease to the two separate lease components (i.e., the fourth floor and fifth floor lease components) on the modification's effective date (i.e., January 1, 20Y1)
- Reassessing the fourth floor lease component's classification based on the modified terms and conditions and facts and circumstances on the modification's effective date
- Remeasuring the lease liability for the fourth floor lease component using the discount rate as of the modification's effective date
- Adjusting the lease liability and ROU asset for the fourth floor lease component by the appropriate amount (which depends, in part, on its classification)
- Measuring and recognizing the lease liability and ROU asset for the fifth floor lease component as of its commencement date (i.e., January 1, 20Y2)

Allocating the remaining consideration

Lessee determines that the remaining consideration in the modified lease is $700,000 (one annual payment of $100,000 in 20Y1 and four annual payments of $150,000 each in 20Y2 through 20Y5). Lessee allocates the $700,000 of remaining consideration between the fourth floor and fifth floor lease components using their relative standalone prices as follows:

	Fourth floor	**Fifth floor**
Standalone price on an annual basis	$100,000	$100,000
Lease term	5 years	4 years
Standalone price over the lease term	$500,000	$400,000
Total of standalone prices over the lease terms ($500,000 + $400,000)	$900,000	$900,000
Standalone price over the lease term relative to the total of standalone prices over the lease terms ($500,000 ÷ $900,000 and $400,000 ÷ $900,000)	55.5556%	44.4444%

	Fourth floor	Fifth floor
Remaining consideration allocated to each lease component ($700,000 × 55.5556% and $700,000 × 44.4444%)	$388,889	$311,111
Remaining consideration for each lease component on an annual basis ($388,889 ÷ 5 years and $311,111 ÷ 4 years)	$77,778	$77,778

Lease classification

Lessee concludes the fourth floor and fifth floor lease components should be classified as operating leases because:

- Ownership of the office space does not transfer to Lessee.
- The lease does not include a purchase option.
- Neither the fourth floor nor fifth floor lease component's lease term makes up a major part of the remaining economic life of the building.
  - On the modification date (January 1, 20Y1), the fourth floor lease component's lease term of five years does not make up a major part of the building's remaining economic life of 45 years.
  - On its commencement date (January 1, 20Y2), the fifth floor lease component's term of four years does not make up a major part of the building's remaining economic life of 44 years.
- The sum of the present value of the lease payments for the fourth floor and fifth floor lease components do not equal or exceed substantially all of the fair values of the fourth floor and fifth floor office space, respectively.
  - On the modification date, the sum of the present value of the fourth floor lease component's lease payments is $318,904 ($77,778 allocated consideration on an annual basis in arrears for five years discounted at 7%), which does not equal or exceed substantially all of the fair value of the fourth floor office space of $1.7 million.
  - On its commencement date, the sum of the present value of the fifth floor lease component's lease payments is $241,896. This amount is computed using annual payments in arrears of $72,222, which is the $77,778 allocated consideration on an annual basis less $5,556 of allocated prepaid rent on an annual basis ($22,222 of prepaid rent over the four-year lease term). Prepaid rent of $22,222 results from the difference between the $100,000 lease payment made on December 31, 20Y1 and the $77,778 of that payment that is allocated to the fourth floor lease component for accounting purposes. Using annual payments in arrears of $72,222 for four years discounted at 7.5% results in the sum of the present value of the fifth floor lease component's lease payments equaling $241,896, which does not equal or exceed substantially all of the fair value of the fifth floor office space of $1.75 million.
- The office space is not of a specialized nature.

Accounting for fourth floor lease component

Lessee adjusts the lease liability for the fourth floor lease component to $318,904 from its carrying amount right before the modification of $421,236. The same adjustment is made to the ROU asset for the fourth floor lease component because that component continues to be classified as an operating lease. As a result, Lessee records the following journal entry on January 1, 20Y1 (the modification date):

	Debit	Credit
Lease liability (fourth floor) ($421,236 – $318,904)	$102,332	
ROU asset (fourth floor)		$102,332

The following table calculates the balance in Lessee's lease liability for the fourth floor lease component at the end of each year in the lease term, provided there are no further modifications to the lease:

Lease liability (fourth floor)	20Y1	20Y2	20Y3	20Y4	20Y5
Beginning balance	$421,236	$263,449	$204,112	$140,622	$72,688
Minus modification adjustment	102,332	-	-	-	-
Adjusted beginning balance	318,904	263,449	204,112	140,622	72,688
Plus accretion (adjusted beginning balance × 7%)	22,323	18,441	14,288	9,844	5,090
Minus lease payment	77,778	77,778	77,778	77,778	77,778
Ending balance	$263,449	$204,112	$140,622	$72,688	$ -

Lessee determines its total lease costs for the fourth floor lease component on an annual basis and uses that amount to calculate the adjustment to the ROU asset each period. Lessee determines that its total lease costs over the term of the modified lease are $388,889 ($77,778 allocated consideration on an annual basis × the 5-year lease term). Lessee recognizes the total lease costs over the lease term of 5 years because the lease term is shorter than the useful life of the office space. In addition, Lessee amortizes the total lease costs over the lease term on a straight-line basis because there is not another systematic and rational basis that better represents the pattern in which Lessee expects to derive benefits from the right to use the office space. As a result, Lessee's annual lease costs are $77,778 per year ($388,889 ÷ 5 years). The amount of the annual lease cost that is reflected as amortization of the ROU asset is the difference between the annual lease cost and the accretion of the lease liability. Because the annual lease cost ($77,778) is the same as the allocated consideration on an annual basis ($77,778), and Lessee did not incur any initial direct costs or receive any lease incentives related to the original or modified lease or recognize any impairment on the ROU asset: (a) the amortization of the ROU asset is the same as the net change in the lease liability and (b) the ending balance in the net ROU asset is the same as the ending balance in the lease liability. These outcomes will continue to be the case over the lease term provided there are no impairments to the ROU asset and no further lease modifications. Lessee records the following journal entry on January 1, 20Y1:

	Debit	Credit
Lease liability (fourth floor) ($77,778 – $22,323)	$55,455	
ROU asset (fifth floor) ($100,000 – $77,778)	22,222	
Lease costs (fourth floor) ($388,889 ÷ 5 years)	77,778	
Cash		$100,000
ROU asset ($77,778 – $22,323)		55,455

Accounting for the fifth floor lease component

On January 1, 20Y2 (the commencement date for the fifth floor lease component), Lessee recognizes the lease liability and ROU asset for the fifth floor lease component:

	Debit	Credit
ROU asset (fifth floor)	$241,896	
Lease liability (fifth floor)		$241,896

The following table calculates the balance in Lessee's lease liability for the fifth floor lease component at the end of each year in the lease term provided there are no further modifications to the lease:

Lease liability (fifth floor)	20Y1	20Y2	20Y3	20Y4	20Y5
Beginning balance	$ -	$241,896	$187,816	$129,680	$67,184
Plus accretion (beginning balance × 7.5%)	-	18,142	14,086	9,726	5,038
Minus lease payment	-	72,222	72,222	72,222	72,222
Ending balance	$ -	$187,816	$129,680	$67,184	$ -

Lessee determines its total lease costs on an annual basis and uses that amount to calculate the adjustment to the ROU asset each period. Lessee determines that its total lease costs over the term of the fifth floor lease component are $311,112 ($77,778 allocated consideration on an annual basis × the 4-year lease term). Lessee recognizes total lease costs over the lease term of four years because the lease term is shorter than the useful life of the office space. In addition, Lessee amortizes the total lease costs on a straight-line basis over the four-year lease term because there is not another systematic and rational basis that better represents the pattern in which Lessee expects to derive benefits from the right to use the office space. As a result, Lessee's annual lease costs are $77,778 per year ($311,112 ÷ 4 years). The amount of the annual lease cost that is reflected as amortization of the ROU asset is the difference between the annual lease cost and the accretion of the lease liability. Lessee records the following journal entry on January 1, 20Y2:

	Debit	Credit
Lease liability (fourth floor) ($77,778 – $18,441)	$59,337	
Lease liability (fifth floor) ($72,222 – $18,142)	54,080	
Lease costs (fourth floor) ($388,889 ÷ 5 years)	77,778	
Lease costs (fifth floor) ($311,112 ÷ 4 years)	77,778	
Cash		$150,000
ROU asset (fourth floor) ($77,778 – $18,441)		59,337
ROU asset (fifth floor) ($77,778 – $18,142)		59,636

The following table shows the activity in Lessee's net ROU asset for the fifth floor lease component at the end of each year in the lease term provided there are no modifications to the lease and no impairments of the ROU asset:

Net ROU asset (fifth floor)	20Y1	20Y2	20Y3	20Y4	20Y5
Beginning balance	$ -	$22,222	$204,482	$140,790	$72,738
Recognition of prepaid rent on January 1, 20Y1	22,222	-	-	-	-
Recognition of ROU asset	-	241,896	-	-	-
Minus amortization (Note 1)	-	59,636	63,692	68,052	72,738
Ending balance	$22,222	$204,482	$140,790	$72,738	$ -

Note 1: The amortization is the difference between the annual lease cost of $77,778 and the annual accretion of the lease liability, except in 20Y5, which reflects the correction of a rounding error of $2.

The following table reconciles the ending balances in the fifth floor lease component's lease liability and ROU asset:

	20Y1	20Y2	20Y3	20Y4
Lease liability ending balance	$ -	$187,816	$129,680	$67,184
Plus unamortized prepaid rent (Note 1)	22,222	16,666	11,110	5,554
ROU asset ending balance	$22,222	$204,482	$140,790	$72,738

Note 1: These amounts are based on a beginning prepaid rent balance of $22,222 being amortized over the four-year lease term. As a result, the amount of unamortized prepaid rent remaining at the end of 20Y2, 20Y3 and

20Y4 represents three-fourths, two-fourths and one-fourth of the beginning prepaid rent balance (with adjustments in some cases to correct for rounding errors), respectively.

7.2.5.2 Modifications resulting from the refund of tax-exempt debt

Consider a situation in which a lessor has a lease that serves as collateral for tax-exempt debt. The timing and amounts of the debt service payments and the lease payments are similar, resulting in the lease payments serving as a guarantee of the debt service payments. If the lease is modified as a result of the lessor refunding the tax-exempt debt (including an advance refunding), the lessee should account for that modification using the same guidance it would use to account for any other modification.

7.2.5.3 Master lease agreements

The accounting for additional rights to use identified underlying assets obtained under master lease agreements (including when obtaining such rights should be accounted for as a modification under ASC 842) is discussed in Section 4.2.1. If obtaining an additional right to use an identified underlying asset under a master lease agreement should be accounted for as a modification, the lessee should consider the accounting implications of the modification on the accounting for each of the rights to use an identified asset already obtained by the lessee under the master lease agreement.

7.2.5.4 Initial direct costs, lease incentives and other payments

Initial direct costs, lease incentives and other amounts paid or received by the lessee in connection with a lease modification should be accounted for in the same way they would be accounted for if they were paid or received in connection with a new lease.

7.2.5.5 Modifications due to reference rate reform

The London Interbank Offered Rate (LIBOR) originally was expected to be eliminated in 2021. However, that timing has changed such that the more common LIBOR tenors (e.g., three month and six month) are not expected to be eliminated until June 2023. The elimination of LIBOR and the expected elimination of other reference rates is referred to as reference rate reform, which will affect leases, as well as many other contracts and transactions, that reference LIBOR or another reference rate that is expected to be discontinued. In the U.S., the Secured Overnight Financing Rate (SOFR) has been recommended as the alternative to LIBOR by the Alternative Reference Rates Committee of the Federal Reserve Board.

The FASB issued ASU 2020-04, which created ASC 848, to provide temporary optional expedients and exceptions to the guidance in U.S. GAAP otherwise applicable to lease and other contract modifications, hedge accounting and other transactions to ease the expected burden on financial reporting related to reference rate reform. One of the temporary optional expedients in ASC 848 may be applied instead of the otherwise applicable guidance on lease modifications discussed in Sections 7.2.5.1 to 7.2.5.4 in certain circumstances involving lease modifications to replace LIBOR (or another reference rate that is expected to be discontinued). The expedient is available if the lease references a rate that is expected to be discontinued due to reference rate reform (e.g., LIBOR), and the terms that are modified directly change, or have the potential to change, a reference rate that is expected to be replaced or discontinued due to reference rate reform. In addition, ASC 848-20-15-2(a) also indicates the following: “If other terms are contemporaneously modified in a manner that changes, or has the potential to change, the amount or timing of contractual cash flows, the guidance in this Subtopic shall apply only if those modifications are related to the replacement of a reference rate.” ASC 848-20-15-3 further indicates that the expedient is not available “if contract modifications are made contemporaneously to terms that are unrelated to the replacement of a reference rate.” For example, if a lease is changed to replace LIBOR with SOFR *and* to extend the lease term, the temporary optional expedient cannot be elected by the lessee to account for the changes.

When an entity appropriately elects the optional expedient applicable to lease modifications, it would continue its existing accounting for the contract with no reassessments or remeasurements required. The change in the reference rate would be accounted for as a variable lease payment that is not reflected in the calculation of the lease liability, and instead is recognized in income when the related obligation is incurred. An entity that appropriately elects the practical expedient must do so for all lease modifications within the scope of ASC 848-20-15-2 and 15-3.

The lease modification practical expedient is not available for lease modifications that occur after December 31, 2022. However, the FASB recently proposed extending the availability of the practical expedient through December 31, 2024. Refer to the FASB website for information about the status of this proposal.

Additional information about ASC 848 and the practical expedient available for certain lease modifications is provided in our white paper, Optional accounting expedients can make LIBOR transition easier.

7.2.5.6 Lease concessions granted as a result of the COVID-19 pandemic

A number of lessees experienced reduced cash flow as a result of the COVID-19 pandemic. Many lessors provided economic relief in the form of lease concessions to their lessees, either voluntarily or as a result of contractual obligations. The FASB staff Q&A, *Topic 842 and Topic 840: Accounting for Lease Concessions Related to the Effects of the COVID-19 Pandemic*, addresses whether lease concessions granted by lessors as a result of the COVID-19 pandemic were required to be accounted for in accordance with the lease modification guidance in ASC 840 or ASC 842 (as applicable). The discussion in this section is focused on the ASC 842 guidance provided in the FASB staff Q&A.

The FASB staff guidance indicates that lessees may elect to not apply the modification accounting guidance in ASC 842 to lease concessions granted as a result of the COVID-19 pandemic, thereby eliminating the need to determine whether the terms of the lease explicitly provide for the possibility of such concessions. This election is only permitted if the lease concessions result in the lease's total cash flows being substantially the same as or less than the lease's total cash flows prior to the concessions.

When a lessee elects to not apply the modification accounting guidance in ASC 842 to lease concessions resulting from the COVID-19 pandemic, the accounting applied to the concessions depends on whether they only affect the timing of the payments (i.e., the concessions only defer payments without making any substantive changes to the total lease payments). When only the timing of payments is affected by the lease concessions, the FASB staff acknowledges that multiple accounting methods may be applied in practice, none of which it believes would be preferable to the others. The two specific accounting methods discussed by the FASB staff would result in the deferred payments resulting from the lease concessions being accounted for as either:

- Increases to lessees' payables as the payables accrue (Under this method, lessees continue to recognize expense as they otherwise would. This method accounts for the concessions as if no changes were made to the lease.)
- Variable lease payments

When a lessee elects to not apply the modification accounting guidance in ASC 842 to lease concessions resulting from the COVID-19 pandemic, and more than just the timing of the payments is affected by the concessions, the accounting for the concessions depends on the facts and circumstances. For example, if a lease concession results in a lease payment being forgiven or waived, it should be accounted for as a variable lease payment.

When a lessee decides to apply (rather than elect out of) the modification accounting guidance in ASC 842 to lease concessions resulting from the COVID-19 pandemic, if the terms of the lease explicitly provide for the possibility of lease concessions resulting from the COVID-19 pandemic, the concessions are accounted for as variable lease payments. If the terms of the lease do not provide for the possibility of such concessions, a lessee applies the modification guidance in ASC 842-10-25-8 to 25-14 to determine whether the lease concession should be accounted for as a separate contract or as a change to the existing contract.

Based on the FASB staff guidance, the election to not apply the modification accounting guidance in ASC 842 to lease concessions granted as a result of the COVID-19 pandemic should be made consistently for leases with similar characteristics and in similar circumstances. In other words, the election may be made on a portfolio-by-portfolio basis.

The FASB staff also indicated in their guidance that disclosures about material concessions and their accounting effects should be provided by lessees.

7.2.6 Lease termination

When a lease is terminated before the end of the lease term and the lessee does not purchase the underlying asset, the lessee should: (a) derecognize the ROU asset and lease liability and (b) recognize the difference between the ROU asset and lease liability in the income statement.

When a lessee terminates a lease before the end of the lease term by purchasing the underlying asset in other than a business combination, the asset should be adjusted for the difference between the underlying asset's purchase price and the lease liability's carrying amount at the time of purchase. ASC 805 should be used to account for the termination of a lease and the purchase of the underlying asset in connection with a business combination. Example 23 in ASC 842-10-55-211 to 55-217 and Example 24 in ASC 842-10-55-218 to 55-224 illustrate how a lessee should account for the purchase of a leased asset resulting from the lessee's exercise of a purchase option.

7.3 Impairment of ROU assets

The impairment models applicable to ROU assets are the same impairment models applicable to property, plant and equipment, which are included in ASC 360-10-35 and address: (a) long-lived assets to be held and used (held-and-used impairment model) and (b) long-lived assets to be abandoned (the abandonment model). Section 7.3.1 summarizes the held-and-used impairment model and also discusses issues that arise when applying that model to a unit of account that includes ROU assets. Section 7.3.2 summarizes the abandonment model and answers certain questions that arise when applying that model to ROU assets a lessee is committed to abandoning.

7.3.1 Impairment model for long-lived assets to be held and used

This section provides an overall summary of the held-and-used impairment model. Additional information about this model can be found in our white paper, Impairment testing of long-lived assets classified as held and used.

7.3.1.1 Unit of account

The unit of account for the held-and-used impairment model is an asset group. An asset group is defined in the Master Glossary of the ASC as "…the lowest level for which identifiable cash flows are largely independent of the cash flows of other groups of assets and liabilities." As noted in the definition, an asset group may include both assets *and liabilities*. While an asset group may include ROU assets and the related lease liabilities, how those lease liabilities affect the application of the held-and-used impairment model depends on the facts and circumstances (see Section 7.3.1.4).

An asset group rarely includes only a single long-lived asset because such an asset is typically not going to have "identifiable cash flows that are largely independent of the cash flows of other groups of assets and liabilities." Likewise, a ROU asset typically does not have "identifiable cash flows in and of itself that are largely independent of the cash flows of other groups of assets and liabilities." As a result, a ROU asset to be held and used is generally not evaluated for impairment on a standalone basis. That said, there may be limited situations in which the nature of the underlying asset could result in the ROU asset having largely independent identifiable cash flows, such as when the underlying asset is a power plant.

7.3.1.2 Frequency of impairment test

Under the held-and-used impairment model, an impairment test is only performed if certain triggers are present. Examples of these triggers include the following:

- The market price of a long-lived asset or asset group has significantly decreased.
- There are current and historical negative cash flows associated with a long-lived asset or asset group.
- The way in which the entity will use a long-lived asset or asset group has been affected by a significant adverse change.

For the decrease in the value of a (or a group of) ROU asset(s) to trigger an impairment test under the held-and-used impairment model, we believe the ROU asset(s) would likely have to represent a significant part of the related asset group's overall value.

7.3.1.3 Impairment models to apply before the held-and-used impairment model

Before an asset group is tested for impairment, any indefinite-lived intangible assets and certain other assets within the asset group (other than goodwill) should first be tested for impairment under the applicable impairment models. Examples of those certain other assets include accounts receivable, inventory and equity-method investments, all of which have their own impairment models. If application of the impairment models for the other assets in the asset group indicate that an impairment loss should be recognized, such loss is recognized before the asset group is tested under the held-and-used impairment model.

7.3.1.4 Applying the held-and-used impairment model

Under the held-and-used impairment model, there are two steps. The first step is referred to as the recoverability test, which involves comparing the carrying amount of the asset group to the undiscounted future expected cash flows of the asset group. If the carrying amount of the asset group is less than the undiscounted cash flows for the asset group, the lessee has passed the recoverability test and no impairment charge should be recognized. Conversely, if the carrying amount of the asset group is more than the undiscounted cash flows for the asset group, the lessee has failed the recoverability test and must move on to Step 2. It is important to note that the recoverability test should not be skipped in lieu of just performing Step 2 of the held-and-used impairment model. An entity may *not* recognize an impairment loss calculated in accordance with Step 2 if it passed the recoverability test.

Under Step 2 of the held-and-used impairment model, the lessee compares the carrying amount of the asset group to its fair value. For this purpose, fair value is determined in accordance with ASC 820. An asset group's undiscounted cash flows used in the recoverability test (i.e., Step 1) and fair value used in Step 2 will be different amounts. Undiscounted cash flows do not take the time value of money into consideration, whereas fair value does take the time value of money into consideration. In addition, undiscounted cash flows are estimated using an entity-specific perspective, while fair value is estimated using a market-participant perspective. When the carrying amount of the asset group is higher than its fair value, an impairment loss exists (see Section 7.3.1.5 for discussion of the amount of impairment loss that should be recognized). When the carrying amount of the asset group is lower than its fair value, an impairment loss does not exist.

Common questions that arise in applying the held-and-used impairment model to an asset group that includes ROU assets deal with how the related lease liabilities and cash flows should be treated in the model. We believe the answers to certain questions may depend on the classification of the lease, and if the lease is classified as an operating lease, which of two analogies the lessee elects as its accounting policy:

- *For finance leases and operating leases for which the lessee chooses to analogize to debt*, we believe the carrying amount of an asset group should not include the lease liabilities related to the ROU assets in that group and that the undiscounted cash flows used in the recoverability test for the asset group should not include the lease payments related to the ROU assets in that asset group. In addition, for fair value purposes, if the fair value of the asset group used in Step 2 of the held-and-used impairment model is determined using discounted cash flows, we believe the cash flows should not include the lease payments related to the ROU assets in that group, and if the fair value of the asset group used in Step 2 of the held-and-used impairment model is determined using a market approach, we believe the fair value of the asset group should be determined without giving effect to the fair value of the lease liabilities.
- *For operating leases for which the lessee chooses to analogize to an operating liability*, we believe the carrying amount of an asset group should include the lease liabilities related to the ROU assets in that group and that the undiscounted cash flows used in the recoverability test for the asset group should include the lease payments related to the ROU assets in that group (but reduced for the accretion of the lease liability). In addition, for fair value purposes, if the fair value of the asset group used in Step 2 of the held-and-used impairment model is determined using discounted cash flows, we believe the cash flows should include the total lease payments (both principal and interest) related to the ROU assets in that asset group, and if the fair value of the asset group used in Step 2 of the held-and-used impairment model is determined using a market approach, we believe the fair value of the asset group should give effect to the fair value of the lease liabilities.

To understand why the classification of a lease affects the answers to the questions posed, it is important to remember that debt is not included in the carrying amount of an asset group and debt-related payments (principal and interest) are not included in the undiscounted cash flows for the asset group used in the recoverability test. As a result, when answering the questions posed, we are essentially indicating whether a lease liability should or should not be treated in the same way as debt for purposes of applying the held-and-used impairment model. With that as a backdrop, the bases for the previous discussion are as follows:

- *Finance leases*. With respect to finance leases, the answers to the questions are consistent with the treatment of debt and with the treatment of capital lease obligations under ASC 840. We believe this is appropriate given the debt-like nature of a finance lease liability.
- *Operating leases: Debt analogy accounting policy*. This accounting policy is based on how an ARO is treated for purposes of the held-and-used impairment model (see ASC 360-10-35-18 to 35-19). An ARO is considered an operating liability instead of debt. However, unlike most other types of operating liabilities, an ARO is long-term and discounted, which is similar to debt. As a result, for purposes of applying the held-and-used impairment model, an ARO is not included in the carrying amount of an asset group, the payments to settle the ARO are not included in the undiscounted cash flows of the asset group used in the recoverability test and the fair value of the asset group should be unaffected by the existence of the ARO liabilities. Given that an operating lease liability is also a long-term discounted operating liability, we believe it would be appropriate for a lessee to elect an accounting policy under which an operating lease liability is treated the same way an ARO is treated for purposes of applying the held-and-used impairment model.
- *Operating leases: Operating liability analogy accounting policy.* Paragraph BC14 of ASU 2016-02 indicates that "Topic 842 characterizes operating lease liabilities as operating liabilities, rather than debt." Because of this, we believe it would be appropriate for a lessee to elect an accounting policy under which the operating lease liability is treated similar to other operating liabilities, such as accounts payable. Under this accounting policy, the operating lease liability is included in the carrying amount of an asset group, the portion of the payments that settle the operating lease liability (i.e., the lease payments reduced by the accretion of the lease liability) are included in the undiscounted cash

flows of the asset group and the fair value of the asset group should be affected by the existence of the lease liabilities.

While we believe a lessee has an accounting policy choice with respect to its treatment of operating lease liabilities and the related cash outflows in the held-and-used impairment model, we generally do not believe different answers will result depending on the accounting policy elected. In other words, if a lessee passes (or fails) the recoverability test under one accounting policy, we generally believe it will pass (or fail) the test under the other accounting policy. Similarly, we generally would not expect the amount of an impairment loss resulting from application of Step 2 in the held-and-used impairment model to be significantly different under one accounting policy compared to the other.

The accounting policy elected by the lessee with respect to its treatment of operating lease liabilities and the related cash outflows in the held-and-used impairment model should be consistently applied and appropriately disclosed.

Cash flows related to variable lease payments that were not included in the measurement of the lease liability (see Section 5.5.3) should be treated as follows in applying the held-and-used impairment model regardless of the lease's classification:

- Included in the undiscounted cash flows of the asset group used in the recoverability test
- Included in the discounted cash flows of the asset group when the fair value of the asset group used in Step 2 of the held-and-used impairment model is determined using a discounted cash flows method

To the extent an entity elects the short-term lease accounting policy (see Section 7.1.1), there is no ROU asset or lease liability to be included in the carrying amount of the asset group. However, payments under those leases should be included in the undiscounted cash flows used in the recoverability test. In addition, those payments should affect the fair value of the asset group used in Step 2 of the held-and-used impairment model.

7.3.1.5 Allocation and recognition of the impairment loss

The starting point for allocating and recognizing an impairment loss is the excess of an asset group's carrying amount over its fair value. This impairment loss is allocated to only the long-lived assets in the asset group (which includes the ROU assets in the asset group) on a pro rata basis using the relative carrying amounts of the assets. However, if the fair value of a long-lived asset is determinable without undue cost and effort, the carrying amount of that asset should not be reduced below its fair value. Any unallocated loss as a result of this limitation should be allocated to the other long-lived assets in the asset group on a pro rata basis using the relative adjusted carrying amounts of those assets. Given this limitation, it is possible that an amount less than the calculated impairment loss is actually recognized.

Unless doing so involves undue cost and effort, a lessee should determine the fair value of its ROU assets for purposes of determining whether there is a limit on the amount of the impairment loss that should be allocated to those assets. For this purpose, the fair value of the ROU assets should be unaffected by the related lease liabilities, regardless of the lease's classification. No part of an impairment loss is allocated to lease liabilities.

Example 7-6: Allocation of an impairment loss

Lessee applied the held-and-used impairment model to an asset group for which impairment triggers were present. The asset group failed the recoverability test, and application of Step 2 to the asset group identified an impairment loss of $2 million. There are four long-lived assets in the asset group (one of which is a ROU asset) to which this $2 million impairment loss should be allocated. The information needed to allocate the $2 million impairment loss and the allocation of that loss are as follows:

Long-lived asset to be held-and-used	Net carrying amount	Fair value	Pro rata allocation before limitation	Allocated impairment loss
A	$1,000,000	$750,000	10%	$200,000
B	2,000,000	1,500,000	20%	400,000
C	4,000,000	3,100,000	40%	800,000
ROU asset	3,000,000	2,500,000	30%	500,000
Total	$10,000,000		100%	$1,900,000

When initially allocating the impairment loss across all four long-lived assets in the asset group, the amount allocated to the ROU asset based on its relative carrying amount would have been $600,000 ($2,000,000 × 30%). However, allocating more than $500,000 of the impairment loss to the ROU asset would result in the carrying amount of the ROU asset being below its fair value, which the held-and-used impairment model prohibits when the fair value of an individual long-lived asset is known. As a result, only $500,000 of the impairment loss is allocated to the ROU asset, and the $100,000 of the impairment loss not allocated to the ROU asset due to the fair value limitation is reallocated to the other long-lived assets in the asset group based on their adjusted carrying amounts, provided doing so does not result in any of those assets having a carrying amount below their known fair value.

Long-lived asset to be held-and-used	Net carrying amount	Allocated impairment loss	Adjusted carrying amount	Pro rata allocation after limitation	Additional allocated impairment loss	Final allocated impairment loss
A	$1,000,000	$200,000	$800,000	14%	$14,000	$214,000
B	2,000,000	400,000	1,600,000	29%	29,000	429,000
C	4,000,000	800,000	3,200,000	57%	57,000	857,000
			$5,600,000	100%	$100,000	
ROU asset	3,000,000	500,000	$2,500,000			500,000
Total	$10,000,000	$1,900,000				$2,000,000

As a final check, Lessee determines that recognition of the final allocated impairment loss does not result in any of the long-lived assets having a carrying amount less than their fair value.

7.3.1.6 Subsequent accounting for a ROU asset that has been impaired

As discussed in Section 7.2.2 (for finance leases) and Section 7.2.3 (for operating leases), once a ROU asset has been impaired, the remaining balance in the ROU asset should be amortized over the shorter of the remaining lease term and the underlying asset's remaining useful life on a straight-line basis or another systematic basis that better represents the pattern of benefit to be derived from the remaining ROU asset. However, also as discussed in those sections, the characterization and presentation of that amortization on the income statement differs based on the classification of the lease.

7.3.2 Long-lived assets to be abandoned

A key date in the abandonment model is the date on which the entity decides to abandon the assets and is committed to a plan to do so (commitment date), which is typically some time before it actually abandons the assets. Another key date in the abandonment model is the date on which the entity ceases to use the asset (cease-use date). On that date, the entity accounts for the abandonment as a disposal.

Between the commitment date and the cease-use date, the entity accounts for the assets to be abandoned as assets that are being held and used. In addition, if the cease-use date is before what would otherwise have been the end of the asset's depreciable or amortizable life, the entity reduces the depreciable or amortizable life and accounts for that change in estimate in accordance with ASC 250-10-45-17 to 45-20. Under that guidance, when the depreciable or amortizable life of a long-lived asset is shortened, the remaining carrying amount of that asset is depreciated or amortized over the shortened depreciable or amortizable life.

Questions that arise in applying the abandonment model to ROU assets the lessee is committed to abandoning, include the following:

- *Does a lessee ceasing use of a ROU asset with a plan to sublease the underlying asset constitute abandonment?* No, provided the lessee has the intent and ability to sublease the underlying asset. When there is the intent and ability to sublease the underlying asset, the ROU asset related to the lease is subject to the held-and-used impairment model (see Section 7.5.1), even if a sublessee has not been identified. If both the intent and ability to sublease the underlying asset do not exist, the lessee should apply the abandonment model to the ROU asset. The accounting for subleases is discussed in Section 7.5.
- *Is the accounting for the asset group to which a ROU asset to be abandoned belongs affected by the expected abandonment of the ROU asset?* It depends. When a ROU asset is expected to be abandoned, the lessee should consider whether the reasons behind that expected abandonment constitute a triggering event that requires an impairment test to be performed on the asset group to which the ROU asset belongs as a whole.
- *Does the accounting for the lease liability related to a ROU asset change if the ROU asset is expected to be or is abandoned?* No. The accounting for a lease liability changes only when a remeasurement of the liability is otherwise required (see Section 7.2.1.1) or the lease is terminated (see Section 7.2.6).
- *How is a change in the amortizable life of a ROU asset to be abandoned reflected in the amortization recognized by the lessee between the commitment date and the cease-use date?* To the extent a ROU asset has not previously been reduced by an impairment loss, we believe it would be acceptable for a lessee to adopt either one of the following accounting policies when there is a change in the amortizable life of a ROU asset to be abandoned: (a) amortize the remaining balance in the ROU asset generally on a straight-line basis over its remaining amortizable life (which is most consistent with the subsequent accounting for a finance lease) or (b) amortize the remaining balance in the ROU asset in a manner that results in straight-line recognition of the remaining lease costs over the ROU asset's remaining amortizable life (which is most consistent with the subsequent accounting for an operating lease). For these purposes, the remaining amortizable life is the period from the commitment date to the cease-use date. The remaining amortizable life does not take into consideration a sublease period because, as discussed earlier, the ROU asset for a lease that the lessee has the intent and ability to enter into a sublease is not subject to the abandonment model (i.e., it is subject to the held-and-used impairment model [see Section 7.5.1]).
- *What if a lessee plans to abandon only a portion of a ROU asset?* Consider a situation in which a lessee leases the seventh through tenth floors in a building and decides to abandon the seventh floor at the end of three months. The lessee considers whether it has the intent and ability to sublease the seventh floor and concludes that it does not. In this situation, the lessee should first determine whether its decision to abandon the seventh floor constitutes an event that triggers the need to perform an impairment test on the asset group to which the related ROU asset belongs. In addition, if the lessee was accounting for the lease of all four floors as a single unit of account, it must consider

whether it did so because: (a) the rights to use each floor did not meet the criteria to be accounted for as separate lease components (Scenario A) or (b) the rights to use each floor met the criteria to be accounted for as separate lease components, but the lessee decided (explicitly or implicitly) to account for those separate lease components on a portfolio basis (Scenario B). In Scenario A, the ROU asset for the single lease component is not accounted for as an asset to be abandoned because only a nonseparable part of the ROU asset is being abandoned, not the ROU asset itself. In Scenario B, the ROU asset and lease liability for the portfolio of separate lease components should be separated, using a reasonable and supportable approach (such as a relative standalone prices approach), into a ROU asset and lease liability for the separate lease component for the seventh floor (i.e., the floor that is being abandoned), and either: (a) a ROU asset and lease liability for the portfolio of the separate lease components that are not being abandoned or (b) a ROU asset and lease liability for each separate lease component that is not being abandoned. The ROU asset for the separate lease component representing the seventh floor of the building should be accounted for as an asset to be abandoned. The ROU asset(s) for the other separate lease component(s) should continue to be accounted for using the subsequent accounting guidance in ASC 842.

- *Does temporarily ceasing use of an underlying asset constitute abandonment for accounting purposes?* In certain situations, a lessee might not have committed to a plan to abandon a ROU asset, but might temporarily idle the underlying asset (either willingly or unwillingly). We believe that the lessee should continue recognition of its operating lease costs in such situations. We believe that temporarily idling an asset should not be considered the same as abandoning the asset.

These questions and answers only address the basic accounting considerations involved when a lessee has decided to abandon a ROU asset in whole or in part. There are numerous facts and circumstances that can complicate this accounting. As such, when a lessee has decided to abandon a ROU asset in whole or in part, it should seek the assistance of subject matter experts on the topic.

Spotlight on change: Impairment and abandonment of an operating lease

While the impairment and abandonment models applied to capital leases under ASC 840 and finance leases under ASC 842 are the same (i.e., the long-lived asset impairment models in ASC 360-10-35), the same cannot be said for the impairment and abandonment models applied to operating leases under ASC 840 and ASC 842.

Prior to the effective date of ASC 842, lessees are subject to the guidance in ASC 420 with respect to accounting for the abandonment of an operating lease that is not part of a discontinued operation. Under ASC 420, a liability is recognized at the cease-use date for costs that a lessee would continue to incur under an abandoned operating lease over its remaining term, without receiving any corresponding economic benefit. This approach typically results in the recognition of a one-time expense on the cease-use date (which is only subsequently adjusted for changes in the estimated costs). The guidance in ASC 420 applicable to operating leases was superseded by ASU 2016-02. As a result, ASC 420 no longer applies to abandoned operating leases once a lessee adopts ASC 842.

Under ASC 842, ROU assets recognized for operating leases and finance leases are both subject to the held-and-used impairment model and the abandonment model in ASC 360-10-35. First, the lessee must consider whether there is a triggering event that would require the asset group to which a ROU asset belongs to be tested under the held-and-used impairment model. Once completing that analysis and accounting (if required), the lessee applies the abandonment model to a ROU asset when it expects to abandon the lease. Abandoning the lease means the lessee expects to cease using the underlying asset and does not have the intent or ability to sublease the underlying asset. Under the abandonment model, when the lessee commits to abandoning a lease (operating or finance), it accelerates recognition of the remaining lease costs between the commitment date and the cease-use date.

Two key differences between how an operating lease is treated from an impairment and abandonment perspective before and after adoption of ASC 842 include the following:

- *Unit of account*. Prior to the adoption of ASC 842, the unit of account for the impairment or abandonment of an operating lease is the individual operating lease itself. After the adoption of ASC 842, the unit of account for impairment is the asset group to which the related ROU asset belongs, and the unit of account for abandonment is the operating lease itself.
- *Timing of expense or loss recognition*. Prior to the adoption of ASC 842, a one-time expense is typically recognized on the cease-use date for an abandoned operating lease. After the adoption of ASC 842, there may be an impairment loss related to the asset group to which a ROU asset for an operating lease belongs (some of which would likely be allocated to the ROU asset). For this to be the case, a triggering event must be present and application of the held-and-used impairment model must give rise to an impairment loss. In addition, after the adoption of ASC 842, application of the abandonment model to an operating lease results in the recognition of the remaining single lease cost over the period from the commitment date to the cease-use date. Recognizing the remaining single lease cost over a shortened period under the abandonment model after the adoption of ASC 842 is significantly different compared to the recognition of a one-time expense on the cease-use date under ASC 420.

7.4 Leases denominated in a foreign currency

Lessees with operations in foreign countries should make sure to have procedures in place to ensure that all contracts entered into in those foreign countries that are or include leases are appropriately identified and accounted for in accordance with ASC 842.

For purposes of foreign currency translation, the ROU asset is a nonmonetary asset and the lease liability is a monetary liability. As such, when a lessee is required by ASC 830-10 to remeasure a lease liability and ROU asset denominated in a foreign currency into the lessee's functional currency, the lessee uses: (a) the current exchange rate at the end of the reporting period for the lease liability and (b) the exchange rate on the lease's commencement date for the ROU asset.

From an income statement perspective, the exchange rates used depend on the classification of the lease. For a finance lease, the lessee uses: (a) the commencement date exchange rate for the amortization cost and (b) the reporting date exchange rate for the interest cost. For an operating lease, the lessee uses: (a) the commencement date exchange rate for the amortization of the ROU asset for the period and (b) the reporting date exchange rate for the accretion of the lease liability for the period. A blended rate is used to translate the single lease costs for an operating lease because one component of those costs (the amortization of the ROU asset) was translated at the exchange rate used for the ROU asset and the other component of those costs (the accretion of the lease liability) was translated at the exchange rate used for the lease liability. If a blended rate were not used for the periodic single lease costs for an operating lease, an unnecessary balance would accumulate in the ROU asset at the end of the lease term.

Example 7-7: Foreign currency effects on lease accounting

Lessee is based in the U.S., but has operations in Germany. Lessee and Lessor entered into a lease in Germany on January 1, 20X6. The terms of the lease and other facts pertinent to the accounting for the lease include the following:

- Lessee's functional currency is the U.S. dollar.
- The lease is denominated in the local currency, which is Euros.
- The underlying asset is a large piece of specifically identified industrial equipment.

- Lessor makes the equipment available to Lessee for its use on January 1, 20X6.
- Lessee has the right to use the equipment for a noncancellable term of three years. There are no extension, termination or purchase options.
- Fixed annual lease payments under the lease are $25,000, $27,000 and $29,000.
- Lease payments are made in arrears.
- There are no variable lease payments, initial direct costs or lease incentives.
- Lessee's incremental borrowing rate is 8% (the rate implicit in the lease is not readily determinable). The rate was determined by considering the borrowing rate Lessee would be charged on collateralized debt in Germany with a term of three years with payments similar to the lease payments in timing and amount.
- The useful life of the equipment is more than three years.
- The exchange rate on January 1, 20X6: €1 equals $1.1463.
- The exchange rates at the end of each year in the lease term (which is also assumed to be the average for each year in the lease term for ease of illustration) are as follows:
  - 20X6: €1 equals 1.1627
  - 20X7: €1 equals 1.1092
  - 20X8: €1 equals 1.0865

To illustrate the accounting for the foreign currency effects of a finance lease and operating lease and how that accounting differs based on the lease's classification, the analysis that follows in this example discusses the accounting for this lease as if it were classified as a finance lease, as well as if it were classified as an operating lease. In reality, Lessee would need to obtain additional information and evaluate the lease classification criteria to determine whether the lease should be classified as a finance lease or an operating lease. Example 7-2 provides a side-by-side comparison of the accounting for a finance lease and an operating lease without the foreign currency effects.

Initial accounting regardless of lease classification

Based on the annual lease payments in arrears of €25,000 for 20X6, €27,000 for 20X7 and €29,000 for 20X8, a lease term of three years and a discount rate of 8%, the present value of the annual lease payments not yet paid is €69,318. The beginning balance of the ROU asset is also €69,318, because there are no adjustments needed to the beginning balance of the lease liability (the starting point for determining the beginning balance of the ROU asset) for items such as lease incentives or initial direct costs.

Subsequent accounting for a lease liability denominated in a local currency regardless of lease classification

The balance in Lessee's lease liability over the lease term is the same, regardless of the lease's classification. The liability is initially translated to Lessee's functional currency based on the exchange rate on the commencement date of the lease. The activity and ending balance in the lease liability for each year of the lease are translated based on the exchange rate at the end of each year. The following table shows the balances and activity in the lease liability in the local currency and Lessee's functional currency:

Lease liability	(A) Local currency	(B) Exchange rate	(A ÷ B) Functional currency
20X6			
Initial recognition	€69,318	$1.1463	$60,471
Payment	(25,000)	$1.1627	(21,501)
Interest	5,545	$1.1627	4,769
Foreign currency translation gain or (loss) (Note 1)			(853)
Ending balance	€49,863	$1.1627	$42,886
20X7			
Payment	(27,000)	1.1092	(24,342)
Interest	3,989	1.1092	3,596
Foreign currency translation gain or (loss) (Note 2)			2,068
Ending balance	€26,852	1.1092	$24,208
20X8			
Payment	(29,000)	1.0865	(26,691)
Interest	2,148	1.0865	1,977
Foreign currency translation gain or (loss) (Note 3)			506
Ending balance	€ -	1.0865	$ -

Note 1: Difference between the sum of the beginning balance, payment and interest measured in the functional currency ($60,471 - $21,501 + $4,769) and the ending balance measured in the functional currency ($42,886).
Note 2: Difference between the sum of the beginning balance, payment and interest measured in the functional currency ($42,886 - $24,342 + $3,596) and the ending balance measured in the functional currency ($24,208).
Note 3: Difference between the sum of the beginning balance, payment and interest measured in the functional currency ($24,208 - $26,691 + $1,977) and the ending balance measured in the functional currency ($0).

One of the differences between the accounting models for a finance lease and an operating lease is the characterization of the accretion of the lease liability. For a finance lease, the accretion is an interest cost. For an operating lease, it is part of the lease cost. This will become more apparent later in the example.

Subsequent accounting for ROU asset denominated in a local currency when the lease is a finance lease

Under the finance lease accounting model, Lessee amortizes the ROU asset over the lease term of three years because it is shorter than the equipment's useful life. In addition, Lessee uses the straight-line method for amortization purposes because there is not another systematic basis that better represents the pattern in which Lessee expects to consume the ROU asset's future economic benefits. As a result, annual amortization of the ROU asset in the local currency is €23,106 (€69,318 ÷ 3 years). The beginning and ending balance of the ROU asset and the related amortization are all translated from the local currency to the functional currency at the historical exchange rate on the lease's commencement date. The following table shows the balances and activity in the ROU asset in the local currency and Lessee's functional currency under the finance lease accounting model:

ROU asset	(A) Local currency	(B) Exchange rate	(A ÷ B) Functional currency
20X6			
Initial recognition	€69,318	$1.1463	$60,471
Amortization	(23,106)	1.1463	(20,157)
Ending balance	€46,212	1.1463	$40,314
20X7			
Amortization	(23,106)	1.1463	(20,157)
Ending balance	€23,106	1.1463	$20,157
20X8			
Amortization	(23,106)	1.1463	(20,157)
Ending balance	€ -	1.1463	$ -

The following journal entries illustrate the effects of accounting for the lease in Lessee's functional currency under the finance lease accounting model:

	20X6		20X7		20X8	
	Debit	Credit	Debit	Credit	Debit	Credit
Lease liability (Note 1)	$17,585		$18,678		$24,208	
Amortization expense	20,157		20,157		20,157	
Interest expense	4,769		3,596		1,977	
Foreign currency translation gain or loss		$853	2,068		506	
Cash		21,501		$24,342		$26,691
ROU asset		20,157		20,157		20,157

Note 1: Net debit activity in the lease liability account ($21,501 – $4,769 + $853 for 20X6; $24,342 – $3,596 – $2,068 for 20X7; and $26,691 – $1,977 – $506 for 20X8).

Subsequent accounting if lease is an operating lease

Under the operating lease accounting model, Lessee determines its total lease cost over the lease term to then calculate its annual lease cost on a straight-line basis. The annual lease cost is then used to calculate the amortization of the ROU asset each period. Lessee determines that its total lease costs over the term of the lease are €81,000, which are the total lease payments of €25,000 for 20X6, €27,000 for 20X7 and €29,000 for 20X8 (with no adjustments for initial direct costs or incentives given none exist in this situation). Lessee recognizes the total lease costs over the lease term of three years because it is shorter than the equipment's useful life. In addition, Lessee uses the straight-line method for purposes of recognizing the lease costs because there is not another systematic basis that better represents the pattern in which Lessee expects to derive benefit from the right to use the underlying asset. As a result, Lessee's annual lease costs are €27,000 per year (€81,000 ÷ 3 years). The amount of the annual lease cost that is reflected as amortization of the ROU asset is the difference between the annual lease cost and the accretion of the lease liability. The beginning and ending balance of the ROU asset and the related amortization are all translated from the local currency to the functional currency at the historical exchange rate on the lease's commencement date. The following table shows the balances and activity in the ROU asset in the local currency and Lessee's functional currency under the operating lease accounting model:

ROU asset	(A) Local currency	(B) Exchange rate	(A ÷ B) Functional currency
20X6			
Initial recognition	€69,318	$1.1463	$60,471
Amortization (€27,000 annual lease costs – €5,545 lease liability accretion)	(21,455)	1.1463	(18,717)
Ending balance	€47,863	1.1463	$41,754
20X7			
Amortization (€27,000 annual lease costs – €3,989 lease liability accretion)	(23,011)	1.1463	(20,074)
Ending balance	€24,852	1.1463	$21,680
20X8			
Amortization (€27,000 annual lease costs – €2,148 lease liability accretion)	(24,852)	1.1463	(21,680)
Ending balance	€ -	1.1463	$ -

The lease costs recognized in the income statement for an operating lease must be translated from the local currency to the functional currency using a blended rate given that one component of those costs (the amortization of the ROU asset) was translated at the exchange rate used for the ROU asset and the other component of those costs (the accretion of the lease liability) was translated at the exchange rate used for the lease liability. The following table shows the lease costs in the local currency and Lessee's functional currency under the operating lease accounting model:

Lease costs	(A) Local currency	(B) Exchange rate	(A ÷ B) Functional currency
20X6			
Amortization of the ROU asset	€21,455	1.1463	$18,717
Accretion of the lease liability	5,545	1.1627	4,769
Total lease costs	€27,000	Blended	$23,486
20X7			
Amortization of the ROU asset	€23,011	1.1463	$20,074
Accretion of the lease liability	3,989	1.1092	3,596
Total lease costs	€27,000	Blended	$23,670
20X8			
Amortization of the ROU asset	€24,852	1.1463	$21,680
Accretion of the lease liability	2,148	1.0865	1,977
Total lease costs	€27,000	Blended	$23,657

Journal entries illustrating the effects of accounting for the lease in Lessee's functional currency are as follows:

	20X6		20X7		20X8	
	Debit	Credit	Debit	Credit	Debit	Credit
Lease liability (Note 1)	$17,585		$18,678		$24,208	
Rent expense	23,486		23,670		23,657	
Foreign currency translation gain or loss		$853	2,068		506	
Cash		21,501		$24,342		$26,691
ROU asset		18,717		20,074		21,680

Note 1: Net debit activity in the lease liability account ($21,501 – $4,769 + $853 for 20X6; $24,342 – $3,596 – $2,068 for 20X7; and $26,691 – $1,977 – $506 for 20X8).

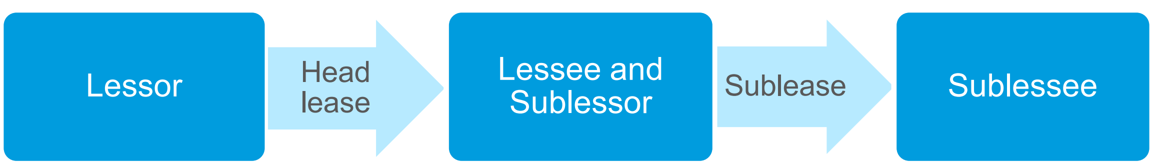
The following table compares the income statement effects in Lessee's functional currency (excluding the foreign currency effects) for each year under the finance lease and operating lease accounting models:

	Finance	Operating
20X6 (Note 1)	$24,926	$23,486
20X7 (Note 1)	23,753	23,670
20X8 (Note 1)	22,134	23,657
Total	$70,813	$70,813

Note 1: For the finance lease, the sum of the interest expense plus the amortization expense ($4,769 + $20,157 for 20X6; $3,596 + $20,157 for 20X7 and $1,977 + $20,157 for 20X8).

7.5 Subleases

A sublease exists when a lessee (i.e., sublessor or intermediate lessor) re-leases the underlying asset to a third party (i.e., sublessee) while the original lease (i.e., the head lease) remains in effect. The following depicts a sublease:



The sublessor should account for a head lease and a sublease as two separate contracts except in the rare circumstance in which the specific contract combination criteria in ASC 842 are met (see Section 4.1).

The effects of a sublease on the sublessor's accounting depends on whether the nature of the sublease is such that the sublessor is relieved of its obligations under the head lease.

When the sublessor is relieved of its obligations under the head lease, it should account for the transaction as a termination of the head lease (see Section 7.2.6). Any amounts paid or received upon termination of the head lease should be taken into consideration when determining the income statement effects of the lease termination, provided those amounts were not included in the lease payments used to account for the head lease prior to the sublease. When the sublessor becomes secondarily liable under the sublease (i.e., the sublessor must make payments if the sublessee does not), it becomes a guarantor and accounts for the guarantee it has provided in accordance with ASC 460, regardless of whether consideration was explicitly transferred in connection with providing the guarantee.

When the sublessor is not relieved of its obligations under the head lease, it accounts for the head lease as a lessee separate from the sublease as a lessor. The specific accounting consequences to a sublessor depend on the classification of the head lease and the sublease. Classification of the sublease is based on the underlying asset and not the ROU asset related to the head lease. In addition, the discount rate used by the sublessor for purposes of classifying the sublease and, depending on its classification, measuring the net investment in the sublease, should be the rate implicit in the sublease unless it cannot be readily determined, in which case the discount rate for the head lease may be used.

The following table highlights the accounting effects of a sublease on the sublessor's accounting for the head lease based on the classification of the head lease and sublease:

Head lease classification	Sublease classification	Accounting effects of the sublease on the sublessor's accounting for the head lease
Finance	Sales-type or direct financing	• *ROU asset related to the head lease*: Derecognize the ROU asset, unless the sublease is a sales-type lease and collectibility of the lease payments is not probable, in which case the guidance in ASC 842-30-25-3 should be applied. • *Lease liability related to head lease*: Continue to account for the lease liability as it was accounted for before the sublease.
Operating	Sales-type or direct financing	• *ROU asset related to the head lease*: Derecognize the ROU asset, unless the sublease is a sales-type lease and collectibility of the lease payments is not probable, in which case the guidance in ASC 842-30-25-3 should be applied. • *Lease liability related to the head lease*: Account for using the finance lease accounting model in ASC 842-20-35-1 and 35-2.
Finance or operating	Operating	• *ROU asset and lease liability*: Continue to apply the same accounting model applied prior to the sublease. • *Impairment of ROU asset*: The lease costs for the sublease's term being more than the anticipated sublease income for that term is an indicator that the carrying amount of the ROU asset may not be recoverable, which may trigger the need to perform an impairment test in accordance with ASC 360-10-35 (see Section 7.3).

With respect to the sublessor's accounting for the sublease, it would apply the guidance in ASC 842-30. As such, when the sublease is classified as a sales-type or direct financing lease, the sublessor would evaluate its investment in the sublease for impairment in accordance with ASC 310-10-35-16 to 35-30 prior to the effective date of ASC 326-20 and in accordance with the impairment model for financial instruments measured at amortized cost in ASC 326-20 after the effective date of ASC 326-20 (see Section 7.5.2). In doing so, the loss allowance on the net investment in the lease should take into consideration the cash flows that the sublessor expects to receive or derive during and after the sublease's remaining term, which would include the expected cash flows related to the lease receivable and the unguaranteed residual asset.

The guidance in ASC 210-20-45 should be applied by the lessee to determine whether it should offset the asset and liability recognized for the head lease (as a lessee) with the asset and liability recognized for the sublease (as a sublessor). We believe that it is very unlikely that the required conditions for offsetting in ASC 210-20-45-1 would be met in a typical situation involving a head lease and a sublease.

ASC 842 does not address whether the costs associated with the head lease and the income associated with the sublease should be presented gross or net on the sublessor's income statement. In general, we believe gross presentation is typically appropriate because, as pointed out in BC115 of ASU 2016-02, the head lease and sublease should be accounted for as separate contracts, except in the rare circumstance in which the specific contract combination criteria in ASC 842 are met (see Section 4.1), and gross presentation is consistent with separately accounting for the contracts. However, there may be limited circumstances in which accounting for the costs associated with the head lease and the income associated with the sublease may be accounted for on a net basis, such as when the sublessor only enters into the sublease for purposes of managing its occupancy costs and needs and the subleasing activity is insignificant.

7.5.1 Impairment model applied to a ROU asset for a head lease

The impairment model applied to a ROU asset for a head lease when the lessee has the intent and ability to sublease the underlying asset or already has subleased the underlying asset is the held-and-used impairment model (see Section 7.3.1), not the abandonment model (see Section 7.3.2). When applying the held-and-used impairment model to the ROU asset for a head lease, the lessee should consider whether and when the head lease and sublease (expected or already in place) may represent their own asset group. The lessee should also consider when a triggering event may be present such that the lessee would have to apply the held-and-used impairment model to the appropriate asset group to determine whether an impairment exists, and if so, in what amount.

7.5.2 Effective date of ASC 326

In 2016, the FASB issued new guidance on credit losses in ASC 326, which introduces the current expected credit loss model. The effective dates for ASC 326 differ depending on the status of the reporting entity as follows:

- *Public business entities that are SEC filers, except for entities eligible to be smaller reporting companies (as defined by the SEC)*. Fiscal years beginning after December 15, 2019, including interim periods within those years.
- *All other entities*. Fiscal years beginning after December 15, 2022, including interim periods within those years.

Entities are permitted to early adopt ASC 326 for fiscal years beginning after December 15, 2018, including interim periods within those fiscal years.

For additional information about ASC 326 and the current expected credit losses model, refer to Chapter 4 and Chapter 6 of our publication, A guide to accounting for investments, loans and other receivables.

7.6 Related-party leases

ASC 842 indicates that a related-party lease should be classified and accounted for based on its legally enforceable terms and conditions. In other words, the classification and accounting for a lease with a related-party lessor should be the same as the classification and accounting would have been if that lease were with an unrelated lessor (except as discussed in Section 8.3 with respect to a specific aspect of accounting for a sale-leaseback transaction). Additionally, lessees are required to apply the disclosure requirements of ASC 850.

When understanding the legally enforceable terms and conditions of a lease, a question arises as to whether the lessee should consider if there are any *implicit* legally enforceable terms and conditions. For example, if a lessee leases construction equipment on a month-to-month basis from a related party and that equipment is going to be used throughout the period of construction of a building that is expected to take two years to complete, should consideration be given to whether there are implicit legally enforceable terms and conditions that would cause the lease term to be evaluated as two years instead of one month? For another example, if a lessee leases a manufacturing facility from a related party for five years with no option to renew, and incurs significant costs related to leasehold improvements that will retain significant value over their useful life of 20 years, should consideration be given to whether there are implicit legally enforceable terms and conditions that would cause the lease term to be evaluated as 20 years instead of five years?

Entities may need the assistance of legal counsel to determine whether any implicit terms and conditions create enforceable rights and obligations on the parties that should be considered in classifying and accounting for the lease under ASC 842.

7.7 Leases acquired in a business combination

As part of a business combination, an acquirer often obtains the acquiree's leases. This section addresses how the acquirer should account for those leases in which the acquiree is the lessee, which generally requires consideration of the following:

- Classifying the acquiree's leases (see Section 7.7.1).
- Deciding on the accounting policy for acquired short-term leases (see Section 7.7.2).
- Determining whether an identifiable intangible asset arises from the lease (see Section 7.7.3).
- Recognizing and measuring ROU assets and lease liabilities (see Section 7.7.4).
- Establishing the amortization period for the ROU asset (see Section 7.7.5).
- Recognizing, measuring and establishing the amortization period for acquired leasehold improvements (see Section 7.7.6).
- Accounting for variable lease payments based on other than an index or rate (see Section 7.7.7).

Each of these considerations is discussed further in the sections noted (the basis for which is the relevant guidance in ASC 805 and ASC 842). In addition, an example illustrating many of these considerations is provided at the end of this section.

7.7.1 Classifying the acquiree's leases

With only one exception, the acquirer should retain the acquiree's lease classification as of the acquisition date, provided the acquiree appropriately determined the lease's classification. The only exception is if the lease is modified in conjunction with the business combination and the modification is not accounted for as a separate contract (see Section 7.2.5.1), in which case the classification of the lease should be reassessed on the acquisition date.

If an acquiree elects the package of transition practical expedients (see Section 10.3.1) when transitioning to ASC 842, leases in existence prior to the effective date of ASC 842 retain the lease's classification under ASC 840. As a result, retaining the acquiree's classification of a lease purchased in a business combination could mean that the acquirer is retaining the ASC 840 classification of the lease. This is appropriate so long as: (a) the lease is not modified in conjunction with the business combination or (b) if the lease is modified in conjunction with the business combination, the modification is accounted for as a separate contract. If the lease is modified in conjunction with the business combination and the modification is accounted for as other than a separate contract, the classification of the lease is reassessed.

As discussed in Section 7.2.5.1, changes to the lease that are considered modifications for accounting purposes are those that change the lease's scope or consideration. As such, a change to remove the acquiree's name and add the acquirer's name as the new lessee is not considered a modification for accounting purposes.

While a lessee reassesses the classification of a lease when the lease term changes (e.g., because a lessee's expectations about exercising a renewal option change) or when the lessee's expectations about exercising a purchase option change, the acquirer in a business combination does not reassess classification of an acquired lease solely because its assessment of factors affecting the lease term or the likelihood of exercising a purchase option are different from the acquiree's assessments. For example, consider a situation in which a lessee enters into a lease with a noncancellable term of four years and a renewal option for one additional year. On the commencement date, the lessee concludes it is reasonably certain to exercise the renewal option. As a result, the lessee concludes the lease term is five years. Based on this lease term and other relevant facts and circumstances, the lessee concludes the lease should be classified as a finance lease. In the following year, there is no reason for the lessee to reassess the lease term or classification, and one year after entering into the lease, the lessee is acquired in a business combination. The acquirer in the business combination determines the acquired lease's remaining lease term for purposes of recognizing and measuring it in the business combination accounting. In doing so, the acquirer concludes it is not reasonably certain to exercise the renewal option. As a result, the acquirer concludes the remaining lease term is three years. The acquirer's reassessment of the lease term on the acquisition date does not trigger the need for it to reassess the acquired lease's classification on the acquisition date. In other words, the lease continues to be classified as a finance lease on the acquisition date regardless of the acquirer's reassessment of the lease term. Assume another year passes, and the acquirer's facts and circumstances change such that it concludes it is reasonably certain to exercise the renewal option, which means the remaining lease term is three years (or one year longer than what the lease term would have been absent the change in facts and circumstances since the acquisition date). In this situation, the reassessment of the lease term does trigger the need for a reassessment of the lease classification.

7.7.2 Deciding on the accounting policy for acquired short-term leases

The acquirer must decide whether to elect an accounting policy by class of underlying asset (which would be applicable to all acquisitions) to not recognize ROU assets and lease liabilities for acquired leases with a remaining lease term of 12 months or less. If the acquirer elects the short-term acquired lease accounting policy, it would also not recognize an intangible asset or liability for short-term leases with terms that are favorable or unfavorable compared to market.

7.7.3 Determining whether an identifiable intangible asset arises from the lease

The acquirer should determine whether the acquired lease gives rise to any identifiable intangible assets. As discussed in the next section, an intangible asset arising from favorable lease terms compared to market is *not* recognized separately as an intangible asset because it is included in the ROU asset. To determine whether another identifiable intangible asset arises from an acquired lease, the acquirer should consider whether a market participant would be willing to pay a price for the lease even if the lease were at market terms. For example, a market participant would likely be willing to pay a price for an at-market lease of retail space in a prime shopping area when it has not been able to obtain retail space in that area. If that is the case, the acquirer would recognize an intangible asset related to the lease provided the definition of an identifiable intangible asset is met.

7.7.4 Recognizing and measuring ROU assets and lease liabilities

For acquired leases with a remaining lease term of more than 12 months, and for those short-term leases for which the acquirer has not elected the accounting policy discussed in Section 7.7.2, the acquirer must recognize ROU assets and lease liabilities. Unlike most other assets and liabilities acquired in a business combination, the lease liability and ROU asset are not recognized at their fair values on the acquisition date. Instead, the acquirer applies the guidance in ASC 842 to determine the remaining lease term and the remaining lease payments as if the commencement date for the lease is the acquisition date. The acquirer uses that information to initially measure a lease liability at the present value of the remaining lease payments. The discount rate used for this purpose is one of the following, as appropriate:

- If known, the rate implicit in the lease (see Section 5.2.1).
- If the rate implicit in the lease is not known, the acquirer's incremental borrowing rate as of the acquisition date (see Section 5.2.2), unless the acquirer is not a public business entity and has elected to use the risk-free rate as the discount rate for the relevant asset class (see Section 5.2.3).
- If the acquirer is not a public business entity and has made the election to use the risk-free rate as the discount rate for the relevant asset class, the risk-free rate as of the acquisition date (see Section 5.2.3).

The initial measurement of the ROU asset is the amount of the lease liability adjusted for the intangible asset or liability arising from the acquired lease having favorable or unfavorable terms compared to market.

Because the acquirer is assuming the acquisition date is the commencement date for the lease, no prepaid or accrued rent should be recognized in the accounting for the business combination.

The amounts recognized for the lease liability and ROU asset in the accounting for the business combination do not vary based on the classification of the lease. However, because the lease liability and ROU asset are subsequently accounted for under ASC 842, the accounting for a lease after the acquisition date does depend on the classification of the lease.

Spotlight on change: Recognizing lease liabilities and ROU assets in the accounting for a business combination

For operating leases acquired in a business combination in which the acquirer is the lessee, ASC 805 was amended by ASU 2016-02 to reflect the new approach used by lessees to account for operating leases outside of a business combination under ASC 842. As such, for operating leases in which the acquirer is the lessee, ASC 805 was amended by ASU 2016-02 to require the acquirer to recognize a lease liability and ROU asset for the lease in the accounting for the business combination. Prior to the amendments by ASU 2016-02, ASC 805 did not provide for such a lease liability or ROU asset to be recognized for an operating lease in the accounting for a business combination, which kept with the approach used by lessees to account for operating leases outside of a business combination under ASC 840. In addition, under ASC 805 prior to the amendments made by ASU 2016-02, an intangible asset or liability was recognized in the accounting for the business combination for the favorable or unfavorable terms (compared to market terms) of an operating lease in which the acquirer is a lessee. Under ASC 805 as amended by ASU 2016-02, an amount is still recognized in the accounting for the business combination for the favorable or unfavorable terms (compared to market terms) of an operating lease in which the acquirer is a lessee, but that amount is included in the balance of the ROU asset.

For finance leases acquired in a business combination in which the acquirer is the lessee, ASC 805 was amended by ASU 2016-02 to require the lease liability and ROU asset recognized in the accounting for the business combination to be measured as of the acquisition date based on the measurement guidance in ASC 842. Prior to the amendments by ASU 2016-02, ASC 805 did not provide an exception from its fair value measurement principle for the liability and asset arising from a capital lease acquired in a business combination in which the acquirer is the lessee. As a result, the liability and asset recognized in the accounting for the business combination for a capital lease prior to the adoption of ASC 842 were measured at their fair value. The significance of changing from measuring the liability and asset for a capital lease using their fair values to measuring the lease liability and ROU asset for a finance lease using the measurement guidance in ASC 842 will depend on the facts and circumstances.

7.7.5 Establishing the amortization period for the ROU asset

In either of the following circumstances, the amortization period for the ROU asset acquired in a business combination should be the remaining useful life of the underlying asset: (a) ownership of the underlying asset transfers to the acquirer or (b) the acquirer is reasonably certain to exercise a purchase option for the underlying asset. Otherwise, the amortization period for the ROU asset should be the remaining lease term.

7.7.6 Recognizing, measuring and establishing the amortization period for acquired leasehold improvements

The acquiree's leasehold improvements should be recognized by the acquirer on the acquisition date and measured at their fair value. In any of the following circumstances, the amortization period for leasehold improvements acquired in a business combination should be their remaining useful life: (a) ownership of the underlying asset transfers to the lessee, (b) the lessee is reasonably certain to exercise a purchase option for the underlying asset or (c) the remaining useful life of the leasehold improvements is shorter than the remaining lease term as of the acquisition date. Otherwise, when the leasehold improvements' useful life is longer than the remaining lease term as of the acquisition date, the amortization period for those leasehold improvements' should be the remaining lease term.

7.7.7 Accounting for variable lease payments based on other than an index or rate

To the extent an acquired lease has variable payments based on other than an index or rate, those payments should be recognized in the same manner as they would have been if the lease had not been acquired (see Section 5.5.3.3, Section 7.2.2.1 and Section 7.2.3.1).

Example 7-8: Accounting for an operating lease acquired in a business combination

Lessee and Lessor entered into a lease on January 1, 20X6. The terms of the lease and other facts pertinent to the accounting for the lease include the following:

- Lessor makes the asset available to Lessee for its use on January 1, 20X6.
- Lessee has the right to use the asset for a noncancellable term of five years. There are no extension, termination or purchase options.
- Fixed lease payments in year one of the lease are $39,000 and increase by $2,500 per year over the noncancellable term.
- Lease payments are made annually in arrears.
- Lessee paid a $5,000 bonus to its employee in connection with entering into the lease.
- Lessor paid a $10,000 lease incentive to Lessee on January 1, 20X6.
- Lessee's incremental borrowing rate is 7% (the rate implicit in the lease is not readily determinable).
- The useful life of the asset is more than five years.

Based on its application of ASC 842, Lessee concludes the lease should be classified as an operating lease. There are no modifications to the lease after January 1, 20X6. Lessee has no other leases.

On January 1, 20X8, Lessee is acquired by Acquirer in a business combination. The carrying amount of the lease liability and ROU asset right before the acquisition are $121,735 and $111,235, respectively. In the accounting for the business combination, Acquirer determines that the fair value of the favorable terms of the lease is $55,000. Acquirer does not identify any other identifiable intangible assets or liabilities related to the lease that should be recognized in the accounting for the business combination. In addition, the Acquirer's incremental borrowing rate at the acquisition date is 6% (the rate implicit in the lease is not readily determinable), and the useful life of the asset as of the acquisition date is more than three years.

Accounting for the lease on the acquisition date

Acquirer continues to classify the lease as an operating lease on the acquisition date.

Based on the remaining annual lease payments in arrears of $44,000 for 20X8, $46,500 for 20X9 and $49,000 for 20Y0, a remaining lease term of three years and Acquirer's incremental borrowing rate of 6%, the lease liability that should be recognized by Acquirer in the accounting for the business combination is $124,035. The ROU asset that should be recognized by Acquirer in the accounting for the business combination is $179,035, calculated by starting with the lease liability on the acquisition date ($124,035) and increasing it by the fair value of the favorable terms of the lease ($55,000). The acquisition date accounting for the lease is unaffected by the previously incurred initial direct costs or previously received lease incentives. The difference between the amounts recognized for the lease liability and the ROU asset essentially affects the amount of goodwill (or gain from a bargain purchase) recognized in the broader accounting for the business combination.

Accounting for the lease after the acquisition date

The following table provides the activity in the lease liability, as well as its beginning and ending balances, for the remaining three years in the lease term:

Lease liability	**20X8**	**20X9**	**20Y0**
Beginning balance	$124,035	$87,477	$46,226
Plus accretion (beginning balance × 6%)	7,442	5,249	2,774
Minus lease payment	44,000	46,500	49,000
Ending balance	$87,477	$46,226	$ -

Under the operating lease accounting model, Acquirer determines its total lease costs over the remaining lease term to calculate the single lease cost for each period, which is then used to determine the amortization of the ROU asset recognized in each period. Lessee determines that its total lease costs over the remaining term of the lease are $194,500, which is the total lease payments of $139,500 ($44,000 in 20X8, $46,500 in 20X9 and $49,000 in 20Y0) increased by the fair value of the favorable terms of the lease ($55,000). Acquirer recognizes the total lease costs over the remaining lease term of three years because it is shorter than the asset's remaining useful life. In addition, Acquirer uses the straight-line method for purposes of recognizing the lease costs because there is not another systematic basis that better represents the pattern in which Acquirer expects to derive benefit from the right to use the underlying asset. As a result, Acquirer's annual lease costs are $64,833 per year ($194,500 ÷ 3 years). The amount of the annual lease cost that is reflected as amortization of the ROU asset is the difference between the annual lease cost and the accretion of the lease liability:

Net ROU asset	**20X8**	**20X9**	**20Y0**
Beginning balance	$179,035	$121,644	$62,060
Minus amortization (Note 1)	57,391	59,584	62,060
Ending balance	$121,644	$62,060	$ -

Note 1: Calculated by taking the difference between the annual lease cost of $64,833 in 20X8 and 20X9 and $64,834 in 20Y0, and the accretion of the lease liability each year, which is $7,442 in 20X8, $5,249 in 20X9 and $2,774 in 20Y0.

Based on the information provided in this example, the following represents the journal entries that Acquirer would record each year after the recognition of the ROU asset and lease liability in the accounting for the business combination:

	Debit	Credit
20X8		
Lease liability ($44,000 payment – $7,442 accretion)	$36,558	
Lease expense	64,833	
Cash		$44,000
ROU asset		57,391
20X9		
Lease liability ($46,500 payment – $5,249 accretion)	$41,251	
Lease expense	64,833	
Cash		$46,500
ROU asset		59,584
20Y0		
Lease liability ($49,000 payment – $2,774 accretion)	$46,226	
Lease expense	64,834	
Cash		$49,000
ROU asset		62,060

7.8 Leases acquired in an asset acquisition

Neither ASC 805-50 nor ASC 842 provide guidance specifically related to the accounting for leases acquired in an asset acquisition.

7.8.1 Lease classification

We believe the classification of a lease acquired in an asset acquisition should be determined by the acquirer (lessee) on the acquisition date by applying the lease classification criteria (see Chapter 6) to its facts and circumstances on that date. We generally do not believe the acquirer (lessee) should retain the seller's (the previous lessee's) lease classification. However, we understand there is diversity in practice on this issue, and as a result, we believe there may be circumstances in which retaining the seller's (the previous lessee's) lease classification would be acceptable. In those situations in which an acquirer (lessee) believes it would be appropriate to retain the seller's (the previous lessee's) lease classification, the assistance of a subject matter expert on the topic should be sought.

7.8.2 Recognition and measurement

We believe it would be appropriate to initially recognize and measure a lease acquired in an asset acquisition in the same manner as required for a lease acquired in a business combination (see Sections 7.7.2 to 7.7.5). However, because the overall accounting for an asset acquisition does not result in the recognition of goodwill or a gain on a bargain purchase, the ultimate amounts recognized for a lease liability and ROU asset may be adjusted from their initial measurements. These adjustments would result from the difference between the consideration transferred in the asset acquisition and the initial measurement of all the acquired assets and liabilities being reallocated to those assets and liabilities.

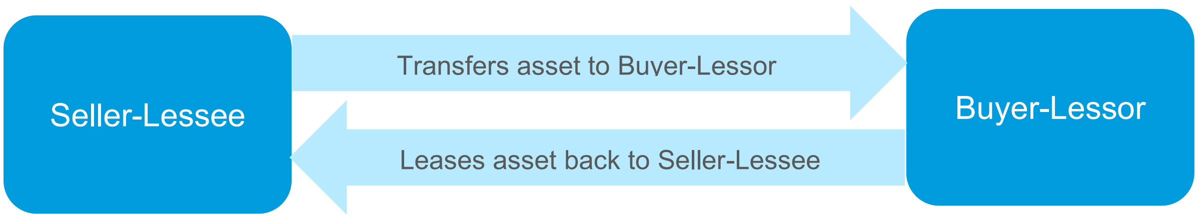
7.9 Recognition of deferred taxes

While ASC 842 affects the lessee's accounting for its leases for financial reporting purposes, it does not affect the lessee's accounting for its leases for tax purposes. In fact, there have not been any changes to how a lessee should account for its leases for tax purposes. The recognition of lease liabilities and ROU assets under ASC 842 for most operating leases without a corresponding change in the accounting for operating leases for tax purposes will give rise to new book-to-tax differences for which the lessee should consider the need to recognize deferred taxes. While recognizing deferred taxes for these differences is not likely to cause a change in the previously recorded net deferred tax asset or liability on the face of the balance sheet, doing so could have a significant effect on the gross amount of deferred tax assets and liabilities disclosed in the notes to the financial statements.

8. Sale-leaseback transactions

8.1 Nature of a sale-leaseback transaction

In a sale-leaseback transaction, the seller-lessee transfers the asset to the buyer-lessor and then the buyer-lessor leases the asset back to the seller-lessee. The following depicts a sale-leaseback transaction:



To the extent the lease that is part of the sale-leaseback transaction would otherwise be within the scope of ASC 842-10, the sale-leaseback transaction is accounted for in accordance with ASC 842-40. This guide only addresses the seller-lessee's accounting for a sale-leaseback transaction. ASC 842-40 addresses the buyer-lessor's accounting for a sale-leaseback transaction.

In a sale-leaseback transaction, the seller-lessee must control the underlying asset (i.e., have the ability to direct its use and obtain substantially all of its remaining benefits) before it is transferred to the lessor. If this is not the case, a sale-leaseback transaction has not occurred. Having legal title to the underlying asset is not the same as having control of the underlying asset. In other words, a seller-lessee having legal title to the underlying asset without having control of the underlying asset before it is transferred to the buyer-lessor is not a sale-leaseback transaction. In addition, lessee indemnification for preexisting environmental contamination does not mean, in and of itself, that the lessee controlled the underlying asset before it was transferred to the buyer-lessor.

Consider a situation in which Lessee and Lessor enter into a contract under which: (a) Lessor will construct a building to Lessee's specifications and then lease that building to Lessee upon completion of its construction and (b) Lessee controls the land on which the building will be built prior to entering into the contract and agrees to lease the land to Lessor. This contract is an example of a build-to-suit arrangement, and depending on the facts and circumstances, may represent a sale-leaseback transaction. Section 8.1.1 discusses build-to-suit arrangements in more detail.

Consider another situation in which an entity both owns an interest in an underlying asset and leases all or a portion of the underlying asset as a lessee in an operating lease, and subsequently, the underlying asset is sold to a third party. This situation is referred to as a sale subject to a preexisting lease. Whether such a situation should be accounted for as a sale-leaseback transaction depends on the facts and circumstances, including whether the scope or price of the preexisting lease is modified as part of the sale and whether the preexisting lease is between parties under common control. Additional information about how to account for a sale subject to a preexisting lease is provided in ASC 842-40-55-8 to 55-10.

Spotlight on change: Sale-leaseback transactions involving real estate

ASC 840-40 includes incremental guidance that must be applied to sale-leaseback transactions involving real estate. This guidance has been superseded by ASC 842-40. As a result, sale-leaseback transactions involving real estate are subject to the same requirements in ASC 842-40 as all other sale-leaseback transactions.

8.1.1 Build-to-suit arrangements

A build-to-suit arrangement is one in which an underlying asset is to be constructed or significantly redesigned for the lessee's eventual use. At the beginning of the build-to-suit arrangement, the underlying asset is not yet available for the lessee's use. Once the construction and redesign are complete, the underlying asset is considered to be made available for the lessee's use. As discussed in Section 5.1, the date the underlying asset is made available for the lessee's use is the lease's commencement date. Whether the lessee is required to make payments related to the construction or redesign of the underlying asset
before, during or after completion of the construction or redesign of the underlying asset depends on the terms of the contract.

One question that arises with respect to the accounting for a build-to-suit arrangement is how the lessee should account for any costs it incurs related to the construction or redesign of the underlying asset before the commencement date of the lease. The answer to this question depends on the nature of the costs and whether there is other applicable U.S. GAAP related to the accounting for those costs. If, for example, the costs meet the definition of property, plant or equipment or inventory, the applicable guidance in ASC 360 or ASC 330, respectively, would be applied to account for those costs. If, however, the costs are related to the right to use the underlying asset, those costs should be accounted for as lease payments, regardless of their form (e.g., cash, contributed construction materials) or timing. Lease payments to the lessor before the lease's commencement date are treated as prepaid rent (see Section 5.5.1 and Section 7.1.3).

Another question that arises with respect to the accounting for a build-to-suit arrangement is whether it should be accounted for as a sale-leaseback transaction. The key to answering this question is whether the lessee controls the underlying asset while it is being constructed or redesigned leading up to the lease's commencement date. The following table summarizes the accounting implications for each of the two potential answers to this question.

Does the lessee control the underlying asset while it is being constructed or redesigned leading up to the lease's commencement date?	
Yes	**No**
Accounting during the construction or redesign period leading up to the lease's commencement date	
• The lessee accounts for any costs it incurs related to the construction or redesign of the underlying asset (other than costs related to the right to use the underlying asset) in accordance with other applicable U.S. GAAP (e.g., ASC 360). • The lessee recognizes an asset under construction and a financing liability for the costs incurred by the lessor during the construction or redesign period.	• The lessee accounts for any costs it incurs related to the construction or redesign of the underlying asset (other than costs related to the right to use the underlying asset) in accordance with other applicable U.S. GAAP (e.g., ASC 360). • The lessee does not recognize an asset under construction and a financing liability for the costs incurred by the lessor during the construction or redesign period.

<table>
<tr><th colspan="2">Does the lessee control the underlying asset while it is being constructed or redesigned leading up to the lease's commencement date?</th></tr>
<tr><th>Yes</th><th>No</th></tr>
<tr><td colspan="2">Accounting on the commencement date</td></tr>
<tr><td>The lessee begins depreciating any costs it incurred and capitalized related to the construction or redesign of the underlying asset.
The lessee accounts for the build-to-suit arrangement as a sale-leaseback transaction.
If a sale has occurred (see Section 8.2), the seller-lessee: (a) accounts for the transfer of the underlying asset to the buyer-lessor as a sale (see Section 8.3), at which point the seller-lessee derecognizes the asset under construction and financing liability recognized during the construction or redesign period leading up to the lease's commencement date and (b) accounts for the leaseback as a lease in accordance with ASC 842-10 and ASC 842-20.
If a sale has not occurred (i.e., there is a failed sale), until a sale has occurred, the seller-lessee: (a) does not derecognize the asset under construction and financing liability recognized during the construction or redesign period, but instead reclassifies the asset under construction to an asset in use and begins depreciating the asset and (b) accounts for the sale-leaseback as a financing arrangement (see Section 8.4).</td><td>The lessee begins depreciating any costs it incurred and capitalized related to the construction or redesign of the underlying asset.
The lessee accounts for the build-to-suit arrangement as a lease in accordance with ASC 842-10 and ASC 842-20.</td></tr>
</table>

Determining whether the lessee controls the underlying asset while it is being constructed or redesigned leading up to the lease's commencement date *first* involves determining whether one or more of the following criteria in ASC 842-40-55-5 are met:

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.

If one or more of these criteria are met, the lessee has control of the underlying asset while it is being constructed or redesigned leading up to the lease's commencement date, and no additional analysis is required. If one or more of these criteria are not met, consideration must be given to whether other factors are present that either individually or in the aggregate indicate that the lessee has control of the underlying asset while it is being constructed or redesigned leading up to the lease's commencement date. For this purpose, we believe a lessee should consider:

- *The guidance in ASC 606 related to what constitutes having control of an asset.* ASC 606-10-25-25 indicates the following: "Control of an asset refers to the ability to direct the use of, and obtain substantially all of the remaining benefits from, the asset. Control includes the ability to prevent other entities from directing the use of, and obtaining the benefits from, an asset." Section 9.1 of our revenue recognition guide discusses the concept of controlling an asset, as well as the indicators provided in ASC 606 that are considered in determining whether an entity controls an asset. Considering the guidance in ASC 606 related to what constitutes having control of an asset may lead a lessee to conclude it does or does not have control of the underlying asset while the asset is being constructed or redesigned leading up to the lease's commencement date.
- *Whether the lessor controls the underlying asset while it is being constructed or redesigned leading up to the lease's commencement date*. Paragraph BC371 of ASU 2016-02 indicates that in a failed sale in a sale-leaseback transaction "a buyer-lessor should not recognize an asset it does not control; to do so would be incompatible with the definition of an asset in Concepts Statement 6 and would result in both parties to the transaction recognizing the same underlying asset concurrently." The FASB is indicating that it would not be appropriate to conclude that control of the underlying asset transfers to the buyer-lessor for purposes of its accounting, but not for purposes of the seller-lessee's accounting. The FASB's basis for reaching that conclusion is that the definition of an asset does not provide for two different parties, such as a buyer-lessor and a seller-lessee in a sale-leaseback transaction, to both control an asset at the same time. We believe the same basis exists to conclude that an underlying asset that is being constructed or redesigned leading up to the lease's commencement date cannot be controlled by both the lessee and lessor in a build-to-suit arrangement. As such, if one or more of the criteria in ASC 842-40-55-5 are not met, it may be instructional for the lessee to consider whether the lessor has control of the underlying asset that is being constructed or redesigned leading up to the lease's commencement date. Because, if it is clear that the lessor controls the asset in this situation, the lessee does not control the asset.

While determining whether the lessee has control of the underlying asset while it is being constructed or redesigned leading up to the lease's commencement date will be relatively straightforward in many cases, there are other cases in which doing so could be quite complex. For example, if a contract includes a lessee call option, the analysis required to determine whether the lessee has the right to obtain the partially constructed underlying asset at any point during the construction period (which is the criterion in ASC 842-40-55-5(a)) could be complex depending on the terms of the call option. In those situations in which determining whether the lessee has control of the underlying asset while it is being constructed or redesigned is not relatively straightforward, the lessee should seek the assistance of subject matter experts on the topic.

Spotlight on change: Build-to-suit arrangements

Under ASC 840-40, the lessee accounts for a build-to-suit arrangement as a sale-leaseback transaction when the lessee is considered the owner of the asset during the construction or redesign period. The lessee is considered the owner of the asset during the construction or redesign period when one or more of the automatic indicators of ownership are present or when the lessee has substantially all of the construction period risks, which is based on a maximum guarantee test. While the basis for determining whether the lessee accounts for a build-to-suit arrangement as a sale-leaseback transaction under ASC 840-40 is risk based, the basis for making that determination under ASC 842-40 is control based. As a result, different conclusions may be reached under ASC 840-40 and 842-40 with respect to whether a lessee should account for a build-to-suit arrangement as a sale-leaseback transaction. In addition, given the differences between ASC 840-40 and ASC 842-40 with respect to determining when a sale of real estate has occurred in a sale-leaseback transaction (see Section 8.2), when a build-to-suit arrangement involving real estate is accounted for as a sale-leaseback transaction, we believe the likelihood of a failed sale decreases under ASC 842-40 compared to ASC 840-40.

While the scope of this guide is focused on the lessee accounting requirements under ASC 842, it is worth noting that ASC 840-40 did not specify the lessor's accounting for a build-to-suit arrangement. We understand that in practice, most lessors do not account for a build-to-suit arrangement as a sale-leaseback transaction under ASC 840-40. In contrast, we believe the guidance on build-to-suit arrangements in ASC 842-40 is equally applicable to lessees and lessors. As such, lessors should perform the same analysis as lessees to determine whether a build-to-suit arrangement should be accounted for as a sale-leaseback transaction, which will result in lessors accounting for at least some build-to-suit arrangements as sale-leaseback transactions.

Example 8-1: Determining whether a build-to-suit lease is within the scope of ASC 842-40

The following example is *Example 3—Lessee Control over an Asset under Construction* from ASC 842-40-55-40 to 55-44:

> Lessee and Lessor enter into a contract whereby Lessor will construct (whether itself or using subcontractors) a building to Lessee's specifications and lease that building to Lessee for a period of 20 years once construction is completed for an annual lease payment of $1,000,000, increasing by 5 percent per year, plus a percentage of any overruns above the budgeted cost to construct the building. The building is expected to have an economic life of 50 years once it is constructed. Lessee does not legally own the building and does not have a right under the contract to obtain the building while it is under construction (for example, a right to purchase the construction in process from Lessor). In addition, while the building is being developed to Lessee's specifications, those specifications are not so specialized that the asset does not have an alternative use to Lessor.
>
> *Case A—Lessee Does Not Control the Asset under Construction*
>
> Assume Lessee controls (that is, Lessee is the owner for accounting purposes) the land upon which the building will be constructed and, as part of the contract, Lessee agrees to lease the underlying land to Lessor for an initial period of 25 years. Lessor also is granted a series of six 5-year renewal options for the land lease.
>
> None of the circumstances in paragraph 842-40-55-5 exist. Even though Lessee owns the land (whether legally or for accounting purposes only) upon which the building will be constructed, Lessor legally owns the property improvements and has rights to use the underlying land for at least substantially all of the economic life of the building. Lessee does not own the building and does not

> have a right under the contract to obtain the building (for example, a right to purchase the building from Lessor). In addition, the building has an alternative use to Lessor. Therefore, Lessee does not control the building under construction. Consequently, the arrangement is not within the scope of this Subtopic. Lessee and Lessor will account for the lease of the building in accordance with Subtopics 842-20 and 842-30, respectively. If Lessee incurs costs related to the construction or design of the building (for example, architectural services in developing the specifications of the building), it will account for those costs as lease payments unless the costs are for goods or services provided to Lessee, in which case Lessee will account for those costs in accordance with other Topics.
>
> *Case B—Lessee Controls the Asset under Construction*
>
> Assume Lessee leases, rather than owns, the land upon which the building will be constructed. Lessee has a 20-year lease of the underlying land and five 10-year renewal options. Therefore, Lessee's lease of the underlying land, together with the renewal options, is for at least substantially all of the economic life of the building under construction. Lessee enters into a sublease with Lessor for the right to use the underlying land for 20 years that commences upon completion of the building. The sublease has a single 10-year renewal option available to Lessor.
>
> Lessee controls the building during the construction period and, therefore, the arrangement is within the scope of this Subtopic. Lessee and Lessor will apply the guidance in this Subtopic to determine whether this arrangement qualifies as a sale and a leaseback or whether this arrangement is, instead, a financing arrangement. Lessee controls the building during the construction period because, in accordance with paragraph 842-40-55-5(e), Lessee controls the use of the land upon which the building will be constructed for a period that is at least substantially all of the economic life of the building and the sublease entered into with Lessor does not both (a) grant Lessor the right to use the land before the beginning of construction and (b) permit Lessor to use the land for substantially all the economic life of the building (that is, the sublease, including Lessor renewal options, only is for 30 years as compared with the 50-year economic life of the building).

8.2 Determining if a sale has occurred

A critical question that must be answered before accounting for a sale-leaseback transaction is whether the transfer of the underlying asset from the seller-lessee to the buyer-lessor should be treated as a sale. To make this determination, the seller-lessee should use the revenue recognition guidance in ASC 606 to determine whether a contract exists (ASC 606-10-25-1 to 25-8) and whether control of the asset has transferred to the customer (ASC 606-10-25-30 [which includes, by reference, ASC 606-10-25-23 to 55-26]). For additional information about ASC 606, refer to our revenue recognition guide.

In applying the relevant guidance in ASC 606, the existence of a leaseback, in and of itself, does not preclude a seller-lessee from concluding that a sale of the underlying asset has occurred. However, a sale has not occurred if the leaseback is a finance lease for the seller-lessee. Additional considerations arise in accounting for a sale-leaseback transaction when:

- *Leaseback includes a repurchase option*. When a substantive repurchase option is included in the leaseback, a sale has not occurred unless both of the following criteria are met: (a) the option's exercise price is (or will be) the same as the underlying asset's fair value when the option is exercised and (b) alternative assets, which are substantially the same as the underlying asset, are readily available in the marketplace (the alternative asset criterion). In paragraph BC352(c) of ASU 2016-02, the FASB stated its position that because of the unique nature of real estate, no two real estate assets can be considered "substantially the same." Consequently, an arrangement that includes a repurchase option cannot satisfy the alternative asset criterion when the underlying asset is real estate, and therefore would not qualify as a sale.
- *Leaseback includes a residual value guarantee*. While a residual value guarantee by the seller-lessee included in the leaseback does not result in a failed sale in and of itself, the guarantee must be considered in assessing whether control of the underlying asset has transferred to the buyer-lessor,

which requires consideration of the indicators in ASC 606-10-25-30. One of those indicators is that the customer has the significant risks and rewards of ownership of the asset. The more significant the residual value guarantee, the more difficult it would be to conclude that the buyer-lessor has the significant risks and rewards of owning the underlying asset, which would be an indicator that control of the underlying asset has not transferred to the buyer-lessor.

- *Transaction entered into to transfer tax benefits*. Sale-leaseback transactions may be entered into for purposes of transferring tax benefits. Additional information about these transactions and how to account for them is provided in ASC 842-40-55-11 to 55-17.

Spotlight on change: Determining whether a sale has occurred

The guidance in ASC 840-40 used to determine whether a sale has occurred depends on whether the underlying asset is real estate (for which a continuing involvement model is used to determine whether a sale has occurred) or equipment (for which a risks and rewards model is used to determine whether a sale has occurred). Conversely, the same guidance is used under ASC 842-40 to determine whether a sale has occurred regardless of the nature of the underlying asset. For this purpose, the control-based model in ASC 606 is used. While the control-based model in ASC 606 considers whether the risks and rewards of ownership have transferred to the customer, there are several additional indicators of control transfer that an entity must also consider.

In applying the control-based model in ASC 606 to a sale-leaseback transaction in which the leaseback would be classified as a finance lease by the seller-lessee, ASC 842-40 indicates that a sale has not occurred. ASC 840-40 does not make the same distinction.

Given the differences between the models used under ASC 840-40 and ASC 842-40 for purposes of determining whether a sale has occurred, what was considered a sale under ASC 840-40 may be considered a failed sale under ASC 842 (which we believe will be more likely when the underlying asset is equipment), or what was considered a failed sale under ASC 840-40 may be considered a sale under ASC 842-40 (which believe will be more likely when the underlying asset is real estate).

8.3 Accounting when there is a sale

When the seller-lessee and buyer-lessor are not related parties and the transfer of the asset in the sale-leaseback transaction is considered a sale, the seller-lessee must determine whether the sale-leaseback transaction is at fair value. To do so, the seller-lessee should identify which of the following sets of information is more readily determinable: (a) the asset's sale price and fair value or (b) the present value of both the lease payments and market rental payments. If there is a difference between the two amounts in the more readily determinable set of information identified by the seller-lessee, the sale-leaseback transaction is not at fair value, and an adjustment to the sale price is required. An adjustment to increase the sale price is essentially a prepayment of rent, and an adjustment to decrease the sale price is essentially additional financing (see Example 8-2).

When the seller-lessee and buyer-lessor are related parties and the transfer of the asset in the sale-leaseback transaction is considered a sale, no consideration is given to whether the sale-leaseback transaction is at fair value. In other words, no adjustments are made to the sale price.

The existence of a variable component in the sale price does not, in and of itself, mean the sale-leaseback transaction is not at fair value. For purposes of determining whether an adjustment to the sale price is needed in those situations, the seller-lessee should take into consideration the amount of the variable component that it reasonably expects to be entitled to receive. In doing so, the seller-lessee should consider all reasonably available information and the guidance on variable consideration in ASC 606-10-32-5 to 32-9. Treatment of a variable component in the sale price in this manner is only relevant for purposes of determining whether the sale-leaseback transaction is at fair value. Other guidance is applicable to the recognition and measurement of that variable component.

Once the determination has been made with respect to whether the sale-leaseback transaction (in which the transfer of the asset is considered a sale) is at fair value, and if not, the amount of the necessary adjustment to the sale price, the seller-lessee accounts for the transaction as follows on the commencement date:

Accounting for…	Seller-lessee
The sale when the sale-leaseback transaction is at fair value or when the sale-leaseback transaction is with a related party	• Recognize the transaction price related to the sale (as determined by applying ASC 606-10-32-2 to 32-20) when the buyer-lessor obtains control of the underlying asset (as determined by applying ASC 606-10-25-30). • Derecognize the carrying amount of the underlying asset.
The sale when sale-leaseback transaction is not at fair value and is not with a related party	• Follow the accounting for when the sale-leaseback transaction is at fair value (see previous row) and: – Adjust the sales price, as appropriate. – Recognize an increase in the sales price as prepaid rent (i.e., an adjustment to the ROU asset for the leaseback). – Recognize a decrease in the sales price as additional financing provided by the buyer-lessor to the seller-lessee (which should be accounted for in accordance with other applicable U.S. GAAP) (see Example 8-2).
The leaseback	• Apply guidance in ASC 842 applicable to lessees.

Spotlight on change: Accounting when a sale has occurred

The guidance in ASC 840-40 used to account for a sale-leaseback transaction in which a sale has occurred depends on a number of factors, including whether the sale results in a gain or loss for the seller-lessee, whether the fair value of the asset is more or less than its carrying amount and the nature and extent of any risks or rewards in the underlying asset retained by the seller-lessee. This guidance differs substantially from the guidance in ASC 842-40, which is summarized in the preceding table. As a result, even in situations where the seller-lessee would conclude that a sale has occurred under both ASC 840-40 and ASC 842-40, the accounting for that sale under each could be significantly different.

Example 8-2: Sale-leaseback transaction in which the transfer of the asset is a sale and the transaction is not at fair value

[Note: This example is based on the facts of *Example 1—Sale and Leaseback Transaction* from ASC 842-10-55-23 to 55-30.]

Facts

On January 1, 20X6, Seller-Lessee sells a building and the related land to Buyer-Lessor for $2 million in cash. Prior to the sale, the land has a carrying amount of $200,000 and the building has a net carrying amount of $800,000. Concurrent with the sale, Seller-Lessee enters into a lease with Buyer-Lessor to lease back the land and building for a period of 10 years (i.e., the lease term ends on December 31, 20Y5). Under the lease, Seller-Lessee is required to make annual payments of $120,000 on December 31 of each year in the lease term. On January 1, 20X6, the observable fair value of the land and building is $1.4 million ($280,000 for the land and $1,120,000 for the building). The rate implicit in the lease is not readily determinable. As such, Seller-Lessee uses its incremental borrowing rate of 6% for accounting purposes. The remaining useful life of the building on January 1, 20X6 is 20 years and Seller-Lessee depreciates the building on a straight-line basis. For ease of illustration, this example assumes that Seller-Lessee did not incur any initial direct costs related to the leaseback.

Analysis

Seller-Lessee must first determine whether the transfer of the land and building in the sale-leaseback transaction should be considered a sale. To do so, Seller-Lessee analyzes its contract for the sale-leaseback transaction with Buyer-Lessor and concludes that a contract exists on January 1, 20X6 under ASC 606-10-25-1 to 25-8 because:

- The sale of the land and building has commercial substance.
- The contract has been signed by both Seller-Lessee and Buyer-Lessor, thereby committing each party to perform under the contract.
- Both Seller-Lessee's and Buyer-Lessor's rights and obligations under the contract are identifiable and enforceable.
- The payment terms are clearly described in the contract.
- There are no collectibility issues related to the sale as Buyer-Lessor paid the $2 million price in cash on January 1, 20X6.

Next, Seller-Lessee determines whether control of the land and building transfers to Buyer-Lessor on January 1, 20X6 by analyzing the guidance and indicators in ASC 606-10-25-30 (which includes, by reference, the guidance in ASC 606-10-25-23 to 25-26). In doing so, Seller-Lessee concludes control of the land and building has transferred to Buyer-Lessor on January 1, 20X6 because:

- Buyer-Lessor has the ability to receive substantially all of the related remaining benefits to be derived from the land and building through the cash flows it will receive from Seller-Lessee over the lease term and the cash flows that could be generated after the lease term by either selling or leasing the land and building or otherwise using them in Buyer-Lessor's own operations.
- Buyer-Lessor has the ability to direct the use of the land and building because it obtains title to them, has the right to sell them separately or together and has the significant risks and rewards of owning the land and building, including the risks and rewards associated with changes in property value.

Based on its analysis, Seller-Lessee concludes that the transfer of the land and building in the sale-leaseback transaction should be considered a sale. Next, Seller-Lessee determines whether the sale-leaseback transaction is at fair value. To do so, Seller-Lessee compares the observable fair value of the land and building ($1.4 million) to the sales price ($2 million) and concludes the sale-leaseback transaction is not at fair value. Accordingly, when accounting for the sale-leaseback transaction, Seller-Lessee recognizes a financial liability for the excess of the sales price over the observable fair value of the land and building ($600,000).

Seller-Lessee records the following journal entry on January 1, 20X6, to reflect the sale of the land and building:

	Debit	Credit
Cash	$2,000,000	
Land		$200,000
Building (net of accumulated depreciation)		800,000
Financial liability		600,000
Gain on sale of land and building		400,000

Because the transfer of the land and building in the sale-leaseback transaction should be considered a sale, Seller-Lessee accounts for the leaseback under ASC 842. In doing so, Seller-Lessee should account for the right to use the land and the right to use the building as separate lease components unless the effects of doing so would be insignificant. For ease of illustration in this example, the assumption has been made that the effects of accounting for the right to use the land and the right to use the building as one lease component instead of two lease components is insignificant.

Seller-Lessee concludes that the leaseback should be classified as an operating lease because:

- Ownership of neither the land nor building transfers to Seller-Lessee under the lease.
- The leaseback does not include a purchase option for either the land or building.
- The lease term of 10 years does not make up a major part of the land's or building's remaining economic life (i.e., 50 years).
- The sum of the present value of the lease payments ($283,210, as calculated in the next paragraph) does not equal or exceed the fair value of the land and building ($1.4 million).
- The land and building are not of a specialized nature.

For purposes of measuring the lease liability and ROU asset related to the leaseback, Seller-Lessee must determine how much of the $120,000 annual payment is attributable to the additional financing it received in the sale-leaseback transaction. Using the amount of the additional financing of $600,000, the term of 10 years and an incremental borrowing rate of 6%, $81,521 of the $120,000 annual payment is attributable to the additional financing. The remaining amount of the annual payment of $38,479 ($120,000 less $81,521) represents the annual payment for the right to use the land and building. Using the annual payment of $38,479, the term of 10 years and an incremental borrowing rate of 6%, Seller-Lessee measures the lease liability at $283,210. Seller-Lessee measures the ROU asset for the same amount because: (a) it did not make any lease payments, or receive any lease incentives, on or before January 1, 20X6, and (b) it did not incur any initial direct costs related to the leaseback. Because there are no lease incentives or initial direct costs, and the lease payments do not change year over year, total lease costs over the term of the lease are $384,790 (which is the annual payment for the right to use the land and building of $38,479 over the 10-year lease term).

Seller-Lessee records the following journal entry on January 1, 20X6, to reflect the accounting for the leaseback of the land and building:

	Debit	Credit
ROU asset	$283,210	
Lease liability		$283,210

Seller-Lessee records the following journal entry on December 31, 20X6 to account for the annual payment and lease costs related to the leaseback:

	Debit	Credit
Lease costs ($384,790 ÷ 10 years)	$38,479	
Lease liability ($38,479 – [$283,210 × 6%])	21,486	
Financial liability ($81,521 – [$600,000 × 6%])	45,521	
Interest costs on financial liability ($600,000 × 6%)	36,000	
Cash		$120,000
ROU asset ($38,479 – [$283,210 × 6%])		21,486

Seller-Lessee recognizes lease costs of $38,479 per year over the lease term (provided there are no lease modifications or ROU asset impairments).

Example 7-2 provides a more in-depth illustration of the lessee's accounting for an operating lease.

8.4 Accounting when there is a failed sale

If the transfer of the asset in a sale-leaseback transaction is not considered a sale (i.e., it is a failed sale), the transaction is treated as a financing transaction by the seller-lessee. As a result, the seller-lessee recognizes a financial liability for any amounts received from the buyer-lessor and does not derecognize the underlying asset. In addition, the seller-lessee must ensure that its accounting for the failed sale-leaseback transaction will result in both of the following:

- Interest on the financial liability not being more than the payments made over the shorter of the lease term and financing term.
- The carrying amount of the asset not being more than the carrying amount of the financial liability upon the earlier of the lease term ending or control of the asset transferring to the buyer-lessor.

If the seller-lessee's accounting will not produce both of these results, the interest rate on the financial liability should be adjusted until its accounting does produce both of these results.

Example 8-3 illustrates the accounting for a sale-leaseback transaction in which the transfer of the asset in the sale-leaseback transaction is not initially considered a sale, but later is considered a sale due to the expiration of a repurchase option. When accounting for the leaseback in such a situation, the discount rate on the date the transaction was originally entered into is used, because that rate more closely reflects the rate that the buyer-lessor would have considered in pricing the lease.

Spotlight on change: Deposit method no longer permitted

In certain circumstances, ASC 840-40 permitted the seller-lessee to use the deposit method to account for a failed sale. This method is not permitted under ASC 842-40.

Example 8-3: Sale-leaseback transaction in which transfer of the asset is not a sale (i.e., failed sale)

Facts

Assume the same facts as Example 8-2, except that: (a) the observable fair value of the land and building on January 1, 20X6 and January 1, 20Y1 is $2 million ($400,000 for the land and $1.6 million for the building), (b) the sale-leaseback transaction provides Seller-Lessee with an option to repurchase the land and building on January 1, 20Y1 for $2.1 million and (c) on January 1, 20X6, Seller-Lessee is not reasonably certain that it will exercise the repurchase option on January 1, 20Y1.

Analysis through January 1, 20Y1 (the date the repurchase option is exercised or expires unused)

Seller-Lessee must first determine whether the transfer of the land and building in the sale-leaseback transaction should be considered a sale. Because the exercise price of the repurchase option is fixed, Seller-Lessee cannot conclude that it is (or will be) the same as the fair value of the land and building on the option's exercise date. As a result, Seller-Lessee concludes a sale has not occurred. Based on the analysis in Example 8-2, the repurchase option is the only factor that precludes Seller-Lessee from accounting for the transfer of the land and building as a sale.

Because the transfer of the land and building is not considered a sale (i.e., it is a failed sale), Seller-Lessee accounts for the failed sale-leaseback transaction as a financing. In doing so, Seller-Lessee recognizes a financial liability for any amounts received from Buyer-Lessor. In addition, Seller-Lessee does not derecognize the land or building, but instead continues to depreciate the building over its remaining useful life.

Seller-Lessee records the following journal entry on January 1, 20X6, to reflect the financing:

	Debit	Credit
Cash	$2,000,000	
Financial liability		$2,000,000

For purposes of its ongoing accounting for the financial liability, Seller-Lessee will use its 6% incremental borrowing rate (assuming it remains reasonably certain that Seller-Lessee will not exercise the repurchase option on January 1, 20Y1), provided both of the following would result: (a) interest on the financial liability is not more than the payments made over the shorter of the lease term and financing term and (b) the carrying amount of the land and building is not more than the carrying amount of the financial liability upon the earlier of the lease term ending or control of the land and building transferring to Buyer-Lessor. Seller-Lessee concludes that both (a) and (b) would result from using its incremental borrowing rate of 6% for accounting purposes because:

- *Interest vs. payments*. Seller-Lessee determines that the shorter of the lease term and financing term is the financing term because it ends on January 1, 20Y1 (which is when either control of the land and building transfers to Buyer-Lessor or Seller-Lessee exercises its repurchase option), while the lease term ends on December 31, 20Y5. Interest on the financial liability using a 6% interest rate would be $600,000 over the financing term ($120,000 annual interest costs × 5 years), which is not more than the payments made over the financing term of $600,000 ($120,000 annual payment × 5 years).
- *Carrying amount of land vs. financial liability*. Seller-Lessee determines control of the land and building could transfer to Buyer-Lessor on January 1, 20Y1 if Seller-Lessee does not exercise its repurchase option, while the lease term ends on December 31, 20Y5. The carrying amount of the land and building on January 1, 20Y1 would be $800,000 ($1 million carrying amount on January 1, 20X6 less five years of annual depreciation on the building of $40,000 [$800,000 ÷ the building's 20-year remaining useful life]), which is not more than the carrying amount of the financial liability

at January 1, 20Y1 (which would be $2 million given that there is no change in the amount of the financial liability over the lease term because the annual payment of $120,000 is equal to the annual interest costs of $120,000 [$2 million × 6%], assuming it remains reasonably certain that Seller-Lessee will not exercise the repurchase option on January 1, 20Y1).

If (a) and (or) (b) had not resulted from using an interest rate of 6%, Seller-Lessee would have needed to adjust the interest rate used for accounting purposes until both (a) and (b) would result (see Example 2 in ASC 842-40-55-31 to 55-38] for a situation in which such an adjustment is required).

Based on this analysis, Seller-Lessee records the following journal entries on December 31, 20X6 through 20Y0 to recognize: (a) the annual payment under the leaseback and interest costs on the financial liability and (b) annual depreciation expense on the building:

	Debit	Credit
Interest costs ($2,000,000 × 6%) (Note 1)	$120,000	
Cash		$120,000
Depreciation expense ($800,000 ÷ 20-year remaining useful life)	$40,000	
Accumulated depreciation (building)		$40,000

Note 1: For ease of illustration, the assumption has been made that Seller-Lessee does not conclude during the financing term that it is reasonably certain to exercise the repurchase option on January 1, 20Y1.

Scenario A: Seller-Lessee exercises the repurchase option

On January 1, 20Y1, Seller-Lessee exercises the option to repurchase the land and building from Buyer-Lessor. As a result, Seller-Lessee records the following journal entry:

	Debit	Credit
Financial liability	$2,000,000	
Interest costs (Note 1)	100,000	
Cash		$2,100,000

Note 1: For ease of illustration, the assumption was made that Seller-Lessee did not conclude during the financing term that it was reasonably certain to exercise the repurchase option on January 1, 20Y1. In this scenario, Seller-Lessee, in all likelihood, would have known it was reasonably certain to exercise the repurchase option sometime prior to January 1, 20Y1. At that point in time, Seller-Lessee would have adjusted its calculation of interest costs on a going forward basis (using the effective interest rate method) to include the additional interest costs of $100,000 such that on January 1, 20Y1 (when the repurchase option is exercised) the financial liability would have been accreted to $2.1 million (the exercise price of the repurchase option).

Seller-Lessee continues to depreciate the building over its remaining useful life.

Scenario B: Seller-Lessee does not exercise the repurchase option

On January 1, 20Y1, Seller-Lessee does not exercise the option to repurchase the land and building from Buyer-Lessor. Because the repurchase option was the only factor that precluded Seller-Lessee from accounting for the transfer of the land and building as a sale, control of the land and building transfers to Buyer-Lessor upon expiration of the option.

Next, Seller-Lessee determines whether the sale-leaseback transaction is at fair value. To do so, Seller-Lessee compares the observable fair value of the land and building on January 1, 20X6 ($2 million) to the sales price on January 1, 20X6 ($2 million) and concludes the sale-leaseback transaction is at fair value. Accordingly, when accounting for the sale-leaseback transaction, Seller-Lessee does not recognize an incremental financial liability. As a result, Seller-Lessee recognizes the sale of the land and building on January 1, 20Y1 by recording the following journal entry:

	Debit	Credit
Financial liability	$2,000,000	
Land		$200,000
Building		600,000
Gain on sale of land and building		1,200,000

For purposes of accounting for the leaseback under ASC 842, the commencement date is January 1, 20Y1 and the lease term is five years. Similar to Example 8-2, for ease of illustration, the assumption has been made that the effects of accounting for the right to use the land and the right to use the building as one lease component instead of two lease components is insignificant. Seller-Lessee concludes that the leaseback should be classified as an operating lease because:

- Ownership of neither the land nor the building transfers to Seller-Lessee under the leaseback.
- The leaseback does not include a purchase option for either the land or building.
- The leaseback term of five years does not make up a major part of the land's or building's remaining economic life (assuming the remaining economic life of the building is 15 years).
- The sum of the present value of the lease payments ($505,484, as calculated in the next paragraph) does not equal or exceed the fair value of the land and building ($2 million).
- The land and building are not of a specialized nature.

For purposes of measuring the lease liability and ROU asset related to the leaseback, Seller-Lessee uses annual payments of $120,000, a lease term of five years and Seller-Lessee's incremental borrowing rate of 6% as determined on January 1, 20X6 (because that rate more closely reflects the rate Buyer-Lessor would have considered in pricing the lease). Using those inputs, Seller-Lessee measures the lease liability at $505,484. Seller-Lessee measures the ROU asset for the same amount because: (a) it did not make any lease payments, or receive any lease incentives, on or before January 1, 20Y1 and (b) it did not incur any initial direct costs related to the leaseback.

Seller-Lessee records the following journal entry on January 1, 20Y1, to reflect the accounting for the leaseback of the land and building:

	Debit	Credit
ROU asset	$505,484	
Lease liability		$505,484

Because there are no lease incentives or initial direct costs, and the lease payments do not change year over year, total lease costs over the remaining term of the lease are $600,000 (which is the annual payment for the right to use the land and building of $120,000 × 5 years). Seller-Lessee records the following journal entry on December 31, 20Y1 to account for the annual payment and lease costs related to the leaseback:

	Debit	Credit
Lease costs ($600,000 ÷ 5 years)	$120,000	
Lease liability ($120,000 – [$505,484 × 6%])	89,671	
Cash		$120,000
ROU asset ($120,000 – [$505,484 × 6%])		89,671

Seller-Lessee recognizes lease costs of $120,000 per year over the leaseback term (provided there are no lease modifications or ROU asset impairments).

Example 7-2 provides a more in-depth illustration of the lessee's accounting for an operating lease.

8.5 Sale-leaseback-sublease

A sale-leaseback-sublease transaction is subject to the same guidance that applies to a sale-leaseback transaction without a sublease. The sublease, in and of itself, does not keep the buyer-lessor from obtaining control of the underlying asset or the seller-lessee from controlling the underlying asset before it is transferred to the buyer-lessor. The accounting for the sublease will depend on whether the transfer of the asset in the sale-leaseback is considered a sale, and if so, the classification of the leaseback and sublease (see Section 7.5).

8.6 Disclosures

To the extent the seller-lessee accounts for the leaseback in a sale-leaseback transaction as a lease (i.e., the transfer of the asset is considered a sale), it should provide the disclosures otherwise required of a lessee. In addition, the seller-lessee should also disclose the main terms and conditions of the transaction and any gains or losses resulting from the transaction separate from any gains or losses resulting from the disposal of other assets. For a complete list of the disclosures lessees must provide under ASC 842, refer to the disclosure checklist included in Appendix D.

To the extent the seller-lessee accounts for the sale-leaseback as a financing transaction (i.e., the transfer of the asset is not considered a sale), it should provide the same disclosures for the financial liability that it would provide for other financial liabilities (e.g., debt).

To the extent the buyer-lessor accounts for the leaseback in a sale-leaseback transaction as a lease (i.e., the transfer of the asset is considered a sale), it should provide the disclosures otherwise required of a lessor (see ASC 842-30-50).

9. Present and disclose leases in financial statements

9.1 Balance sheet

For ROU assets and lease liabilities recognized under ASC 842, lessees should either present the assets and liabilities for finance leases and operating leases as separate line items on the balance sheet or disclose them separately in the notes to the financial statements. If a lessee does not present them as separate line items on the balance sheet, it must disclose which line items in the balance sheet include those assets and liabilities. The ROU assets and lease liabilities related to finance leases cannot be included in the same balance-sheet line items that include the ROU assets and lease liabilities related to operating leases.

For purposes of current and noncurrent classification, lease liabilities and ROU assets are subject to the same considerations as other similar liabilities and assets. Given that a lease liability is a financial liability, the portion of the lease liability that is expected to be paid within 12 months (or, if longer, the lessee's operating cycle) should be classified as current, which is similar to the portion of debt that is expected to be paid within 12 months (or, if longer, the lessee's operating cycle), which is classified as current. Conversely, given that a ROU asset (an amortizable asset) is most similar to property, plant and equipment (a depreciable asset), the ROU asset should typically be classified as noncurrent in its entirety similar to the classification of property, plant and equipment, which is classified as noncurrent in its entirety. However, if a lessee does not elect the short-term lease accounting policy (see Section 7.1.1) for its short-term leases, the ROU assets recognized related to those short-term leases should be classified as current.

Example 9-1: Balance-sheet presentation of operating and finance leases

Facts

Lessee is a private company with a calendar year end and is preparing its December 31, 20X6 financial statements. Lessee applies U.S. GAAP and has already transitioned to ASC 842. For ease of illustration, a comparative period is not presented in the financial statements.

Lessee has two leases. One lease is a finance lease, and the other is an operating lease. Neither lease is part of a discontinued operation. Neither of the underlying assets is being used to construct an asset. Lessee is not constructing any other assets that would otherwise result in the capitalization of interest. It is important to keep in mind that the answers provided in this example, as well as Example 9-2 and Example 9-3 could change if either (or both) of the leases were part of a discontinued operation, either (or both) underlying assets were being used to construct an asset and (or) Lessee were constructing an asset that would result in the capitalization of interest.

Additional information about both leases is included in the following table:

	Finance lease	Operating lease
Lease term	10 years	10 years
Remaining lease term at December 31, 20X6	9 years	9 years
Fixed lease payments	$100,000 per year on December 31	$150,000 per year on December 31
Variable lease payments	$50,000 paid on December 31, 20X6 given that a usage threshold was met	None
Incremental borrowing rate	6%	6.5%

	Finance lease	Operating lease
Balance in ROU asset at December 31, 20X6	$662,408 ($736,009 less $73,601 in accumulated amortization)	$998,416 ($1,078,325 less $79,909 in accumulated amortization)
Balance in lease liability at December 31, 20X6	$680,169	$998,416 (Note 1)
Principal amount of lease liability due within 12 months	$59,190	$85,102
Interest expense for 20X6	$44,161	N/A
Amortization expense for 20X6	$73,601	N/A
Rent expense for 20X6	N/A	$150,000

Note 1: The ROU asset and lease liability for the operating lease have the same balance only because there were no lease incentives, prepayments or initial direct costs related to the lease.

Lessee considers how to present its ROU assets and lease liabilities on its balance sheet as of December 31, 20X6. Following are two alternatives (but not necessarily the only two alternatives) available to Lessee based on the balance-sheet presentation guidance in ASC 842.

Alternative 1

Alternative 1 presents the ROU asset and lease liability for the operating lease and the ROU asset and lease liability for the finance lease by themselves on separate line items on the face of the balance sheet. While this presentation is not required by ASC 842, if ROU assets or lease liabilities are included in a line item with other amounts, Lessee would have to disclose in the footnotes the amounts of the ROU asset and lease liability for the operating lease separate from the amounts of the ROU asset and lease liability for the finance lease and also indicate in which line items on the balance sheet each of those amounts is included (see Alternative 2). In addition, Lessee is precluded from combining the ROU asset and lease liability for the operating lease with the ROU asset and lease liability for the finance lease, respectively (e.g., Lessee may not present both lease liabilities in a single separate line item).

Following is Lessee's balance sheet under Alternative 1:

ASSETS		
Current assets		
Cash and equivalents	$	860,531
Accounts receivable, net		2,090,951
Inventory		3,330,201
Other current assets		680,987
Total current assets		6,962,670
Noncurrent assets		
Property and equipment		9,820,442
Accumulated depreciation		(4,680,065)
Property and equipment, net		5,140,377
ROU asset for operating lease, net		998,416
ROU asset for finance lease, net		662,408
Intangible assets		660,102
Goodwill		570,748
Deferred tax assets		490,625
Other noncurrent assets		448,068
Total assets	$	15,933,414

LIABILITIES AND EQUITY		
Current liabilities		
Accounts payable	$	2,250,125
Current operating lease liability		85,102
Current finance lease liability		59,190
Other current liabilities		47,652
Total current liabilities		2,442,069
Noncurrent liabilities		
Long-term debt		3,560,413
Lease liability for operating lease		913,314
Lease liability for finance lease		620,979
Other noncurrent liabilities		472,777
Shareholders' equity		
Common stock		100,000
Additional paid-in capital		4,354,413
Retained earnings		3,469,449
Total shareholders' equity		7,923,862
Total liabilities and equity	$	15,933,414

Alternative 2

Alternative 2 includes the ROU assets and lease liabilities for the operating lease and finance lease in other line items on the balance sheet. With this presentation, Lessee also discloses the following information in its footnotes to comply with ASC 842:

- The ROU asset and lease liability for the operating lease are included in the following line items on the balance sheet: (a) the net ROU asset of $998,416 is included in Other noncurrent assets, (b) the current portion of the lease liability of $85,102 is included in Accounts payable and (c) the noncurrent portion of the lease liability of $913,314 is included in Other noncurrent liabilities.
- The ROU asset and lease liability for the finance lease are included in the following line items on the balance sheet: (a) the gross ROU asset of $736,009 is included in Property, plant and equipment, (b) the accumulated amortization for the ROU asset of $73,601 is included in Accumulated depreciation and amortization, (c) the current portion of the lease liability of $59,190 is included in Other current liabilities and (d) the noncurrent portion of the lease liability of $620,979 is included in Long-term debt.

Note that Lessee is precluded from including the amounts for the operating lease and finance lease in the same line item. For example, ASC 842 prohibits inclusion of the noncurrent portion of both the lease liabilities in Other noncurrent liabilities.

Following is Lessee's balance sheet under Alternative 2:

ASSETS			LIABILITIES AND EQUITY		
Current assets			**Current liabilities**		
Cash and equivalents	$	860,531	Accounts payable	$	2,335,227
Accounts receivable, net		2,090,951	Other current liabilities		106,842
Inventory		3,330,201	Total current liabilities		2,442,069
Other current assets		680,987			
Total current assets		6,962,670			
Noncurrent assets			**Noncurrent liabilities**		
Property and equipment		10,556,451	Long-term debt		4,181,392
Accumulated deprec. and amort.		(4,753,666)	Other noncurrent liabilities		1,386,091
Property and equipment, net		5,802,785	**Shareholders' equity**		
Intangible assets		660,102	Common stock		100,000
Goodwill		570,748	Additional paid-in capital		4,354,413
Deferred tax assets		490,625	Retained earnings		3,469,449
Other noncurrent assets		1,446,484	Total shareholders' equity		7,923,862
Total assets	$	15,933,414	**Total liabilities and equity**	$	15,933,414

As mentioned earlier, Alternatives 1 and 2 are not the only balance-sheet presentation alternatives available to Lessee. But, they do represent the two ends of the spectrum that Lessee could be on with respect to the level of detail it provides on the face of its balance sheet about its ROU assets and lease liabilities. In addition, materiality considerations normally taken into consideration with respect to presentation and disclosure matters should also factor into Lessee's decision about the approach it should take with respect to presenting its ROU assets and lease liabilities on its balance sheet.

9.2 Income statement

Classification of lease costs under ASC 842 that are recognized as an expense on the income statement depends on the classification of the lease. If the lease is classified as a finance lease, classification of the expense related to the amortization of the ROU asset and the expense related to interest on the lease liability should be consistent with how the lessee classifies similar expenses on its income statement (e.g., depreciation and interest expense related to the financed purchase of property, plant or equipment).

If the lease is classified as an operating lease, the expense should be included in the lessee's income from continuing operations, unless it is part of a component or group of components treated as discontinued operations.

ASC 842 does not explicitly discuss the income-statement presentation of variable lease costs not included in the lease liability (e.g., variable lease payments based on other than an index or rate) that are recognized as an expense. We believe the presentation of such costs depends on the classification of the lease as follows:

- *Operating lease*. We believe variable lease costs not included in the lease liability that are recognized as an expense should be presented in the same manner as the lease costs included in the lease liability that are recognized as an expense. As such, if the lease costs included in the lease liability for an operating lease are presented in the Rent expense line item on the income statement, variable lease costs related to the operating lease should also be presented in the Rent expense line item on the income statement.
- *Finance lease*. ASC 842 indicates that the payment of a variable lease cost not included in the lease liability should be classified as an operating activity in the cash flow statement. As such, we believe the related expense should be included in the lessee's income from continuing operations, unless it is part of a component or group of components treated as discontinued operations. If the lessee has operating leases, we believe the lessee should consider presenting a variable lease cost not included in the lease liability for a finance lease in a manner that is consistent with either: (a) the presentation of its operating lease costs or (b) the presentation of interest costs on variable rate debt.

ASC 842 also does not explicitly discuss the income-statement presentation of short-term lease costs (i.e., the costs associated with those leases for which the lessee has elected the short-term lease accounting policy [see Section 7.1.1]) that are recognized as an expense. However, ASC 842 does discuss the presentation of the cash payments related to those costs in the cash flow statement and indicates that such payments should be included in operating activities. As such, we believe short-term lease costs recognized as an expense should be included in the lessee's income from continuing operations, unless they are part of a component or group of components treated as discontinued operations. In addition, if the lessee has operating leases, we believe the lessee should present short-term lease costs recognized as an expense in the same manner it presents its operating lease costs recognized as an expense.

Example 9-2: Income statement presentation of operating and finance lease activity

Facts

This example is a continuation of Example 9-1.

Analysis

For the rent expense related to the operating lease, Lessee may either include a separate line item for rent expense that is included in the determination of income from continuing operations or include the amount of rent expense in another suitable operating expense line item that is included in the determination of income from continuing operations. Separately, Lessee is required to disclose the amount of lease costs related to its operating leases.

With respect to the finance lease, if Lessee had financed the purchase of the underlying asset instead of leasing the underlying asset, it would have: (a) included the depreciation of the underlying asset in the Depreciation and amortization line item on its income statement and (b) included the interest expense related to the financing in the Interest expense line item on its income statement. As such, Lessee: (a) includes the amortization of the ROU asset in the Depreciation and amortization line item on the income statement and (b) includes the interest expense related to the accretion of the lease liability in the Interest expense line item on the income statement. Separately, Lessee is required to disclose the amount of lease costs related to its finance leases.

Lessee also had a variable lease cost in 20X6 related to the finance lease. Given that the variable lease cost was not reflected in the lease liability (because it was based on meeting a usage threshold), Lessee must present this cost in its income from continuing operations. In addition, Lessee should consider presenting such cost in the Rent expense line item. Separately, Lessee is required to disclose the amount of variable lease costs recognized.

9.3 Cash flow statement

If the lease is classified as a finance lease, the lessee classifies: (a) the portion of the related lease payment representing repayment of principal as a financing activity, (b) the portion of the lease payment representing interest in the same manner that it classifies interest payments on debt (e.g., if none of the interest payment is capitalized, it is classified as an operating activity) and (c) variable lease payments not included in the lease liability as an operating activity.

If the lease is classified as an operating lease, lease payments (including all variable lease payments) are classified as operating activities. However, the portion (if any) of those lease payments representing costs that were capitalized in accordance with other U.S. GAAP (e.g., lease payments for a piece of equipment being used in the construction of a building) should be classified as investing activities.

When the lessee has elected an accounting policy to not recognize ROU assets and lease liabilities for some (by class of underlying asset) or all of its short-term leases (see Section 7.1.1), lease payments under those leases are classified as operating activities.

Example 9-3: Cash flow statement presentation of operating and finance lease payments

Facts

This example is a continuation of Example 9-1 and Example 9-2.

Analysis

Lessee classifies the $150,000 payment made on December 31, 20X6 for the operating lease as an operating activity on the cash flow statement.

Lessee’s cash flow statement classification of the $100,000 payment made on December 31, 20X6 for the finance lease is as follows:

- Because $44,161 was reflected as interest expense for the finance lease, Lessee classifies $44,161 of the $100,000 payment as an operating activity on the cash flow statement.
- Because $55,839 of the $100,000 payment ($100,000 payment – $44,161 interest cost = $55,839 principle reduction) was treated as a reduction to the lease liability for the finance lease, Lessee classifies $55,839 as a financing activity on the cash flow statement.

Lessee classifies the $50,000 variable lease payment made for the finance lease as an operating activity on the cash flow statement.

Separately, Lessee must disclose the cash payments made for amounts included in its finance lease liabilities and operating lease liabilities. In addition, Lessee must disclose supplemental noncash information about obtaining ROU assets from incurring lease liabilities.

9.4 Disclosures

The overall disclosure objective for lessees is to provide information that enables users of the financial statements to assess the effects leases have on the amount, timing and uncertainly of cash flows. To satisfy this objective, there are a variety of disclosure requirements that lessees must comply with by providing a variety of qualitative and quantitative information about their leases in the notes to the financial statements. Examples of the information that must be provided to comply with the disclosure requirements in ASC 842 include:

- Information about significant assumptions and judgments made when accounting for leases in accordance with ASC 842, including those significant assumptions and judgments used in determining whether a contract includes a lease, separating lease and nonlease components and determining the discount rate used in the accounting for the lease.
- The weighted-average remaining lease term and weighted-average discount rate, separately for finance and operating leases.
- A reconciliation of the total lease payments shown in the separate lease payment maturity analyses for finance and operating leases to the separate lease liabilities recognized in the balance sheet for finance and operating leases.

For a complete list of the disclosures lessees must provide under ASC 842, refer to the disclosure checklist included in Appendix D.

Spotlight on change: More disclosure requirements

Many of the disclosure requirements in ASC 842 are new compared to the disclosure requirements under ASC 840.

9.4.1 Interim disclosures after the year of adoption

For lessees, ASC 842 only includes *annual* disclosure requirements. In addition, ASC 270 does not include any lessee-specific disclosures that must be provided in interim financial statements. However, ASC 270-10-50-3 indicates the following:

> There is a presumption that users of summarized interim financial data will have read the latest published annual report, including the financial disclosures required by the generally accepted accounting principles (GAAP) and management's commentary concerning the annual financial results, and that the summarized interim data will be viewed in that context. In this connection, management is encouraged to provide commentary relating to the effects of significant events upon the interim financial results.

As such, while there are no specific disclosures that a lessee must provide in its interim financial statements, it should consider whether there have been any significant changes in its leasing activities since its year end. If so, those changes should be disclosed in the lessee's interim financial statements. In addition, to the extent a lessee's leasing activities are significant to its financial statements, it should consider whether interim disclosure of some of the information only required to be disclosed on an annual basis is warranted.

9.4.2 Interim disclosures in the year of adoption

While ASC 842 and ASC 270 do not include any specific interim disclosure requirements (see Section 9.4.1), when a lessee applies ASC 842 in its interim financial statements for one or more interim periods before it applies ASC 842 in its annual financial statements, the lessee must provide all the required annual disclosures in those interim financial statements. After the lessee applies ASC 842 in its annual financial statements for the first time (and provides all the required annual disclosures in those financial statements), the required annual disclosures are no longer required in its future interim financial statements. Section 9.4.1 discusses the disclosures that a lessee may be required to make on an interim basis after the year of adoption.

For example, consider a public entity with a calendar year end that files financial statements with the SEC on a quarterly basis and did not adopt ASC 842 early. This public entity should include all of the annual disclosures required by ASC 842 in: (a) the interim financial statements it files with the SEC for its quarters ending March 31, June 30 and September 30, 2019 and (b) the annual financial statements it files with the SEC for its year ending December 31, 2019. Going forward into 2020, the required annual disclosures are no longer required in its interim financial statements. Section 9.4.1 discusses the disclosures that a lessee may be required to make on an interim basis after the year of adoption.

10. Effective date and transition

10.1 Effective date

With one exception, ASC 842 is effective for the following entities in annual reporting periods beginning after December 15, 2018 and the interim periods therein: (a) public business entities, (b) not-for-profit entities that have issued, or are conduit bond obligors for, securities that are traded, listed or quoted on an exchange or an over-the-counter market and (c) employee benefit plans that file or furnish financial statements to the SEC. As such, for a public business entity with a calendar year end, ASC 842 is effective on January 1, 2019 for both its interim and annual reporting periods, with the one exception. For all other entities (e.g., private companies), ASC 842 is effective in annual reporting periods beginning after December 15, 2021, and interim periods within fiscal years beginning after December 15, 2022. As such, for a private company with a calendar year end, ASC 842 is effective for the year ending December 31, 2022 and for interim periods in the year ending December 31, 2023. Early adoption is permitted for all entities.

10.2 Transition methods

A lessee may elect either of the following transition methods for purposes of its initial application of ASC 842.

- *Transition Method A*. ASC 842 is applied retrospectively to each prior reporting period presented in the financial statements with a cumulative-effect adjustment recognized as of the beginning of the earliest period presented.
- *Transition Method B*. ASC 842 is applied retrospectively to the beginning of the period of adoption through a cumulative-effect adjustment recognized as of the beginning of that period.

If the lessee elects Transition Method A, the date of initial application of ASC 842 for a particular lease is the later of the beginning of the earliest period presented and a lease's commencement date. If the lessee elects Transition Method B, the date of initial application of ASC 842 for a particular preexisting lease is the beginning of the reporting period in which ASC 842 is first applied. Regardless of the transition method selected by the lessee, the effective date of ASC 842 is the first day of the annual financial reporting period in which the lessee transitions to ASC 842. As such, when Transition Method B is elected, the date of initial application for a preexisting lease and the effective date are the same. A preexisting lease refers to a lease in existence prior to the date of initial application.

Consider a situation in which there is a private company lessee with a calendar year end that does not early adopt ASC 842 and includes one comparative period in its financial statements. In this situation, the transition methods translate to the following for the lessee:

- *Transition Method A*. The effective date of ASC 842 is January 1, 2022. ASC 842 is retrospectively applied on a modified basis to 2021 with a cumulative-effect adjustment recognized as of January 1, 2021. The date of initial application for a lease with a commencement date prior to January 1, 2021, is January 1, 2021. The date of initial application for a lease with a commencement date on or between January 1, 2021 and December 31, 2021 is the lease’s commencement date. ASC 842 applies in its entirety to any leases with commencement dates of January 1, 2022 or later.
- *Transition Method B*. The effective date of ASC 842 is January 1, 2022. ASC 842 is retrospectively applied on a modified basis to January 1, 2022 with a cumulative-effect adjustment recognized as of January 1, 2022. The date of initial application for a lease with a commencement date prior to January 1, 2022 is January 1, 2022. ASC 842 applies in its entirety to any leases with commencement dates of January 1, 2022 or later.

What we expect: Election of Transition Method B

Given the difficulty in retrospectively applying ASC 842, even on a modified retrospective basis under Transition Method A, we expect most lessees to select Transition Method B.

10.2.1 Normal asset capitalization threshold

From a practical perspective, an entity typically has a normal asset capitalization threshold that it uses in determining whether certain costs should be capitalized or expensed. For example, an entity may determine that any asset purchases below $5,000 should be expensed, under the theory that the accounting effects of expensing such asset purchases compared to capitalizing and depreciating them is immaterial. Having a normal asset capitalization threshold is a reasonable practice provided the entity has a basis for concluding that its effects on the entity's financial statements are immaterial.

Upon its transition to ASC 842, an entity should consider whether any adjustments to its normal asset capitalization threshold are needed. In addition, if an entity that is a lessee anticipates applying the normal asset capitalization threshold to ROU assets, consideration must be given to the fact that doing so would also affect the lessee's liabilities. In other words, if a ROU asset is not recognized because it is below $5,000, for example, a corresponding lease liability would also not be recognized. While the effects of not recognizing the ROU asset in that situation might be immaterial, the lessee also needs to be sure that the effects of not recognizing the lease liability in that situation are also immaterial.

10.3 Practical expedients

When applying either Transition Method A or B, the lessee may elect the following practical expedients: (a) a package of transition practical expedients (see Section 10.3.1), (b) a hindsight practical expedient (see Section 10.3.2) and (c) a land easement practical expedient (see Section 10.3.3). A lessee may elect one or more of these practical expedients, but if elected, must apply the practical expedient to all preexisting leases (or easements).

10.3.1 Package of transition practical expedients

ASC 842-10-65-1(f) includes three practical expedients that if elected must be elected as a package. If a lessee elects the package of transition practical expedients, it does not reassess its prior conclusions under ASC 840 regarding the following:

- *Whether a preexisting contract is or contains a lease*. Determining whether a contract is or contains a lease is different under ASC 842 compared to ASC 840 (see Chapter 3). If the package of transition practical expedients is elected, and a preexisting contract was deemed to be or include a lease under ASC 840, then upon transition to ASC 842, the contract is deemed to be or include a lease under ASC 842, without consideration of the otherwise applicable guidance in ASC 842. The same would be true for the inverse situation in which a preexisting contract was not deemed to be nor to include a lease under ASC 840. In this situation, upon transition to ASC 842, the preexisting contract is not deemed to be nor to include a lease under ASC 842, without consideration of the otherwise applicable guidance in ASC 842. If the package of transition practical expedients is not elected, the lessee must evaluate whether its preexisting contracts are or contain one or more leases using the applicable guidance in ASC 842.

- *Whether a preexisting lease should be classified as an operating or finance lease*. Determining the classification of a lease changed under ASC 842 compared to ASC 840 (see Chapter 6). If the package of transition practical expedients is elected, and a preexisting lease was classified as an operating lease under ASC 840, it is classified as an operating lease under ASC 842, without consideration of the otherwise applicable guidance in ASC 842. Similarly, a preexisting lease that was classified as a capital lease under ASC 840 is classified as a finance lease under ASC 842, without consideration of the otherwise applicable guidance in ASC 842. If the package of transition practical expedients is not elected, the lessee must evaluate the classification of each of its preexisting leases using the applicable guidance in ASC 842, which could lead to changes in the classification of the lease upon transition to ASC 842.

- *Whether the initial direct costs capitalized for a preexisting lease under ASC 840 qualify for capitalization*. The definition of initial direct costs was narrowed in ASC 842 compared to ASC 840 (i.e., ASC 840 has a broader definition of such costs) (see Section 7.1.3.1). If the package of transition practical expedients is elected, any initial direct costs capitalized under ASC 840 for a preexisting lease remain capitalized under ASC 842, without consideration of the otherwise applicable guidance in ASC 842. If the package of transition practical expedients is not elected, any initial direct costs capitalized for a preexisting lease under ASC 840 prior to the date of initial application are written off to equity if they do not meet the definition of initial direct costs in ASC 842.

A lessee must elect these practical expedients as a package (i.e., either all or none), and if elected, must apply the package of transition practical expedients to all preexisting leases.

A lessee may not use election of the package of transition practical expedients to *grandfather* errors in the application of ASC 840. For example, all of the following should be considered errors in the application of ASC 840:

- *The lessee did not identify all leases under ASC 840 or misidentified contracts as leases under ASC 840*. For example, the lessee did not properly identify that a service arrangement included a lease under ASC 840.
- *The lessee did not properly classify a lease under ASC 840*. For example, a lessee classified a lease as an operating lease under ASC 840 when it should have been classified as a capital lease.
- *The lessee inappropriately applied the definition of initial direct costs in ASC 840*. For example, the lessee capitalized costs for a preexisting lease as initial direct costs and those costs did not meet the definition of initial direct costs under ASC 840.

An error in the application of ASC 840 should be carefully evaluated to understand its effects on the financial statements, and whether those effects warrant correction of an error before the adoption of ASC 842. For example, an error in which a service arrangement should have been identified as a lease (or as including a lease) under ASC 840 and classified and accounted for as an operating lease may not have significantly affected the financial statements if the accounting for the arrangement as a service contract closely mirrored what the accounting would have been if the arrangement were accounted for as an operating lease under ASC 840. Depending on the facts and circumstances, this error may not warrant correction before the adoption of ASC 842. In contrast, an error in which an operating lease should have been classified as a capital lease under ASC 840 may significantly affect the financial statements given that the accounting for an operating lease and a capital lease under ASC 840 do not mirror each other. Depending on the facts and circumstances, this error may warrant correction before the adoption of ASC 842. Paragraph BC393 of ASU 2016-02 notes that the package of transition practical expedients in ASC 842 only grandfathers *proper* assessments under ASC 840. Improper assessments should be evaluated as errors and corrected in accordance with ASC 250 as warranted.

What we expect: Election of package of transition practical expedients

Given the efficiencies to be gained in electing the package of transition practical expedients, particularly with respect to not having to reevaluate all preexisting contracts to determine whether those contracts are or include leases under ASC 842 and not having to reevaluate whether a lease should be classified as an operating or finance lease under ASC 842, we expect most lessees to elect the package of transition practical expedients.

10.3.2 Hindsight practical expedient

Lessees are permitted to make an election to use hindsight when determining the following:

- *Lease term*. For example, if a lessee elects the hindsight practical expedient, it would evaluate its option to renew or terminate the preexisting lease or purchase the underlying asset using hindsight.
- *Impairment of ROU assets*. For example, if a lessee elects the hindsight practical expedient, it would use hindsight when evaluating the ROU assets related to preexisting leases for impairment under ASC 360-10-35 (see Section 7.3).

If a lessee elects the hindsight practical expedient, it should consider all facts and circumstances that have changed, through the effective date of ASC 842 (or the adoption date when the lessee early adopts ASC 842), in applying hindsight. In applying the hindsight practical expedient, lessees should not consider events that occurred after the effective (or adoption) date, but prior to the first time it issues its financial statements reflecting the adoption of ASC 842 (i.e., hindsight only extends to the effective [or adoption] date).

If a lessee does not elect the hindsight practical expedient, it would determine the lease term and impairment of ROU assets for preexisting leases based on the facts and circumstances in existence when those determinations were otherwise made.

The hindsight practical expedient may be elected separately or in conjunction with the package of transition practical expedients described in Section 10.3.1. A lessee must apply the hindsight practical expedient to all preexisting leases or apply it to none of them.

What we expect: Carefully consider whether to elect hindsight practical expedient

Electing the hindsight practical expedient could lead to a change in the lease term. For example, consider a situation in which a 10-year lease with a 5-year renewal option was entered into seven years before the date of initial application of ASC 842. When the lease was entered into, the lessee concluded that election of the renewal option was not reasonably assured. As such, the lease term under ASC 840 was determined to be 10 years. Seven years later, on the date of initial application, the lessee elects the hindsight practical expedient. The lessee concludes that election of the renewal option is reasonably assured based on hindsight because it added significant leasehold improvements with a 10-year life at the end of the lease's fifth year that were not anticipated at lease inception. As a result, the total lease term on the date of initial application is 15 years and the remaining lease term is eight years (three years related to the original lease term and five years related to the renewal option). If the lessee had not elected the hindsight practical expedient, the total lease term on the date of initial application would have continued to be 10 years, and the remaining lease term would have been three years.

If electing the hindsight practical expedient changes the lease term, the accounting for the preexisting lease in transition changes, which may or may not be a desired outcome for the lessee. Continuing with the previous example, also assume the following:

- The lessee elects Transition Method B and the package of transition practical expedients.
- The lessee's preexisting leases have not been modified on or after the effective date.
- The lessee has not been required to remeasure the lease liability based on the guidance in ASC 842-20-35-4 and 35-5, for any reason on or after the effective date.

As presented in the applicable Lessee transition grid included in Section 10.4.5, when the hindsight practical expedient is elected, and using hindsight changes the lease term, initially measuring the lease liability and ROU asset for the preexisting lease will likely require more effort than initially measuring the lease liability and ROU asset for the preexisting lease when either: (a) the lease term does not change or (b) the lessee does not elect the hindsight practical expedient to begin with. While applying hindsight when transitioning to the new guidance on a modified retrospective basis inherently seems like it should result in less effort, that may not necessarily be the case when transitioning to ASC 842.

We encourage lessees to carefully consider the effects of electing the hindsight practical expedient in the context of its own facts and circumstances, with the goal of determining whether those effects are worth any additional effort that may be required in applying that practical expedient.

10.3.2.1 Interaction of package of transition practical expedients and the hindsight practical expedient

As discussed in Section 10.3.2, when a lessee elects the hindsight practical expedient, the lease term and lease payments may change or there may be a change in the assessment as to whether a lessee is reasonably certain to exercise a purchase option. Absent election of the package of transition practical expedients (see Section 10.3.1), the lessee would need to consider whether these changes result in a different classification for the lease under ASC 842. With the election of the package of transition practical expedients in addition to the hindsight practical expedient, we believe the package of transition practical expedients takes precedence in that the lessee is not required to reassess the lease's classification under ASC 842 even if the lease term, lease payments or purchase option exercise assessment change as a result of applying the hindsight practical expedient, which would otherwise require reassessment of the lease classification. While we believe the lessee would not be *required to* reassess the lease's classification under ASC 842 in this situation, we also believe they would not be *precluded from* doing so.

10.3.3 Land easement practical expedient

A land easement is also known as a right of way that provides the lessee with the right to use, access or cross another entity's land for a specified purpose. When a lessee elects the land easement practical expedient:

- The lessee does not assess whether preexisting or expired land easements that were not previously accounted for as leases under ASC 840 are or contain a lease under ASC 842.
- The lessee does assess whether preexisting or expired land easements entered into (or modified) on or after the date of initial application are or contain a lease under ASC 842.

When a lessee does *not* elect the land easement practical expedient, the lessee must assess the following:

- Whether preexisting or expired land easements that were not previously accounted for as leases under ASC 840 are or contain a lease under ASC 842.
- Whether those land easements entered into (or modified) on or after the date of initial application are or contain a lease under ASC 842.

A lessee that accounted for preexisting or expired land easements as leases under ASC 840 may *not* elect the land easement practical expedient for those land easements.

The land easement practical expedient may be elected separately or in conjunction with either or both the package of transition practical expedients and (or) the hindsight practical expedient described in Section 10.3.2. A lessee must apply the land easement practical expedient to all preexisting land easements or apply it to none of them.

What we expect: Election of land easement practical expedient

We expect most lessees to elect the land easement practical expedient given: (a) lessees have not typically identified land easements as leases in the past and (b) the difficulties that would arise in assessing whether preexisting or expired land easements are or contain a lease under ASC 842.

10.4 Initial and subsequent measurement guidance for preexisting leases

10.4.1 Factors affecting the initial and subsequent measurement guidance for preexisting leases

The measurement of the lease liability and ROU asset for a preexisting lease when transitioning to ASC 842 depends on a number of factors, including:

- Whether the lessee elects Transition Method A or B.
- Whether the lessee elects one or more practical expedients.
- How the lease is classified under ASC 840 and ASC 842.

The Lessee transition grids in Sections 10.4.2 to 10.4.9 summarize the initial and subsequent measurement guidance for preexisting leases when transitioning to ASC 842, excluding build-to-suit leases (see ASC 842-10-65-1[u]), leveraged leases (see ASC 842-10-65-1[z]) and sale-leaseback transactions (see ASC 842-10-65-1[aa] to 65-1[ee]), all of which have their own specialized transition guidance. In addition, the Lessee transition grids apply to a lessee's preexisting leases as of the date of initial application, unless:

- *The lease has been modified on or after the effective date and the modification is not accounted for as a separate contract (see Section 7.2.5.1)*. In this situation, the guidance in ASC 842 is applied from the effective date of the modification. If a preexisting lease is modified on or after the effective date and the modification is accounted for as a separate contract, the transition guidance in ASC 842 applies to the preexisting lease, while the separate contract is subject to the guidance in ASC 842 in its entirety.
- *The lessee is required to remeasure the lease liability for any reason on or after the effective date (see Section 7.2.1.1)*. In this situation, once the lease liability is remeasured, the ROU asset is also remeasured, and both are subsequently accounted for based on the subsequent accounting guidance in ASC 842.

The Lessee transition grids are based on the transition elections a lessee may make. For starters, the transition grids are presented in two primary parts, one based on the lessee having elected Transition Method B and the other based on the lessee having elected Transition Method A. Next, the transition grids for each transition method address transition under the following four scenarios (for a total of eight transition scenarios across both transition methods):

1. The lessee elects neither the package of transition practical expedients nor the hindsight practical expedient.
2. The lessee elects the package of transition practical expedients, but not the hindsight practical expedient.
3. The lessee elects the hindsight practical expedient, but not the package of transition practical expedients.
4. The lessee elects both the package of transition practical expedients and the hindsight practical expedient.

While a lessee can also elect the land easement practical expedient, the results of doing so affects the population of leases for which a lease liability and ROU asset are recognized in transition, not how they are measured. As a result, the initial and subsequent measurement guidance for preexisting leases when transitioning to ASC 842 does not vary depending on whether that practical expedient is or is not elected. For the reasons discussed earlier in this chapter in the context of what we expect, we believe the most common transition scenario will be the lessee electing Transition Method B and the package of transition practical expedients.

Within each transition scenario, the initial and subsequent measurement guidance for preexisting leases when transitioning to ASC 842 is further differentiated as follows (to the extent necessary):

- Preexisting leases classified as operating leases under ASC 840 and ASC 842 (i.e., operating to operating).
- Preexisting leases classified as operating leases under ASC 840 and finance leases under ASC 842 (which would generally only be possible when the lessee has *not* elected the package of transition practical expedients) (i.e., operating to finance).
- Preexisting leases classified as capital leases under ASC 840 and finance leases under ASC 842 (i.e., capital to finance).
- Preexisting leases classified as capital leases under ASC 840 and operating leases under ASC 842 (which would generally only be possible when the lessee has *not* elected the package of transition practical expedients) (i.e., capital to operating).

10.4.1.1 Short-term leases in transition

As discussed in Section 7.1.1, lessees may elect an accounting policy (by class of underlying asset) for short-term leases that results in the lessee not recognizing lease liabilities and ROU assets. By definition, a short-term lease is one in which: (a) the lease term is 12 months or less and (b) there is not an option to purchase the underlying asset that the lessee is reasonably certain to exercise. In determining whether a preexisting lease may be considered short term for purposes of applying this accounting policy to those preexisting leases on the date of initial application, the lessee should consider the lease's full lease term (which would be its original lease term if the lease had not been modified), and not its remaining lease term, as of that date.

For example, consider a situation in which the lessee's date of initial application for purposes of transitioning to ASC 842 is January 1, 2022, and the lessee entered into a lease on December 31, 2020 with a lease term of two years. While the remaining lease term is less than twelve months as of January 1, 2022, the full lease term is two years. As such, the lease is not considered a short-term lease for purposes of applying the short-term leases accounting policy in transition.

10.4.1.2 Lease term used when determining the incremental borrowing rate on the date of initial application

As discussed in Section 5.2.2, one of the factors reflected in the incremental borrowing rate when it is used to account for a lease (or a portfolio of similar leases) is the lease term. In other words, the incremental borrowing rate should be based on a hypothetical loan with a term that is the same as the lease term. Depending on the transition scenario, a lessee may be required to determine the incremental borrowing rate for a preexisting lease (or a portfolio of similar preexisting leases) on the date of initial application. A question that arises in doing so is whether the term of the hypothetical loan used to identify the incremental borrowing rate should match the remaining lease term on the date of initial application or the full lease term. This question was addressed in the SEC staff speech (Berrigan 2017), in which the SEC staff indicated that the lessee could choose to use either the remaining lease term or full lease term when determining the incremental borrowing rate for a preexisting lease (or portfolio of similar preexisting leases) on the date of initial application, so long as the lessee consistently applies its choice. We believe this position is appropriate for all entities (and not just public entities) when applying ASC 842.

10.4.1.3 Leases denominated in a foreign currency in transition

Section 7.4 discusses the accounting under ASC 842 and ASC 830-10 for leases denominated in a foreign currency. When applying this guidance to preexisting leases in transition, a question arises with respect to the exchange rates that should be used to remeasure a lease liability and ROU asset denominated in a foreign currency into the lessee's functional currency on the date of initial application. We believe the answer to that question depends on the classification of the lease under ASC 840 and ASC 842 as follows:

	Operating under ASC 842	Finance under ASC 842
Operating under ASC 840	*Lease liability*: On the date of initial application and at the end of each subsequent reporting period, remeasure the lease liability using the current exchange rate for the functional currency. *ROU asset*: On the date of initial application, after initially measuring the ROU asset in the currency of the lease, remeasure the ROU asset using the current exchange rate for the functional currency. On a going forward basis, at the end of each subsequent reporting period, the ROU asset should continue to be remeasured at the exchange rate used on the date of initial application.	*Lease liability*: On the date of initial application and at the end of each subsequent reporting period, remeasure the lease liability using the current exchange rate for the functional currency. *ROU asset*: On the date of initial application, after initially measuring the ROU asset in the currency of the lease, remeasure the ROU asset using the current exchange rate for the functional currency. On a going forward basis, at the end of each subsequent reporting period, the ROU asset should continue to be remeasured at the exchange rate used on the date of initial application.
Capital under ASC 840	*Lease liability*: On the date of initial application and at the end of each subsequent reporting period, remeasure the lease liability using the current exchange rate for the functional currency. *ROU asset*: On the date of initial application, after initially measuring the ROU asset in the currency of the lease, remeasure the ROU asset using the current exchange rate for the functional currency. On a going forward basis, at the end of each subsequent reporting period, the ROU asset should continue to be remeasured at the exchange rate used on the date of initial application.	*Lease liability*: On the date of initial application and at the end of each subsequent reporting period, remeasure the lease liability using the current exchange rate for the functional currency. *ROU asset*: On the date of initial application and at the end of each subsequent reporting period, remeasure the ROU asset using the exchange rate on the lease's commencement date, or if later, on the date the lease was last modified (and a new exchange rate was used).

Note that the subsequent accounting for the lease liability always calls for remeasuring the lease liability at the end of subsequent reporting periods using the current exchange rate, which is consistent with the treatment of a lease liability as discussed in Section 7.4.

10.4.1.4 Including or excluding executory costs from minimum rental payments under ASC 840

There is diversity in practice under ASC 840 with respect to whether fixed payments to the lessor for executory costs (e.g., insurance, maintenance, taxes) should be included or excluded from minimum rental payments under ASC 840. As a result, each lessee essentially has an accounting policy to either include or exclude fixed payments to the lessor for executory costs from minimum rental payments under ASC 840. When transitioning to ASC 842, recognition of a lease liability and ROU asset for a preexisting lease classified as an operating lease under ASC 840 is based on the remaining minimum rental payments. Because of this, and because the treatment of executory costs under ASC 842 is different than ASC 840, the question has arisen with respect to how a lessee should treat fixed payments to the lessor for executory costs when transitioning to ASC 840. This question was addressed in two SEC staff speeches (Berrigan 2017 and Pidgeon 2018).

In both SEC staff speeches (Berrigan 2017 and Pidgeon 2018), the SEC staff agree that ASC 840 is unclear with respect to whether fixed payments to the lessor for executory costs should be included in or excluded from minimum rental payments. As such, either of the following accounting policies is acceptable:

- Minimum rental payments under ASC 840 include fixed payments to the lessor for executory costs.
- Minimum rental payments under ASC 840 exclude fixed payments to the lessor for executory costs.

One of the SEC staff speeches (Pidgeon 2018) also indicated that a lessee may proceed with either of the following approaches with respect to applying its selected accounting policy when transitioning to ASC 842:

- *Continue to apply the same accounting policy for purposes of transitioning to ASC 842.* Under this approach, when the transition guidance in ASC 842 requires the lessee to use the minimum rental payments under ASC 840 to measure the lease liability and ROU asset on the date of initial application of ASC 842, the lessee should use its existing accounting policy with respect to whether minimum rental payments include or exclude fixed payments to the lessor for executory costs.
- *Change its accounting policy in accordance with ASC 250 before or when transitioning to ASC 842.* Under this approach, the lessee may change its accounting policy with respect to whether fixed payments to the lessor for executory costs are included in or excluded from minimum rental payments under ASC 840. In doing so, the lessee should apply the guidance in ASC 250 to change its accounting policy, which typically requires retrospective application of the change in accounting policy and a conclusion that its new accounting policy is preferable to its old accounting policy. When Transition Method B is elected, retrospective application of this change in accounting policy for leases classified as operating leases under ASC 840 would typically just affect the lessee's disclosures of its future minimum rental payments. Whether the lessee is changing to a preferable accounting policy would depend on the facts and circumstances.

We believe either of these approaches may be applied by any entity (and not just a public entity) when transitioning to ASC 842.

10.4.1.5 Measuring variable lease payments based on an index or rate for purposes of minimum rental payments under ASC 840

ASC 840 requires a lessee to disclose its future minimum rental payments. There is diversity in practice with respect to whether future minimum rental payments should include variable lease payments based on an index or rate measured using: (a) the index or rate at lease inception or (b) the current rate or index. When transitioning to ASC 842, measurement of the lease liability and ROU asset recognized for a preexisting lease classified as an operating lease under ASC 840 is based on the remaining minimum rental payments under ASC 840. Because of this, a question has arisen with respect to how a lessee should measure variable lease payments based on an index or rate for purposes of their inclusion in the minimum rental payments used to measure the lease liability and ROU asset recognized upon transition to ASC 842. This question was addressed in an SEC staff speech (Pidgeon 2018), in which the SEC staff acknowledged the lack of clarity in ASC 840 with respect to the measurement of variable lease payments based on an index or rate for purposes of their inclusion in the future minimum rental payments used for disclosure purposes. The SEC staff also indicated that the diversity in practice resulted in lessees adopting one of the following accounting policies with respect to how variable lease payments based on an index or rate should be measured for disclosure purposes under ASC 840:

- Measure the variable lease payments based on an index or rate using the index or rate at lease inception (or if the lease was modified and the modification was accounted for as a new lease, the variable lease payments in the new lease that were based on an index or rate would be measured using the index or rate at the modification date).
- Measure the variable lease payments based on an index or rate using the current index or rate.

For purposes of their inclusion in the minimum rental payments used to measure the lease liability and ROU asset recognized upon transition to ASC 842 for preexisting leases classified as operating leases, the SEC staff indicated a lessee may take one of the following two approaches:

- Use the accounting policy that was used to measure variable lease payments based on an index or rate for purposes of disclosing the future minimum rental payments under ASC 840.
- Before its adoption of ASC 842, change the accounting policy that was used to measure variable lease payments based on an index or rate for purposes of disclosing the future minimum rental payments under ASC 840 and use the changed accounting policy for purposes of transitioning to ASC 842.

For purposes of the accounting policy under which the lessee would measure the variable lease payments based on an index or rate using the current index or rate, the current index or rate for preexisting leases would be the index or rate on the date of initial application.

If the lessee elects to change its accounting policy, it must do so in accordance with ASC 250, which typically requires retrospective application of the change in accounting policy and a conclusion that its new accounting policy is preferable to its old accounting policy. When Transition Method B is elected, retrospective application of this change in accounting policy for leases classified as operating leases under ASC 840 would typically just affect the lessee’s disclosures of its future minimum rental payments. Whether the lessee is changing to a preferable accounting policy would depend on the facts and circumstances.

We believe either of the approaches discussed by the SEC staff with respect to measuring variable lease payments based on an index or rate for purposes of their inclusion in the minimum rental payments under ASC 840 used to measure the lease liability and ROU asset recognized upon transition to ASC 842 may be applied by any entity (and not just a public entity).

10.4.1.6 ROU asset impairments in transition

The FASB clearly contemplated the possibility of a lessee recognizing a ROU asset impairment when transitioning to ASC 842 given that the hindsight practical expedient, if elected, provides for the lessee to use hindsight in measuring ROU asset impairments in transition. Unfortunately, there is not much more guidance in ASC 842 with respect to the recognition or measurement of a ROU asset impairment in transition. As such, the discussion in this section is based on our understanding of the direction the practice is headed with respect to whether a ROU asset impairment should be recognized in transition, and if so, how that impairment should be measured.

Section 7.3.1 of this guide provides an overall summary of the held-and-used impairment model in ASC 360-10-35 and discusses how that impairment model applies to ROU assets in general. Many of the concepts discussed in Section 7.3.1 are referred to in this section.

To understand when an ROU asset impairment should be recognized in transition, it is important to understand the concept of a hidden impairment. A hidden impairment arises due to the approach used in the held-and-used impairment model to allocate impairment losses and the limitation it places on not writing any of the long-lived assets in the asset group below their fair value. If an entity is unable to recognize the full amount of an impairment loss because of this limitation, the portion of the impairment loss not recognized is a hidden impairment. Consider the following example.

Example 10-1: Existence of a hidden impairment

Lessee is a private company with a calendar year end and only annual financial reporting requirements. At December 31, 2021, Lessee analyzes whether there are any triggering events present that would require it to test an asset group for impairment using the held-and-used impairment model. Based on this analysis, Lessee concludes that one of its asset groups should be tested for impairment.

Lessee's testing indicates that the asset group failed the recoverability test, and application of Step 2 to the asset group identified an impairment loss of $2 million. There are four long-lived assets in the asset group to which this $2 million impairment loss should be allocated. The information needed to allocate the $2 million loss and the allocation of that loss are as follows:

Long-lived asset to be held-and-used	(a) Net carrying amount	(b) Pro rata allocation % before limitation	(c) Allocated impairment loss (without consideration of limitation) ($2 million×b)	(d) Fair value	(e) Maximum impairment loss that could be recognized on each asset (a – d)	Actual impairment loss recognized (c > e, e e > c, c)
A	$1,000,000	10%	$200,000	$825,000	$175,000	$175,000
B	2,000,000	20%	400,000	1,650,000	350,000	350,000
C	3,000,000	30%	600,000	2,500,000	500,000	500,000
D	4,000,000	40%	800,000	3,275,000	725,000	725,000
Total	$10,000,000	100%	$2,000,000			$1,750,000

In this example, the amount of the impairment loss that could be allocated to each long-lived asset was limited to the excess of the carrying amount of the asset over its fair value because that amount was less than the amount of the impairment loss that would have otherwise been allocated to the asset. In addition, because all four of the assets were written down to their fair value, there was no additional allocation of the impairment loss that could not be allocated to the individual assets (i.e., the $250,000 difference between the $2 million impairment loss determined in Step 2 of the held-and-used impairment model and the $1.75 million of that impairment loss that could be allocated to the long-lived assets to be held and used in the asset group) (see Example 7-6 for an illustration of allocating more of the impairment loss to assets that were not written down to their fair values after the initial pro rata allocation of the impairment loss). The total impairment loss Lessee recognizes is $1,750,000, which is $250,000 less than the $2 million impairment loss Lessee would have recognized if it was not limited in the amount it could allocate to each asset. This $250,000 is referred to as a hidden impairment.

We understand that the FASB's intent was not to make lessees adjust or reperform their application of the held-and-used impairment model prior to the date of initial application. In addition, we generally expect that the held-and-used impairment model will only need to be applied on the date of initial application in limited situations involving hidden impairments.

As discussed in Section 7.3.1.1, it would be very unusual for an asset group to consist of one long-lived asset. In other words, applying the definition of an asset group typically results in an asset group including more than one long-lived asset. As such, when ROU assets are recognized in transition for operating leases, those ROU assets are typically included in preexisting asset groups. In the unusual circumstance in which a newly recognized ROU asset for an operating lease is a new asset group in and of itself, there is no need to consider whether there is a hidden impairment to recognize in transition. Going forward, that new asset group should be monitored for impairment testing in the same manner as the lessee's other asset groups are monitored for impairment testing.

In the more likely circumstance in which a ROU asset for an operating lease recognized in transition is added to an existing asset group, we believe that the addition of that ROU asset should only trigger the need to perform impairment testing under the held-and-used impairment model on the date of initial application when the lessee's application of that model to the asset group in the reporting period that ended right before the date of initial application resulted in a hidden impairment. When that is the case, the lessee applies the held-and-used impairment model to the asset group on the date of initial application. If doing so results in a portion of any identified impairment loss being allocated to the ROU asset, the allocated impairment loss is recognized by reducing equity and the amount of the ROU asset that would have otherwise been recognized in transition. The subsequent accounting for a ROU asset that has been impaired depends on the classification of the lease (see Section 7.2.2 and Section 7.2.3), and for ROU assets arising from operating leases, there is a significant change in the subsequent accounting for those assets when they have been impaired compared to the subsequent accounting for such assets that have not been impaired (see Section 7.2.3.2).

It is important to note that we do not believe a lessee is automatically required to apply the held-and-used impairment model as of the reporting period end right before the effective date of ASC 842. But, if a lessee is otherwise required to do so because one or more triggering events were present, and a hidden impairment results, consideration must be given to whether any of that hidden impairment should be recognized in transition to ASC 842.

Any triggering events that arise on or after the effective date should result in the application of the held-and-used impairment model. Any impairment loss resulting from application of that model should be recognized in the income statement.

The following example illustrates a situation in which a lessee must recognize the impairment of a ROU asset in transition.

Example 10-2: Recognition of a hidden impairment in transition

This example is a continuation of Example 10-1.

Lessee transitions to ASC 842 effective January 1, 2022. It has one operating lease, and based on the transition guidance in ASC 842, Lessee concludes it should recognize a lease liability and ROU asset in the amount of $2,510,000 in transition on January 1, 2022. However, the ROU asset is included in the asset group for which there was a hidden impairment at December 31, 2021. As such, Lessee must consider whether an impairment of that ROU asset should be recognized in transition given that there was a hidden impairment in the applicable asset group in the period end right before the effective date of ASC 842.

Because Lessee applied the held-and-used impairment model to the asset group (in which the ROU asset will be included) on December 31, 2021, it concludes that applying that model on January 1, 2022 (the date of initial application) would produce the same results other than the need to consider whether any of the hidden impairment should be allocated to the ROU asset and recognized in transition. In doing so, Lessee determines that the fair value of the ROU asset is $2,390,000. The difference between the ROU asset Lessee would have otherwise recognized on January 1, 2022 and the fair value of that asset is $120,000. Because that amount is less than the hidden impairment of $250,000, Lessee recognizes a ROU asset impairment in transition of $120,000 as follows:

	Debit	Credit
ROU asset	$2,390,000	
Retained earnings (ROU asset impairment in transition)	120,000	
Lease liability		$2,510,000

After transition, Lessee continues to monitor whether any triggering events occur that would require it to perform impairment testing for this asset group (as well as its other asset groups). The existence of a $130,000 hidden impairment in the asset group ($250,000 original hidden impairment – $120,000 ROU asset impairment recognized in transition) increases the likelihood of Lessee needing to recognize an additional long-lived asset impairment for this asset group in the future. If that occurs, any impairment loss would be recognized in the income statement.

If the fair value of the ROU asset on the effective date had been $2.7 million, Lessee would not have recognized a ROU asset impairment in transition. If a hidden impairment did not exist at December 31, 2021, Lessee would not have applied the held-and-used impairment model on January 1, 2022 (the date of initial application).

The more time that passes between the date of the impairment testing that resulted in a hidden impairment and the date of initial application, the more likely it is that performing the impairment testing on the date of initial application will result in a different impairment amount being allocated to the ROU asset in the asset group. For example, if the hidden impairment was identified on September 30, 2021 in this example (instead of December 31, 2021), the application of the held-and-used impairment model on the date of initial application (January 1, 2022) would likely result in a different impairment amount being allocated to the ROU asset compared to what would otherwise have been allocated to the ROU asset based on the impairment testing on September 30, 2021 (unless all of the assumptions used in the September 30, 2021 impairment testing were consistent with actual experience between September 30, 2021 and January 1, 2022).

10.4.1.7 Preexisting leases acquired in a business combination or asset acquisition

When a preexisting operating lease was acquired in a business combination and the lessee recognized an asset or liability under ASC 805-20 for the favorable or unfavorable terms of the lease, the lessee should derecognize the asset or liability by adjusting the ROU asset recognized upon transition to ASC 842. We believe the same is true for a preexisting operating lease acquired in an asset acquisition when the lessee recognized an asset or liability under ASC 805-50 for the favorable or unfavorable terms of the lease. In other words, the asset or liability for the favorable or unfavorable terms of the preexisting operating lease should be derecognized by the lessee by adjusting the ROU asset recognized upon transition to ASC 842.

10.4.2 Lessee transition grid: Transition Method B and package of transition practical expedients are elected, but not the hindsight practical expedient (i.e., most common transition scenario)

This grid addresses the first (and what we expect to be the most common) of the eight transition scenarios discussed in Section 10.4.1, which should be read in conjunction with using this grid to fully understand its applicability.

Elections:	Transition Method B and the package of transition practical expedients, but not the hindsight practical expedient
Operating to operating	
Initial accounting for a lease within the scope of this grid	
Lease liability	**ROU asset**
Measure at the PV of the sum of the following: (a) the remaining minimum rental payments under ASC 840 and (b) the amount probable of being owed under a residual value guarantee (if any). Determine the discount rate used for PV purposes under ASC 842 as of the date of initial application. (If a nonpublic lessee elects to use the risk-free rate to account for some or all of its leases [see Section 5.2.3], that rate would also be used for PV purposes on the date of initial application.) [ASC 842-10-65-1(l)]	Measure using the lease liability on the date of initial application adjusted for the following (as applicable) on the date of initial application: (a) prepaid or accrued lease payments, (b) the remaining balance of any lease incentives received, (c) unamortized initial direct costs, (d) impairment of the ROU asset (see Section 10.4.1.6) and (e) the carrying amount of any exit or disposal cost obligation for which a liability has been recognized in accordance with ASC 420. [ASC 842-10-65-1(m); ASC 842-20-35-3(b)]
Subsequent accounting for leases within the scope of this grid	
Lease liability	**ROU asset**
Measure at the PV of the sum of the following: (a) the remaining minimum rental payments under ASC 840 and (b) the amount probable of being owed under a residual value guarantee (if any). The discount rate used for PV purposes is the same as that used on the date of initial application. [ASC 842-10-65-1(l)]	If the ROU asset was not adjusted on the date of initial application for the carrying amount of an exit or disposal cost liability previously recognized in accordance with ASC 420, measure using the lease liability adjusted for the following (as applicable): (a) prepaid or accrued lease payments, (b) the remaining balance of any lease incentives received, (c) unamortized initial direct costs and (d) impairment of the ROU asset. If the ROU asset was adjusted on the date of initial application for the carrying amount of an exit or disposal cost liability previously recognized in accordance with ASC 420, apply the recognition and subsequent measurement guidance in ASC 842-20-25 and ASC 842-20-35. If the ROU asset was impaired under ASC 842 on or after the date of initial application, measure it after impairment using the guidance in ASC 842-20-35-10. [ASC 842-10-65-1(n); ASC 842-20-35-3(b)]

Elections: Transition Method B and the package of transition practical expedients, but not the hindsight practical expedient	
Capital to finance	
Initial accounting for a lease within the scope of this grid	
Lease liability	**ROU asset**
Measure at the carrying amount of the lease obligation determined in accordance with ASC 840 on the date of initial application. [ASC 842-10-65-1(r)(1)]	Measure at the carrying amount of the lease asset determined in accordance with ASC 840 on the date of initial application plus unamortized initial direct costs. [ASC 842-10-65-1(r)(1) and 65-1(r)(2)]
Subsequent accounting for leases within the scope of this grid	
Lease liability	**ROU asset**
Apply the subsequent measurement guidance in ASC 842-20-35-4 and 35-5 and ASC 842-20-35-8; except, when applying ASC 842-20-35-4, the lessee should disregard ASC 842-10-35-4(c)(3) related to remeasuring the lease payments for amounts probable of being owed under a residual value guarantee. [ASC 842-10-65-1(r)(5)]	

Example 10-3: Applying Transition Method B and the package of transition practical expedients (i.e., the most common transition scenario)

General facts

Lessee is a private company with a calendar year end. In its annual financial statements, Lessee provides one comparative period on its balance sheet and two comparative periods on its income statement and other activity-based statements. Lessee does not prepare interim financial statements in accordance with U.S. GAAP. Lessee has two separate leases with different counterparties (Lease A and Lease B). Neither lessor provided Lessee with any lease incentives. Both leases were entered into on January 1, 2019. The underlying asset for each lease is a piece of equipment. The leases do not include any nonlease components (e.g., maintenance services) or transfer ownership of the equipment to Lessee at the end of the lease term. In addition, neither of the leases includes any options to purchase the underlying asset or to extend or terminate the lease. Over the term of each lease, there are no modifications to either lease, no remeasurements of either lease's lease liability and no impairment of either lease's ROU asset. In addition, a liability is not recognized for either lease in accordance with ASC 420. Lessee elects to apply Transition Method B and the package of transition practical expedients upon transition to ASC 842.

Analysis of general facts

The effective date of ASC 842 for Lessee is January 1, 2022, which is the beginning of the first annual period in which Lessee must apply ASC 842. Because Lessee has elected Transition Method B, January 1, 2022 is also Lessee's date of initial application for ASC 842. As a result of Lessee electing the package of transition practical expedients, Lessee does not do any of the following in applying

Transition Method B: (a) reassess whether either lease is or includes a lease, (b) reassess the classification of either lease or (c) reassess whether any initial direct costs deferred in accordance with ASC 840 meet the revised definition of initial direct costs under ASC 842.

Additional facts for Lease A

- Lease A is classified as an operating lease in accordance with ASC 840.
- The noncancellable lease term is five years.
- The lease payments are as follows: (a) $31,000 is due on December 31, 2019 and 2020 and (b) $33,000 is due on December 31, 2021, 2022 and 2023 (for a total of $161,000).
- Initial direct costs of $500 are deferred and amortized over the lease term on a straight-line basis.
- The lease does not include a residual value guarantee.
- The rate implicit in the lease is not readily determinable.
- Lessee's incremental borrowing rate on January 1, 2022 (the date of initial application) is 6%.
- Lessee has recognized the following amounts in 2019, 2020 and 2021 in accordance with ASC 840:

	2019	2020	2021
Rent expense ([$161,000 minimum rental payments + $500 initial direct costs] ÷ 5 year lease term)	$32,300	$32,300	$32,300
Ending balance in straight-line rent liability (or accrued rent) (excess of cumulative rent expense [excluding amortization of initial direct costs] over cumulative lease payments)	$1,200	$2,400	$1,600
Ending balance in deferred initial direct costs ($500 beginning balance minus accumulated amortization)	$400	$300	$200

- Under ASC 842, straight-line amortization is used by Lessee to measure total remaining lease costs over the remaining lease term (i.e., the single lease cost recognized each year).

Analysis of Lease A

Because Lessee elected the package of transition practical expedients, Lease A's operating lease classification under ASC 840 is retained as its lease classification under ASC 842. Lessee recognizes a ROU asset and a lease liability as of January 1, 2022 (the date of initial application under Transition Method B). The lease liability for Lease A is initially measured at $60,502, which is the present value of the two remaining payments of $33,000 on December 31, 2022 and 2023, using the discount rate of 6%. The ROU asset for Lease A is initially measured at $59,102, which is the lease liability of $60,502 plus unamortized initial direct costs of $200 on December 31, 2021 minus the straight-line rent liability of $1,600 on December 31, 2021. The following journal entry illustrates the effects of ASC 842 on Lessee's date of initial application (January 1, 2022):

	Debit	Credit
ROU asset	$59,102	
Straight-line lease liability	1,600	
Lease liability		$60,502
Deferred initial direct costs		200

Total remaining lease costs as of January 1, 2022 are $64,600 (total lease payments of $161,000 + $500 of initial direct costs – $96,900 of lease costs recognized in prior periods [$32,300 rent expense ×

3 years]). Annual (i.e., single) lease costs over the remaining two-year lease term are $32,300 ($64,600 ÷ 2 years). The following table summarizes the accounting for the lease liability and ROU asset for Lease A after the date of initial application of January 1, 2022:

Lease liability	**2022**	**2023**
Beginning balance	$60,502	$31,132
Plus accretion (beginning balance × 6%)	3,630	1,868
Minus lease payment	33,000	33,000
Ending balance	$31,132	$ -
ROU asset		
Beginning balance	$59,102	$30,432
Minus amortization (Note 1)	28,670	30,432
Ending balance (Note 2)	$30,432	$ -

Note 1: The amortization of the ROU asset in each year is the difference between the single lease cost of $32,300 and the accretion of the liability in each year.

Note 2: The components of the ending balance of the net ROU asset at the end of 2022 are as follows:

Net ROU asset components	**2022**
Balance of the lease liability	$31,132
Minus accrued lease liability (see next table)	800
Plus unamortized initial direct costs	100
Ending balance	$30,432

Calculation of accrued lease liability at year end	**2022**
Total lease payments to be paid to the lessor that will be reflected in the single lease cost over the lease term	$161,000
Multiplied by: Fraction of lease term that has passed by the end of the year	4/5
Cumulative amount of total lease payments to be paid to the lessor that have been reflected in the lease costs through the end of the year	128,800
Less: Cumulative lease payments paid to the lessor through the end of the year	128,000
Accrued lease liability	$800

The ending balances in Lessee's lease liability and ROU asset are presented as amounts related to operating leases in its 2022 financial statements (see Sections 9.1 to 9.3).

Additional facts for Lease B

- Lease B is classified as a capital lease in accordance with ASC 840.
- The noncancellable lease term is seven years.
- Annual lease payments are $25,000, payable in arrears.
- The lease has a residual value guarantee of $8,190 that is probable of being owed over the lease term and is paid at the end of the lease term.
- The rate implicit in the lease is not readily determinable.
- Lessee's incremental borrowing rate on January 1, 2019 (date of lease commencement) is 6%.
- Lessee defers and amortizes initial direct costs of $2,800 over the lease term.

- The carrying amounts of the capital lease obligation, lease asset and unamortized initial direct costs related to Lease B on January 1, 2022 as determined in accordance with ASC 840 are $93,115, $82,861 and $1,600, respectively.
- The straight-line amortization method is used by Lessee to subsequently account for the ROU asset under ASC 842.

Analysis of Lease B

Because Lessee elected the package of transition practical expedients, the classification of Lease B under ASC 842 is a finance lease. Lessee recognizes a ROU asset and a lease liability on January 1, 2022, which is the date of initial application of ASC 842 under Transition Method B. The lease liability for Lease B is initially measured at the carrying amount of the capital lease obligation determined in accordance with ASC 840 on January 1, 2022, which is $93,115. The ROU asset for Lease B is initially measured at $84,461, which is the carrying amount of the lease asset determined in accordance with ASC 840 on January 1, 2022 ($82,861) plus the carrying amount of the unamortized initial direct costs determined in accordance with ASC 840 on January 1, 2022 ($1,600). The following journal entry illustrates the effects of ASC 842 on Lessee's date of initial application (January 1, 2022):

	Debit	Credit
ROU asset (under ASC 842)	$84,461	
Capital lease obligation (under ASC 840)	93,115	
Lease liability (under ASC 842)		$93,115
Capital lease asset (under ASC 840)		82,861
Deferred initial direct costs (under ASC 840)		1,600

Starting on January 1, 2022, the lease liability and ROU asset are subsequently accounted for in accordance with ASC 842-20-35 (see Section 7.2.1 and Section 7.2.2.2). The following table summarizes the accounting for Lease B after the date of initial application of January 1, 2022:

Lease liability	**2022**	**2023**	**2024**	**2025**
Beginning balance	$93,115	$73,702	$53,124	$31,311
Plus accretion (Note 1)	5,587	4,422	3,187	1,879
Minus lease payment (Note 2)	25,000	25,000	25,000	33,190
Ending balance	$73,702	$53,124	$31,311	$ -
ROU asset				
Beginning balance	$84,461	$63,346	$42,231	$21,116
Minus amortization (Note 3)	21,115	21,115	21,115	21,116
Ending balance	$63,346	$42,231	$21,116	$ -

Note 1: Accretion is calculated as the beginning balance of the lease liability in each year multiplied by 6%.
Note 2: The payment in 2025 is the $25,000 annual lease payment plus payment of the $8,190 residual value guarantee.
Note 3: Annual amortization of the ROU asset is calculated as the amount of the ROU asset on January 1, 2022 ($84,461) divided by the four-year remaining lease term.

The ending balances in Lessee's lease liability and ROU asset are presented as amounts related to finance leases starting in its 2022 financial statements (see Sections 9.1 to 9.3).

10.4.3 Lessee transition grid: Transition Method B is elected, but not the package of transition practical expedients or the hindsight practical expedient

This grid addresses one of the eight transition scenarios discussed in Section 10.4.1, which should be read in conjunction with using this grid to fully understand its applicability.

Elections: Transition Method B and neither the package of transition practical expedients nor the hindsight practical expedient	
Operating to operating	
Initial accounting for a lease within the scope of this grid	
Lease liability	**ROU asset**
Measure at the PV of the sum of the following: (a) the remaining minimum rental payments under ASC 840 and (b) the amount probable of being owed under a residual value guarantee (if any). Determine the discount rate used for PV purposes under ASC 842 as of the date of initial application. (If a nonpublic lessee elects to use the risk-free rate to account for some or all of its leases [see Section 5.2.3], that rate would also be used for PV purposes on the date of initial application.) [ASC 842-10-65-1(l)]	Measure using the lease liability on the date of initial application adjusted for the following (as applicable) on the date of initial application: (a) prepaid or accrued lease payments, (b) the remaining balance of any lease incentives received, (c) unamortized initial direct costs that meet the definition of such costs under ASC 842, (d) impairment of the ROU asset (see Section 10.4.1.6) and (e) the carrying amount of any exit or disposal cost obligation for which a liability has been recognized in accordance with ASC 420. Writeoff to equity any unamortized initial direct costs incurred prior to the date of initial application that do not meet the definition of such costs in ASC 842. [ASC 842-10-65-1(m) and 65-1(p); ASC 842-20-35-3(b)]
Subsequent accounting for leases within the scope of this grid	
Lease liability	**ROU asset**
Measure at the PV of the sum of the following: (a) the remaining minimum rental payments under ASC 840 and (b) the amount probable of being owed under a residual value guarantee (if any). The discount rate used for PV purposes is the same as that used on the date of initial application. [ASC 842-10-65-1(l)]	If the ROU asset was not adjusted on the date of initial application for the carrying amount of an exit or disposal cost liability previously recognized in accordance with ASC 420, measure using the lease liability adjusted for the following (as applicable): (a) prepaid or accrued lease payments, (b) the remaining balance of any lease incentives received, (c) unamortized initial direct costs and (d) impairment of the ROU asset. If the ROU asset was adjusted on the date of initial application for the carrying amount of an exit or disposal cost liability previously recognized in accordance with ASC 420, apply the recognition

Elections: Transition Method B and neither the package of transition practical expedients nor the hindsight practical expedient	
	and subsequent measurement guidance in ASC 842-20-25 and ASC 842-20-35. If the ROU asset was impaired under ASC 842 on or after the date of initial application, measure it after impairment using the guidance in ASC 842-20-35-10. [ASC 842-10-65-1(n); ASC 842-20-35-3(b)]
Operating to finance	
Initial accounting for a lease within the scope of this grid	
Lease liability	**ROU asset**
Measure at the PV of the sum of the following: (a) the remaining minimum rental payments under ASC 840 and (b) the amount probable of being owed under a residual value guarantee (if any). Determine the discount rate used for PV purposes under ASC 842 as of the date of initial application. (If a nonpublic lessee elects to use the risk-free rate to account for some or all of its leases [see Section 5.2.3], that rate would also be used for PV purposes on the date of initial application.) [ASC 842-10-65-1(l)]	Measure using the applicable proportion of the lease liability at the commencement date (which can be imputed from the lease liability as of the date of initial application) adjusted for: (a) the carrying amount of any prepaid or accrued lease payments and (b) the carrying amount of any exit or disposal cost obligation for which a liability has been recognized in accordance with ASC 420. Measure the applicable proportion as the remaining lease term (under ASC 840) at the date of initial application compared to the total lease term (under ASC 840). Writeoff to equity any unamortized initial direct costs incurred prior to the date of initial application that do not meet the definition of such costs in ASC 842. [ASC 842-10-65-1(o) and 65-1(p)]
Subsequent accounting for leases within the scope of this grid	
Lease liability	**ROU asset**
Measure at the PV of the sum of the following: (a) the remaining minimum rental payments under ASC 840 and (b) the amount probable of being owed under a residual value guarantee (if any). The discount rate used for PV purposes is the same as that used on the date of initial application. [ASC 842-10-65-1(l)]	Measure using the applicable proportion of the lease liability at the commencement date (which can be imputed from the lease liability) adjusted for: (a) the carrying amount of any prepaid or accrued lease payments and (b) the carrying amount of any exit or disposal cost obligation for which a liability has been recognized in accordance with ASC 420. Measure the applicable proportion as the remaining lease term compared to the total lease term. [ASC 842-10-65-1(o)]

Elections: Transition Method B and neither the package of transition practical expedients nor the hindsight practical expedient	
Capital to finance	
Initial accounting for a lease within the scope of this grid	
Lease liability	**ROU asset**
Measure at the carrying amount of the lease obligation determined in accordance with ASC 840 on the date of initial application. [ASC 842-10-65-1(r)(1)]	Measure at the carrying amount of the lease asset determined in accordance with ASC 840 on the date of initial application plus unamortized initial direct costs that meet the definition of such costs in ASC 842. Writeoff to equity any unamortized initial direct costs that do not meet the definition of such costs in ASC 842 and that were not included in the measurement of the capital lease asset under ASC 840. [ASC 842-10-65-1(r)(1) to 65-1(r)(3)]
Subsequent accounting for leases within the scope of this grid	
Lease liability	**ROU asset**
Apply the subsequent measurement guidance in ASC 842-20-35-4 and 35-5 and ASC 842-20-35-8; except, when applying ASC 842-20-35-4, the lessee should disregard ASC 842-10-35-4(c)(3) related to remeasuring the lease payments for amounts probable of being owed under a residual value guarantee. [ASC 842-10-65-1(r)(5)]	
Capital to operating	
Initial accounting for a lease within the scope of this grid	
Lease liability	**ROU asset**
Derecognize the carrying amount of the capital lease obligation recorded under ASC 840. Recognize a lease liability in accordance with ASC 842-20-35-3(a). [ASC 842-10-65-1(s)(1) and 65-1(s)(2); ASC 842-20-35-3(a)]	Derecognize the carrying amount of the lease asset recorded under ASC 840. Account for any net difference between the carrying amount of the capital lease obligation under ASC 840 and the carrying amount of the lease asset recorded under ASC 840 in the same way as prepaid or accrued rent. Recognize a ROU asset in accordance with ASC 842-20-35-3(b). Writeoff to equity any unamortized initial direct costs that do not meet the definition of such costs in ASC 842. [ASC 842-10-65-1(s)(1) and 65-1(s)(2); ASC 842-10-65-1(s)(5); ASC 842-20-35-3(b)]

Elections: Transition Method B and neither the package of transition practical expedients nor the hindsight practical expedient	
Subsequent accounting for leases within the scope of this grid	
Lease liability	**ROU asset**
Apply the guidance in ASC 842-20. [ASC 842-10-65-1(r)(4)]	Apply the guidance in ASC 842-20. [ASC 842-10-65-1(r)(4)]

10.4.4 Lessee transition grid: Transition Method B and hindsight practical expedient are elected, but not the package of transition practical expedients

This grid addresses one of the eight transition scenarios discussed in Section 10.4.1, which should be read in conjunction with using this grid to fully understand its applicability.

Elections: Transition Method B and the hindsight practical expedient, but not the package of transition practical expedients	
Operating to operating	
Initial accounting for a lease within the scope of this grid	
Lease liability	**ROU asset**
If the application of hindsight in evaluating lease options does not change the lease term, measure at the PV of the sum of the following: (a) the remaining minimum rental payments under ASC 840 and (b) the amount probable of being owed under a residual value guarantee (if any). Determine the discount rate used for PV purposes under ASC 842 as of the date of initial application. (If a nonpublic lessee elects to use the risk-free rate to account for some or all of its leases [see Section 5.2.3], that rate would also be used for PV purposes on the date of initial application.) If the application of hindsight in evaluating lease options changes the lease term, measure the lease liability under ASC 842. [ASC 842-10-65-1(l)]	If the application of hindsight in evaluating lease options does not change the lease term, measure using the lease liability on the date of initial application adjusted for the following (as applicable) on the date of initial application: (a) prepaid or accrued lease payments, (b) the remaining balance of any lease incentives received, (c) unamortized initial direct costs that meet the definition of such costs under ASC 842, (d) impairment of the ROU asset (see Section 10.4.1.6) and (e) the carrying amount of any exit or disposal cost obligation for which a liability has been recognized in accordance with ASC 420. If the application of hindsight in evaluating lease options changes the lease term, measure the ROU asset under ASC 842 and adjust for the carrying amount of any exit or disposal cost obligation for which a liability has been recognized in accordance with ASC 420. Regardless of the effects of applying hindsight in evaluating lease options, writeoff to equity any unamortized initial direct costs incurred prior to the date of initial application that do not meet the definition of such costs in ASC 842.

Elections: Transition Method B and the hindsight practical expedient, but not the package of transition practical expedients	
	Use hindsight in assessing impairment of the ROU asset. [ASC 842-10-65-1(m); ASC 842-10-65-1(p); ASC 842-20-35-3(b)]
Subsequent accounting for leases within the scope of this grid	
Lease liability	**ROU asset**
If the application of hindsight in evaluating lease options does not change the lease term at transition, measure at the PV of the sum of the following: (a) the remaining minimum rental payments under ASC 840 and (b) the amount probable of being owed under a residual value guarantee (if any). The discount rate used for PV purposes is the same as that used on the date of initial application. If the application of hindsight in evaluating lease options changes the lease term at transition, measure the lease liability under ASC 842. [ASC 842-10-65-1(l)]	If the application of hindsight in evaluating lease options does not change the lease term at transition and the ROU asset was not adjusted on the date of initial application for the carrying amount of an exit or disposal cost liability previously recognized in accordance with ASC 420, measure using the lease liability adjusted for the following (as applicable): (a) prepaid or accrued lease payments, (b) the remaining balance of any lease incentives received, (c) unamortized initial direct costs and (d) impairment of the ROU asset. If the application of hindsight in evaluating lease options does not change the lease term at transition and the ROU asset was adjusted on the date of initial application for the carrying amount of an exit or disposal cost liability recognized in accordance with ASC 420, apply the recognition and subsequent measurement guidance in ASC 842-20-25 and ASC 842-20-35. If the application of hindsight in evaluating lease options changes the lease term at transition, measure the ROU asset under ASC 842. If the ROU asset was impaired under ASC 842 on or after the date of initial application, measure it after impairment using the guidance in ASC 842-20-35-10. [ASC 842-10-65-1(n); ASC 842-20-35-3(b)]

Elections: Transition Method B and the hindsight practical expedient, but not the package of transition practical expedients	
Operating to finance	
Initial accounting for a lease within the scope of this grid	
Lease liability	**ROU asset**
If the application of hindsight in evaluating lease options does not change the lease term, measure at the PV of the sum of the following: (a) the remaining minimum rental payments under ASC 840 and (b) the amount probable of being owed under a residual value guarantee (if any). Determine the discount rate used for PV purposes under ASC 842 as of the date of initial application. (If a nonpublic lessee elects to use the risk-free rate to account for some or all of its leases [see Section 5.2.3], that rate would also be used for PV purposes on the date of initial application.) If the application of hindsight in evaluating lease options changes the lease term, measure the lease liability under ASC 842. [ASC 842-10-65-1(l)]	If the application of hindsight in evaluating lease options does not change the lease term, measure using the applicable proportion of the lease liability at the commencement date (which can be imputed from the lease liability as of the date of initial application) adjusted for: (a) the carrying amount of any prepaid or accrued lease payments and (b) the carrying amount of any exit or disposal cost obligation for which a liability has been recognized in accordance with ASC 420. Measure the applicable proportion as the remaining lease term (under ASC 840) at the date of initial application compared to the total lease term (under ASC 840). If the application of hindsight in evaluating lease options changes the lease term, measure the ROU asset under ASC 842 and adjust for the carrying amount of any exit or disposal cost obligation for which a liability has been recognized in accordance with ASC 420. Regardless of the effects of applying hindsight in evaluating lease options, writeoff to equity any unamortized initial direct costs incurred prior to the date of initial application that do not meet the definition of such costs in ASC 842. Use hindsight in assessing impairment of the ROU asset. [ASC 842-10-65-1(o) to 65-1(p)]
Subsequent accounting for leases within the scope of this grid	
Lease liability	**ROU asset**
If the application of hindsight in evaluating lease options does not change the lease term, measure at the PV of the sum of the following: (a) the remaining minimum rental payments under ASC 840 and (b) the amount probable of being owed under a residual value guarantee (if any). The	If the application of hindsight in evaluating lease options does not change the lease term at transition, measure using the applicable proportion of the lease liability at the commencement date (which can be imputed from the lease liability) adjusted for: (a) the carrying

Elections: Transition Method B and the hindsight practical expedient, but not the package of transition practical expedients	
discount rate used for PV purposes is the same as that used on the date of initial application. If the application of hindsight in evaluating lease options changes the lease term at transition, measure the lease liability under ASC 842. [ASC 842-10-65-1(l)]	amount of any prepaid or accrued lease payments and (b) the carrying amount of any exit or disposal cost obligation for which a liability has been recognized in accordance with ASC 420. Measure the applicable proportion as the remaining lease term compared to the total lease term. If the application of hindsight in evaluating lease options changes the lease term at transition, measure the ROU asset under ASC 842. [ASC 842-10-65-1(o)]
Capital to finance	
Initial accounting for a lease within the scope of this grid	
Lease liability	**ROU asset**
If the application of hindsight in evaluating lease options does not change the lease term, measure at the carrying amount of the lease obligation determined in accordance with ASC 840 on the date of initial application. If the application of hindsight in evaluating lease options changes the lease term, measure the lease liability under ASC 842. [ASC 842-10-65-1(r)(1)]	If the application of hindsight in evaluating lease options does not change the lease term, measure at the carrying amount of the lease asset determined in accordance with ASC 840 on the date of initial application plus unamortized initial direct costs that meet the definition of such costs in ASC 842. Writeoff to equity any unamortized initial direct costs that do not meet the definition of such costs in ASC 842 and that were not included in the measurement of the capital lease asset under ASC 840. If the application of hindsight in evaluating lease options changes the lease term, measure the ROU asset under ASC 842. Writeoff to equity any unamortized initial direct costs that do not meet the definition of such costs in ASC 842. Use hindsight in assessing impairment of the ROU asset. [ASC 842-10-65-1(r)(1) to 65-1(r)(3)]
Subsequent accounting for leases within the scope of this grid	
Lease liability	**ROU asset**
Apply the subsequent measurement guidance in ASC 842-20-35-4 and 35-5 and ASC 842-20-35-8; except, when applying ASC 842-20-35-4, the lessee should disregard ASC 842-10-35-4(c)(3) related to remeasuring the lease payments for amounts probable of being owed under a residual value guarantee. [ASC 842-10-65-1(r)(5)]	

Elections: Transition Method B and the hindsight practical expedient, but not the package of transition practical expedients	
Capital to operating	
Initial accounting for a lease within the scope of this grid	
Lease liability	**ROU asset**
Derecognize the carrying amount of the capital lease obligation recorded under ASC 840. Recognize a lease liability in accordance with ASC 842-20-35-3(a). [ASC 842-10-65-1(s)(1) and 65-1(s)(2); ASC 842-20-35-3(a)]	Derecognize the carrying amount of the lease asset recorded under ASC 840. Account for any net difference between the carrying amount of the capital lease obligation under ASC 840 and the carrying amount of the lease asset recorded under ASC 840 in the same way as prepaid or accrued rent. Recognize a ROU asset in accordance with ASC 842-20-35-3(b). Writeoff to equity any unamortized initial direct costs that do not meet the definition of such costs in ASC 842. Use hindsight in assessing impairment of the ROU asset. [ASC 842-10-65-1(s)(1) and 65-1(s)(2); ASC 842-10-65-1(s)(5); ASC 842-20-35-3(b)]
Subsequent accounting for leases within the scope of this grid	
Lease liability	**ROU asset**
Apply the guidance in ASC 842-20. [ASC 842-10-65-1(r)(4)]	Apply the guidance in ASC 842-20. [ASC 842-10-65-1(r)(4)]

10.4.5 Lessee transition grid: Transition Method B and both the package of transition practical expedients and hindsight practical expedient are elected

This grid addresses one of the eight transition scenarios discussed in Section 10.4.1, which should be read in conjunction with using this grid to fully understand its applicability.

Elections: Transition Method B and both the package of transition practical expedients and the hindsight practical expedient	
Operating to operating	
Initial accounting for a lease within the scope of this grid	
Lease liability	**ROU asset**
If the application of hindsight in evaluating lease options does not change the lease term, measure	If the application of hindsight in evaluating lease options does not change the lease term, measure

Elections: Transition Method B and both the package of transition practical expedients and the hindsight practical expedient	
at the PV of the sum of the following: (a) the remaining minimum rental payments under ASC 840 and (b) the amount probable of being owed under a residual value guarantee (if any). Determine the discount rate used for PV purposes under ASC 842 as of the date of initial application. (If a nonpublic lessee elects to use the risk-free rate to account for some or all of its leases [see Section 5.2.3], that rate would also be used for PV purposes on the date of initial application.) If the application of hindsight in evaluating lease options changes the lease term, measure the lease liability under ASC 842. [ASC 842-10-65-1(l)]	using the lease liability on the date of initial application adjusted for the following (as applicable) on the date of initial application: (a) prepaid or accrued lease payments, (b) the remaining balance of any lease incentives received, (c) unamortized initial direct costs, (d) impairment of the ROU asset (see Section 10.4.1.6) and (e) the carrying amount of any exit or disposal cost obligation for which a liability has been recognized in accordance with ASC 420. If the application of hindsight in evaluating lease options changes the lease term, measure the ROU asset under ASC 842 and adjust for the carrying amount of any exit or disposal cost obligation for which a liability has been recognized in accordance with ASC 420. Use hindsight in assessing impairment of the ROU asset. [ASC 842-10-65-1(m); ASC 842-20-35-3(b)]
Subsequent accounting for leases within the scope of this grid	
Lease liability	**ROU asset**
If the application of hindsight in evaluating lease options does not change the lease term at transition, measure at the PV of the sum of the following: (a) the remaining minimum rental payments under ASC 840 and (b) the amount probable of being owed under a residual value guarantee (if any). The discount rate used for PV purposes is the same as that used on the date of initial application. If the application of hindsight in evaluating lease options changes the lease term at transition, measure the lease liability under ASC 842. [ASC 842-10-65-1(l)]	If the application of hindsight in evaluating lease options does not change the lease term at transition and the ROU asset was not adjusted on the date of initial application for the carrying amount of an exit or disposal cost liability previously recognized in accordance with ASC 420, measure using the lease liability adjusted for the following (as applicable): (a) prepaid or accrued lease payments, (b) the remaining balance of any lease incentives received, (c) unamortized initial direct costs and (d) impairment of the ROU asset. If the application of hindsight in evaluating lease options does not change the lease term at transition and the ROU asset was adjusted on the date of initial application for the carrying amount of an exit or disposal cost liability recognized in accordance with ASC 420, apply the recognition and subsequent measurement guidance in ASC 842-20-25 and ASC 842-20-35.

Elections: Transition Method B and both the package of transition practical expedients and the hindsight practical expedient	
	If the application of hindsight in evaluating lease options changes the lease term at transition, measure the ROU asset under ASC 842. If the ROU asset was impaired under ASC 842 on or after the date of initial application, measure it after impairment using the guidance in ASC 842-20-35-10. [ASC 842-10-65-1(n); ASC 842-20-35-3(b)]
Capital to finance	
Initial accounting for a lease within the scope of this grid	
Lease liability	**ROU asset**
If the application of hindsight in evaluating lease options does not change the lease term, measure at the carrying amount of the lease obligation determined in accordance with ASC 840 on the date of initial application. If the application of hindsight in evaluating lease options changes the lease term, measure the lease liability under ASC 842. [ASC 842-10-65-1(r)(1)]	If the application of hindsight in evaluating lease options does not change the lease term, measure at the carrying amount of the lease asset determined in accordance with ASC 840 on the date of initial application plus unamortized initial direct costs. If the application of hindsight in evaluating lease options changes the lease term, measure the ROU asset under ASC 842. Use hindsight in assessing impairment of the ROU asset. [ASC 842-10-65-1(r)(1) to 65-1(r)(2)]
Subsequent accounting for leases within the scope of this grid	
Lease liability	**ROU asset**
Apply the subsequent measurement guidance in ASC 842-20-35-4 and 35-5 and ASC 842-20-35-8; except, when applying ASC 842-20-35-4, the lessee should disregard ASC 842-10-35-4(c)(3) related to remeasuring the lease payments for amounts probable of being owed under a residual value guarantee. [ASC 842-10-65-1(r)(5)]	

10.4.6 Lessee transition grid: Transition Method A is elected, but not the package of transition practical expedients or hindsight practical expedient

This grid addresses one of the eight transition scenarios discussed in Section 10.4.1, which should be read in conjunction with using this grid to fully understand its applicability.

Elections: Transition Method A and neither the package of transition practical expedients nor the hindsight practical expedient	
Operating to operating	
Initial accounting for a lease within the scope of this grid	
Lease liability	**ROU asset**
Measure at the PV of the sum of the following: (a) the remaining minimum rental payments under ASC 840 and (b) the amount probable of being owed under a residual value guarantee (if any). Determine the discount rate used for PV purposes under ASC 842 as of the date of initial application. (If a nonpublic lessee elects to use the risk-free rate to account for some or all of its leases [see Section 5.2.3], that rate would also be used for PV purposes on the date of initial application.) [ASC 842-10-65-1(l)]	Measure using the lease liability on the date of initial application adjusted for the following (as applicable) on the date of initial application: (a) prepaid or accrued lease payments, (b) the remaining balance of any lease incentives received, (c) unamortized initial direct costs that meet the definition of such costs in ASC 842, (d) impairment of the ROU asset (see Section 10.4.1.6) and (e) the carrying amount of any exit or disposal cost obligation for which a liability has been recognized in accordance with ASC 420. Writeoff to equity any unamortized initial direct costs incurred prior to the date of initial application that do not meet the definition of such costs in ASC 842. Expense as incurred those initial direct costs incurred after the date of initial application that do not meet the definition of such costs in ASC 842. [ASC 842-10-65-1(m); ASC 842-10-65-1(p); ASC 842-20-35-3(b)]
Subsequent accounting for leases within the scope of this grid	
Lease liability	**ROU asset**
Measure at the PV of the sum of the following: (a) the remaining minimum rental payments under ASC 840 and (b) the amount probable of being owed under a residual value guarantee (if any). The discount rate used for PV purposes is the same as that used on the date of initial application. [ASC 842-10-65-1(l)]	If the ROU asset was not adjusted on the date of initial application for the carrying amount of an exit or disposal cost liability previously recognized in accordance with ASC 420, measure using the lease liability adjusted for the following (as applicable): (a) prepaid or accrued lease payments, (b) the remaining balance of any lease incentives received, (c) unamortized initial direct costs and (d) impairment of the ROU asset. If the ROU asset was adjusted on the date of initial application for the carrying amount of an exit or disposal cost liability previously recognized in accordance with ASC 420, apply the recognition and subsequent measurement guidance in ASC 842-20-25 and ASC 842-20-35.

Elections: Transition Method A and neither the package of transition practical expedients nor the hindsight practical expedient	
	If the ROU asset was impaired under ASC 842 on or after the date of initial application, measure it after impairment using the guidance in ASC 842-20-35-10. [ASC 842-10-65-1(n); ASC 842-20-35-3(b)]
Operating to finance	
Initial accounting for a lease within the scope of this grid	
Lease liability	**ROU asset**
Measure at the PV of the sum of the following: (a) the remaining minimum rental payments under ASC 840 and (b) the amount probable of being owed under a residual value guarantee (if any). Determine the discount rate used for PV purposes under ASC 842 as of the date of initial application. (If a nonpublic lessee elects to use the risk-free rate to account for some or all of its leases [see Section 5.2.3], that rate would also be used for PV purposes on the date of initial application.) [ASC 842-10-65-1(l)]	Measure using the applicable proportion of the lease liability at the commencement date (which can be imputed from the lease liability as of the date of initial application) adjusted for: (a) the carrying amount of any prepaid or accrued lease payments and (b) the carrying amount of any exit or disposal cost obligation for which a liability has been recognized in accordance with ASC 420. Measure the applicable proportion as the remaining lease term (under ASC 840) at the date of initial application compared to the total lease term (under ASC 840). Writeoff to equity any unamortized initial direct costs incurred prior to the date of initial application that do not meet the definition of such costs in ASC 842. Expense as incurred those initial direct costs incurred after the date of initial application that do not meet the definition of such costs in ASC 842. [ASC 842-10-65-1(o) and 65-1(p)]
Subsequent accounting for leases within the scope of this grid	
Lease liability	**ROU asset**
Measure at the PV of the sum of the following: (a) the remaining minimum rental payments under ASC 840 and (b) the amount probable of being owed under a residual value guarantee (if any). The discount rate used for PV purposes is the same as that used on the date of initial application. [ASC 842-10-65-1(l)]	Measure using the applicable proportion of the lease liability at the commencement date (which can be imputed from the lease liability) adjusted for: (a) the carrying amount of any prepaid or accrued lease payments and (b) the carrying amount of any exit or disposal cost obligation for which a liability has been recognized in accordance with ASC 420. Measure the applicable proportion as the remaining lease term compared to the total lease term. [ASC 842-10-65-1(o)]

<table>
<tr><th colspan="2">Elections: Transition Method A and neither the package of transition practical expedients nor the hindsight practical expedient</th></tr>
<tr><td colspan="2">Capital to finance</td></tr>
<tr><td colspan="2">Initial accounting for a lease within the scope of this grid</td></tr>
<tr><td>Lease liability</td><td>ROU asset</td></tr>
<tr><td>Measure at the carrying amount of the lease obligation determined in accordance with ASC 840 on the date of initial application.

[ASC 842-10-65-1(r)(1)]</td><td>Measure at the carrying amount of the lease asset determined in accordance with ASC 840 on the date of initial application plus unamortized initial direct costs that meet the definition of such costs in ASC 842. Writeoff to equity any unamortized initial direct costs incurred prior to the date of initial application that do not meet the definition of such costs in ASC 842 and that were not included in the measurement of the capital lease asset under ASC 840. Expense as incurred those initial direct costs incurred after the date of initial application that do not meet the definition of such costs in ASC 842.

[ASC 842-10-65-1(r)(1) to 65-1(r)(3)]</td></tr>
<tr><td colspan="2">Subsequent accounting for leases within the scope of this grid</td></tr>
<tr><td>Lease liability</td><td>ROU asset</td></tr>
<tr><td colspan="2">Apply the subsequent measurement guidance in ASC 842-20-35-4 and 35-5 and ASC 842-20-35-8; except, when applying ASC 842-20-35-4, the lessee should disregard ASC 842-10-35-4(c)(3) related to remeasuring the lease payments for amounts probable of being owed under a residual value guarantee.

[ASC 842-10-65-1(r)(5)]</td></tr>
<tr><td colspan="2">Capital to operating</td></tr>
<tr><td colspan="2">Initial accounting for a lease within the scope of this grid</td></tr>
<tr><td>Lease liability</td><td>ROU asset</td></tr>
<tr><td>Derecognize the carrying amount of the capital lease obligation recorded under ASC 840. For leases that commenced before the date of initial application, recognize a lease liability in accordance with ASC 842-20-35-3(a). For leases that commenced on or after the date of initial application, recognize a lease liability using the initial measurement guidance for a lease in ASC 842-20-30-1.</td><td>Derecognize the carrying amount of the lease asset recorded under ASC 840. Account for any net difference between the following on the date of initial application in the same way as prepaid or accrued rent: (a) the carrying amount of the capital lease obligation under ASC 840 and (b) the carrying amount of the lease asset recorded under ASC 840.</td></tr>
</table>

Elections: Transition Method A and neither the package of transition practical expedients nor the hindsight practical expedient	
[ASC 842-10-65-1(s)(1) to 65-1(s)(3); ASC 842-20-30-1; ASC 842-20-35-3(a)]	For leases that commenced before the date of initial application, recognize a ROU asset in accordance with ASC 842-20-35-3(b). Writeoff to equity any unamortized initial direct costs incurred prior to the date of initial application that do not meet the definition of such costs in ASC 842. For leases that commenced on or after the date of initial application, recognize a ROU asset using the initial measurement guidance for a lease in ASC 842-20-30-1. Expense as incurred those initial direct costs incurred after the date of initial application that do not meet the definition of such costs in ASC 842. [ASC 842-10-65-1(s)(1) to 65-1(s)(3); ASC 842-10-65-1(s)(5); ASC 842-20-35-3(b)]
Subsequent accounting for leases within the scope of this grid	
Lease liability	**ROU asset**
Apply the guidance in ASC 842-20. [ASC 842-10-65-1(r)(4)]	Apply the guidance in ASC 842-20. [ASC 842-10-65-1(r)(4)]

10.4.7 Lessee transition grid: Transition Method A and the package of transition practical expedients are elected, but not the hindsight practical expedient

This grid addresses one of the eight transition scenarios discussed in Section 10.4.1, which should be read in conjunction with using this grid to fully understand its applicability.

Elections: Transition Method A and the package of transition practical expedients, but not the hindsight practical expedient	
Operating to operating	
Initial accounting for a lease within the scope of this grid	
Lease liability	**ROU asset**
Measure at the PV of the sum of the following: (a) the remaining minimum rental payments under ASC 840 and (b) the amount probable of being owed under a residual value guarantee (if any). Determine the discount rate used for PV purposes under ASC 842 as of the date of initial application. (If a nonpublic lessee elects to use the risk-free rate to account for some or all of its leases [see	Measure using the lease liability on the date of initial application adjusted for the following (as applicable) on the date of initial application: (a) prepaid or accrued lease payments, (b) the remaining balance of any lease incentives received, (c) unamortized initial direct costs, (d) impairment of the ROU asset (see Section 10.4.1.6) and (e) the carrying amount of any exit

Elections: Transition Method A and the package of transition practical expedients, but not the hindsight practical expedient	
Section 5.2.3], that rate would also be used for PV purposes on the date of initial application.) [ASC 842-10-65-1(l)]	or disposal cost obligation for which a liability has been recognized in accordance with ASC 420. Expense as incurred those initial direct costs incurred after the date of initial application that do not meet the definition of such costs in ASC 842. [ASC 842-10-65-1(m); ASC 842-10-65-1(p); ASC 842-20-35-3(b)]
Subsequent accounting for leases within the scope of this grid	
Lease liability	**ROU asset**
Measure at the PV of the sum of the following: (a) the remaining minimum rental payments under ASC 840 and (b) the amount probable of being owed under a residual value guarantee (if any). The discount rate used for PV purposes is the same as that used on the date of initial application. [ASC 842-10-65-1(l)]	If the ROU asset was not adjusted on the date of initial application for the carrying amount of an exit or disposal cost liability previously recognized in accordance with ASC 420, measure using the lease liability adjusted for the following (as applicable): (a) prepaid or accrued lease payments, (b) the remaining balance of any lease incentives received, (c) unamortized initial direct costs and (d) impairment of the ROU asset. If the ROU asset was adjusted on the date of initial application for the carrying amount of an exit or disposal cost liability previously recognized in accordance with ASC 420, apply the recognition and subsequent measurement guidance in ASC 842-20-25 and ASC 842-20-35. If the ROU asset was impaired under ASC 842 on or after the date of initial application, measure it after impairment using the guidance in ASC 842-20-35-10. [ASC 842-10-65-1(n); ASC 842-20-35-3(b)]
Capital to finance	
Initial accounting for a lease within the scope of this grid	
Lease liability	**ROU asset**
Measure at the carrying amount of the lease obligation determined in accordance with ASC 840 on the date of initial application. [ASC 842-10-65-1(r)(1)]	Measure at the carrying amount of the lease asset determined in accordance with ASC 840 on the date of initial application plus unamortized initial direct costs.

Elections: Transition Method A and the package of transition practical expedients, but not the hindsight practical expedient	
	Expense as incurred those initial direct costs incurred after the date of initial application that do not meet the definition of such costs in ASC 842. [ASC 842-10-65-1(r)(1) to 65-1(r)(3)]
Subsequent accounting for leases within the scope of this grid	
Lease liability	**ROU asset**
Apply the subsequent measurement guidance in ASC 842-20-35-4 and 35-5 and ASC 842-20-35-8; except, when applying ASC 842-20-35-4, the lessee should disregard ASC 842-10-35-4(c)(3) related to remeasuring the lease payments for amounts probable of being owed under a residual value guarantee. [ASC 842-10-65-1(r)(5)]	

Example 10-4: Applying Transition Method A and the package of transition practical expedients

[Note**:** This example is built off the facts of *Example 28—Lessee Transition—Existing Capital Lease* and *Example 29—Lessee Transition—Existing Operating Lease* from ASC 842-10-55-243 to 55-254.]

General facts

Lessee is a private company with a calendar year end. In its annual financial statements, Lessee provides one comparative period on its balance sheet and two comparative periods on its income statement and other activity-based statements. Lessee does not prepare interim financial statements in accordance with U.S. GAAP. Lessee has two separate leases with different counterparties (Lease A and Lease B). Neither lessor provided Lessee with any lease incentives. Both leases were entered into on January 1, 2019. The underlying asset for each lease is a piece of equipment. The leases do not include any nonlease components (e.g., maintenance services) or transfer ownership of the equipment to Lessee at the end of the lease term. In addition, neither of the leases includes any options to purchase the underlying asset or to extend or terminate the lease. Over the term of each lease, there are no modifications to either lease, no remeasurements of either lease's lease liability and no impairment of either lease's ROU asset. In addition, a liability is not recognized in accordance with ASC 420 for either lease. Lessee elects to apply Transition Method A and the package of transition practical expedients upon transition to ASC 842. Lessee does not elect the hindsight practical expedient.

Analysis of general facts

The effective date of ASC 842 for Lessee is January 1, 2022, which is the beginning of the first annual period in which Lessee must apply ASC 842. The beginning of the earliest comparative period presented by Lessee is January 1, 2020. The later of the lease commencement date for each lease and the beginning of the earliest comparative period presented by Lessee (i.e., the date of initial application) is January 1, 2020. As a result of Lessee electing the package of transition practical expedients, Lessee does not do any of the following in applying Transition Method A: (a) reassess whether either lease is or includes a lease, (b) reassess the classification of either lease or (c) reassess whether any initial direct costs deferred in accordance with ASC 840 meet the revised definition of initial direct costs under ASC 842.

Additional facts for Lease A

- Lease A is classified as an operating lease in accordance with ASC 840.
- The noncancellable lease term is five years.
- The lease payments are as follows: (a) $31,000 is due on December 31, 2019 and 2020 and (b) $33,000 is due on December 31, 2021, 2022 and 2023.
- Initial direct costs of $500 are deferred and amortized over the lease term.
- The lease does not include a residual value guarantee.
- The rate implicit in the lease is not readily determinable.
- Lessee's incremental borrowing rate on January 1, 2020 (the date of initial application) is 6%.
- As of January 1, 2020, Lessee has recognized the following amounts in accordance with ASC 840: (a) an accrued rent liability of $1,200 ($32,200 rent expense recognized in 2019 [which is total lease payments of $161,000 ÷ the lease term of 5 years] minus the $31,000 lease payment in 2019) and (b) unamortized initial direct costs of $400 ($500 initial direct costs × four-fifths [portion of lease term remaining]).
- Straight-line amortization is used by Lessee to measure total remaining lease costs over the remaining lease term (i.e., the single lease cost recognized each year).

Analysis of Lease A

Because Lessee elected the package of transition practical expedients, Lease A's operating lease classification under ASC 840 is retained as its lease classification under ASC 842. Lessee recognizes a ROU asset and a lease liability as of January 1, 2020 (the date of initial application). The lease liability for Lease A is initially measured at $112,462, which is the present value of the sum of the following using a discount rate of 6%: (a) one payment of $31,000 on December 31, 2020 and (b) three payments of $33,000 each on December 31, 2021, 2022 and 2023. The ROU asset for Lease A is initially measured at $111,662, which is the lease liability of $112,462 plus unamortized initial direct costs of $400 minus the accrued rent liability of $1,200. The following journal entry illustrates the effects of ASC 842 on Lessee's date of initial application (January 1, 2020):

	Debit	Credit
ROU asset	$111,662	
Straight-line lease liability	1,200	
Lease liability		$112,462
Deferred initial direct costs		400

The following table summarizes the accounting for Lease A after the date of initial application of January 1, 2020:

Lease liability	2020	2021	2022	2023
Beginning balance	$112,462	$88,209	$60,502	$31,132
Plus accretion (beginning balance × 6%)	6,747	5,293	3,630	1,868
Minus lease payment	31,000	33,000	33,000	33,000
Ending balance	$88,209	$60,502	$31,132	$ -

ROU asset	2020	2021	2022	2023
Beginning balance	$111,662	$86,109	$59,102	$30,432
Minus amortization (Note 1)	25,553	27,007	28,670	30,432
Ending balance (Note 2)	$86,109	$59,102	$30,432	$ -

Note 1: Total remaining lease costs as of January 1, 2020 are $129,200 (total lease payments of $161,000 plus $500 of initial direct costs minus $32,300 of lease costs recognized in prior periods [$161,500 ÷ 5 years × 1 prior period]). Annual (i.e., single) lease costs over the remaining four-year lease term are $32,300 ($129,200 ÷ 4 years). The amortization of the ROU asset in each year is the difference between the single lease cost of $32,300 and the accretion of the liability in each year, except in 2023, which also reflects the correction of a rounding error of $2.

Note 2: The components of the ending balance of the net ROU asset at the end of each year are as follows:

Net ROU asset components	2020	2021	2022
Balance of the lease liability	$88,209	$60,502	$31,132
Minus accrued lease liability (see next table)	2,400	1,600	800
Plus unamortized initial direct costs	300	200	100
Ending balance	$86,109	$59,102	$30,432

Calculation of accrued lease liability at year end	2020	2021	2022
Total lease payments to be paid to the lessor that will be reflected in the single lease cost over the lease term	$161,000	$161,000	$161,000
Multiplied by: Fraction of lease term that has passed by the end of the year	2/5	3/5	4/5
Cumulative amount of total lease payments to be paid to the lessor that have been reflected in the lease costs through the end of the year	64,400	96,600	128,800
Less: Cumulative lease payments paid to the lessor through the end of the year	62,000	95,000	128,000
Accrued lease liability	$2,400	$1,600	$800

The ending balances in Lessee’s lease liability and ROU asset are presented as amounts related to operating leases in its 2021 financial statements, including those amounts presented for comparative purposes in 2021 (see Sections 9.1 to 9.3).

Additional facts for Lease B

- Lease B is classified as a capital lease in accordance with ASC 840.
- The noncancellable lease term is seven years.
- Annual lease payments are $25,000, payable in arrears.
- The lease has a residual value guarantee of $8,190 that is probable of being owed over the lease term and is paid at the end of the lease term.
- The rate implicit in the lease is not readily determinable.
- Lessee’s incremental borrowing rate on January 1, 2019 (date of lease commencement) is 6%.
- Lessee defers and amortizes initial direct costs of $2,800 over the lease term.
- The carrying amounts of the capital lease obligation, lease asset and unamortized initial direct costs related to Lease B on January 1, 2020 as determined in accordance with ASC 840 are $128,707, $124,291 and $2,400, respectively.

- The straight-line amortization method is used by Lessee to subsequently account for the ROU asset.

Analysis of Lease B

Because Lessee elected the package of transition practical expedients, the classification of Lease B under ASC 842 is a finance lease. Lessee recognizes a ROU asset and a lease liability as of January 1, 2020. The lease liability for Lease B is initially measured at the carrying amount of the capital lease obligation determined in accordance with ASC 840 on January 1, 2020, which is $128,707. The ROU asset for Lease B is initially measured at $126,691, which is the carrying amount of the lease asset determined in accordance with ASC 840 on January 1, 2020 ($124,291) plus the carrying amount of the unamortized initial direct costs determined in accordance with ASC 840 on January 1, 2020 ($2,400). The following journal entry illustrates the effects of ASC 842 on Lessee's date of initial application (January 1, 2020):

	Debit	Credit
ROU asset (under ASC 842)	$126,691	
Capital lease obligation (under ASC 840)	128,707	
Deferred initial direct costs (under ASC 840)		$2,400
Lease liability (under ASC 842)		128,707
Lease asset (under ASC 840)		124,291

Until January 1, 2022 (the effective date of ASC 842), the lease liability and ROU asset are subsequently accounted for in accordance with ASC 840-30-35. Starting on January 1, 2022, the lease liability and ROU asset are subsequently accounted for in accordance with ASC 842-20-35. The following table summarizes the accounting for Lease B after the date of initial application of January 1, 2020:

	ASC 840-30-35		ASC 842-20-35			
Lease liability	**2020**	**2021**	**2022**	**2023**	**2024**	**2025**
Beginning balance	$128,707	$111,429	$93,115	$73,702	$53,124	$31,311
Plus accretion (Note 1)	7,722	6,686	5,587	4,422	3,187	1,879
Minus lease payment (Note 2)	25,000	25,000	25,000	25,000	25,000	33,190
Ending balance	$111,429	$93,115	$73,702	$53,124	$31,311	$ -
ROU asset						
Beginning balance	$126,691	$105,576	$84,461	$63,346	$42,231	$21,116
Minus amortization (Note 3)	21,115	21,115	21,115	21,115	21,115	21,116
Ending balance	$105,576	$84,461	$63,346	$42,231	$21,116	$ -

Note 1: Accretion is calculated as the beginning balance of the lease liability in each year multiplied by 6%.
Note 2: The payment in 2025 is the $25,000 annual lease payment plus payment of the $8,190 residual value guarantee.
Note 3: Annual amortization of the ROU asset is calculated as the amount of the ROU asset on January 1, 2020 ($126,691) divided by the six-year remaining lease term.

The ending balances in Lessee's lease liability and ROU asset are presented as amounts related to finance leases in its 2022 financial statements, including those amounts presented for comparative purposes in 2021 (see Sections 9.1 to 9.3).

10.4.8 Lessee transition grid: Transition Method A and the hindsight practical expedient are elected, but not the package of transition practical expedients

This grid addresses one of the eight transition scenarios discussed in Section 10.4.1, which should be read in conjunction with using this grid to fully understand its applicability.

<table>
<tr><th colspan="2">Elections: Transition Method A and the hindsight practical expedient, but not the package of transition practical expedients</th></tr>
<tr><td colspan="2">Operating to operating</td></tr>
<tr><td colspan="2">Initial accounting for a lease within the scope of this grid</td></tr>
<tr><td>Lease liability</td><td>ROU asset</td></tr>
<tr><td>If the application of hindsight in evaluating lease options does not change the lease term, measure at the PV of the sum of the following: (a) the remaining minimum rental payments under ASC 840 and (b) the amount probable of being owed under a residual value guarantee (if any). Determine the discount rate used for PV purposes under ASC 842 as of the date of initial application. (If a nonpublic lessee elects to use the risk-free rate to account for some or all of its leases [see Section 5.2.3], that rate would also be used for PV purposes on the date of initial application.)

If the application of hindsight in evaluating lease options changes the lease term, measure the lease liability under ASC 842.

[ASC 842-10-65-1(l)]</td><td>If the application of hindsight in evaluating lease options does not change the lease term, measure using the lease liability on the date of initial application adjusted for the following (as applicable) on the date of initial application: (a) prepaid or accrued lease payments, (b) the remaining balance of any lease incentives received, (c) unamortized initial direct costs that meet the definition of such costs in ASC 842, (d) impairment of the ROU asset (see Section 10.4.1.6) and (e) the carrying amount of any exit or disposal cost obligation for which a liability has been recognized in accordance with ASC 420.

If the application of hindsight in evaluating lease options changes the lease term, measure the ROU asset under ASC 842 and adjust for the carrying amount of any exit or disposal cost obligation for which a liability has been recognized in accordance with ASC 420.

Regardless of the effects of applying hindsight in evaluating lease options, writeoff to equity any unamortized initial direct costs incurred prior to the date of initial application that do not meet the definition of such costs in ASC 842. In addition, expense as incurred those initial direct costs incurred after the date of initial application that do not meet the definition of such costs in ASC 842.

Use hindsight in assessing impairment of the ROU asset.

[ASC 842-10-65-1(m); ASC 842-10-65-1(p); ASC 842-20-35-3(b))</td></tr>
</table>

Elections: Transition Method A and the hindsight practical expedient, but not the package of transition practical expedients	
Subsequent accounting for leases within the scope of this grid	
Lease liability	**ROU asset**
If the application of hindsight in evaluating lease options does not change the lease term at transition, measure at the PV of the sum of the following: (a) the remaining minimum rental payments under ASC 840 and (b) the amount probable of being owed under a residual value guarantee (if any). The discount rate used for PV purposes is the same as that used on the date of initial application. If the application of hindsight in evaluating lease options changes the lease term at transition, measure the lease liability under ASC 842. [ASC 842-10-65-1(l)]	If the application of hindsight in evaluating lease options does not change the lease term at transition and the ROU asset was not adjusted on the date of initial application for the carrying amount of an exit or disposal cost liability previously recognized in accordance with ASC 420, measure using the lease liability adjusted for the following (as applicable): (a) prepaid or accrued lease payments, (b) the remaining balance of any lease incentives received, (c) unamortized initial direct costs and (d) impairment of the ROU asset. If the application of hindsight in evaluating lease options does not change the lease term at transition and the ROU asset was adjusted on the date of initial application for the carrying amount of an exit or disposal cost liability previously recognized in accordance with ASC 420, apply the recognition and subsequent measurement guidance in ASC 842-20-25 and ASC 842-20-35. If the application of hindsight in evaluating lease options changes the lease term at transition, measure the ROU asset under ASC 842. If the ROU asset was impaired under ASC 842 on or after the date of initial application, measure it after impairment using the guidance in ASC 842-20-35-10. [ASC 842-10-65-1(n); ASC 842-20-35-3(b)]
Operating to finance	
Initial accounting for a lease within the scope of this grid	
Lease liability	**ROU asset**
If the application of hindsight in evaluating lease options does not change the lease term, measure at the PV of the sum of the following: (a) the remaining minimum rental payments under ASC 840 and (b) the amount probable of being owed under a residual value guarantee (if any). Determine the discount rate used for PV purposes	If the application of hindsight in evaluating lease options does not change the lease term, measure using the applicable proportion of the lease liability at the commencement date (which can be imputed from the lease liability as of the date of initial application) adjusted for: (a) the carrying amount of any prepaid or accrued lease payments

Elections: Transition Method A and the hindsight practical expedient, but not the package of transition practical expedients	
under ASC 842 as of the date of initial application. (If a nonpublic lessee elects to use the risk-free rate to account for some or all of its leases [see Section 5.2.3], that rate would also be used for PV purposes on the date of initial application.) If the application of hindsight in evaluating lease options changes the lease term, measure the lease liability under ASC 842. [ASC 842-10-65-1(l)]	and (b) the carrying amount of any exit or disposal cost obligation for which a liability has been recognized in accordance with ASC 420. Measure the applicable proportion as the remaining lease term (under ASC 840) at the date of initial application compared to the total lease term (under ASC 840). If the application of hindsight in evaluating lease options changes the lease term, measure the ROU asset under ASC 842 and adjust for the carrying amount of any exit or disposal cost obligation for which a liability has been recognized in accordance with ASC 842. Regardless of the effects of applying hindsight in evaluating lease options, writeoff to equity any unamortized initial direct costs incurred prior to the date of initial application that do not meet the definition of such costs in ASC 842. In addition, expense as incurred those initial direct costs incurred after the date of initial application that do not meet the definition of such costs in ASC 842. Use hindsight in assessing impairment of the ROU asset. [ASC 842-10-65-1(o) and 65-1(p)]
Subsequent accounting for leases within the scope of this grid	
Lease liability	**ROU asset**
If the application of hindsight in evaluating lease options does not change the lease term, measure at the PV of the sum of the following: (a) the remaining minimum rental payments under ASC 840 and (b) the amount probable of being owed under a residual value guarantee (if any). The discount rate used for PV purposes is the same as that used on the date of initial application. If the application of hindsight in evaluating lease options changes the lease term at transition, measure the lease liability under ASC 842. [ASC 842-10-65-1(l)]	If the application of hindsight in evaluating lease options does not change the lease term at transition, measure using the applicable proportion of the lease liability at the commencement date (which can be imputed from the lease liability) adjusted for: (a) the carrying amount of any prepaid or accrued lease payments and (b) the carrying amount of any exit or disposal cost obligation for which a liability has been recognized in accordance with ASC 420. Measure the applicable proportion as the remaining lease term compared to the total lease term. If the application of hindsight in evaluating lease options changes the lease term at transition, measure the ROU asset under ASC 842. [ASC 842-10-65-1(o)]

Elections: Transition Method A and the hindsight practical expedient, but not the package of transition practical expedients	
Capital to finance	
Initial accounting for a lease within the scope of this grid	
Lease liability	**ROU asset**
If the application of hindsight in evaluating lease options does not change the lease term, measure at the carrying amount of the lease obligation determined in accordance with ASC 840 on the date of initial application. If the application of hindsight in evaluating lease options changes the lease term, measure the lease liability under ASC 842. [ASC 842-10-65-1(r)(1)]	If the application of hindsight in evaluating lease options does not change the lease term, measure at the carrying amount of the lease asset determined in accordance with ASC 840 on the date of initial application plus unamortized initial direct costs that meet the definition of such costs in ASC 842. If the application of hindsight in evaluating lease options changes the lease term, measure the ROU asset under ASC 842. Regardless of the effects of applying hindsight in evaluating lease options, writeoff to equity any unamortized initial direct costs incurred prior to the date of initial application that do not meet the definition of such costs in ASC 842. Expense as incurred those initial direct costs incurred after the date of initial application that do not meet the definition of such costs in ASC 842. Use hindsight in assessing impairment of the ROU asset. [ASC 842-10-65-1(r)(1) to 65-1(r)(3)]
Subsequent accounting for leases within the scope of this grid	
Lease liability	**ROU asset**
Apply the subsequent measurement guidance in ASC 842-20-35-4 and 35-5 and ASC 842-20-35-8; except, when applying ASC 842-20-35-4, the lessee should disregard ASC 842-10-35-4(c)(3) related to remeasuring the lease payments for amounts probable of being owed under a residual value guarantee. [ASC 842-10-65-1(r)(5)]	

Elections: Transition Method A and the hindsight practical expedient, but not the package of transition practical expedients	
Capital to operating	
Initial accounting for a lease within the scope of this grid	
Lease liability	**ROU asset**
Derecognize the carrying amount of the capital lease obligation recorded under ASC 840. For leases that commenced before the date of initial application, recognize a lease liability in accordance with ASC 842-20-35-3(a). For leases that commenced on or after the date of initial application, recognize a lease liability using the initial measurement guidance for a lease in ASC 842-20-30-1. [ASC 842-10-65-1(s)(1) to 65-1(s)(3); ASC 842-20-30-1; ASC 842-20-35-3(a)]	Derecognize the carrying amount of the lease asset recorded under ASC 840. Account for any net difference between the following on the date of initial application in the same way as prepaid or accrued rent: (a) the carrying amount of the capital lease obligation under ASC 840 and (b) the carrying amount of the lease asset recorded under ASC 840. For leases that commenced before the date of initial application, recognize a ROU asset in accordance with ASC 842-20-35-3(b). Writeoff to equity any unamortized initial direct costs incurred prior to the date of initial application that do not meet the definition of such costs in ASC 842. For leases that commenced on or after the date of initial application, recognize a ROU asset using the initial measurement guidance for a lease in ASC 842-20-30-1. Expense as incurred those initial direct costs incurred after the date of initial application that do not meet the definition of such costs in ASC 842. Use hindsight in assessing impairment of the ROU asset. [ASC 842-10-65-1(s)(1) to 65-1(s)(3); ASC 842-10-65-1(s)(5); ASC 842-20-35-3(b)]
Subsequent accounting for leases within the scope of this grid	
Lease liability	**ROU asset**
Apply the guidance in ASC 842-20. [ASC 842-10-65-1(r)(4)]	Apply the guidance in ASC 842-20. [ASC 842-10-65-1(r)(4)]

10.4.9 Lessee transition grid: Transition Method A, the package of transition practical expedients and the hindsight practical expedient are elected

This grid addresses one of the eight transition scenarios discussed in Section 10.4.1, which should be read in conjunction with using this grid to fully understand its applicability.

Elections: Transition Method A and both the package of transition practical expedients and the hindsight practical expedient	
Operating to operating	
Initial accounting for a lease within the scope of this grid	
Lease liability	**ROU asset**
If the application of hindsight in evaluating lease options does not change the lease term, measure at the PV of the sum of the following: (a) the remaining minimum rental payments under ASC 840 and (b) the amount probable of being owed under a residual value guarantee (if any). Determine the discount rate used for PV purposes under ASC 842 as of the date of initial application. (If a nonpublic lessee elects to use the risk-free rate to account for some or all of its leases [see Section 5.2.3], that rate would also be used for PV purposes on the date of initial application.) If the application of hindsight in evaluating lease options changes the lease term, measure the lease liability under ASC 842. [ASC 842-10-65-1(l)]	If the application of hindsight in evaluating lease options does not change the lease term, measure using the lease liability on the date of initial application adjusted for the following (as applicable) on the date of initial application: (a) prepaid or accrued lease payments, (b) the remaining balance of any lease incentives received, (c) unamortized initial direct costs, (d) impairment of the ROU asset (see Section 10.4.1.6) and (e) the carrying amount of any exit or disposal cost obligation for which a liability has been recognized in accordance with ASC 420. Expense as incurred those initial direct costs incurred after the date of initial application that do not meet the definition of such costs in ASC 842. Use hindsight in assessing impairment of the ROU asset. [ASC 842-10-65-1(m); ASC 842-10-65-1(p); ASC 842-20-35-3(b)]
Subsequent accounting for leases within the scope of this grid	
Lease liability	**ROU asset**
If the application of hindsight in evaluating lease options does not change the lease term at transition, measure at the PV of the sum of the following: (a) the remaining minimum rental payments under ASC 840 and (b) the amount probable of being owed under a residual value guarantee (if any). The discount rate used for PV purposes is the same as that used on the date of initial application. If the application of hindsight in evaluating lease options changes the lease term at transition, measure the lease liability under ASC 842. [ASC 842-10-65-1(l)]	If the application of hindsight in evaluating lease options does not change the lease term at transition and the ROU asset was not adjusted on the date of initial application for the carrying amount of an exit or disposal cost liability previously recognized in accordance with ASC 420, measure using the lease liability adjusted for the following (as applicable): (a) prepaid or accrued lease payments, (b) the remaining balance of any lease incentives received, (c) unamortized initial direct costs and (d) impairment of the ROU asset. If the application of hindsight in evaluating lease options does not change the lease term at transition and the ROU asset was adjusted on the date of initial application for the carrying amount

Elections: Transition Method A and both the package of transition practical expedients and the hindsight practical expedient	
	of an exit or disposal cost liability previously recognized in accordance with ASC 420, apply the recognition and subsequent measurement guidance in ASC 842-20-25 and ASC 842-20-35. If the application of hindsight in evaluating lease options changes the lease term at transition, measure the ROU asset under ASC 842. If the ROU asset was impaired under ASC 842 on or after the date of initial application, measure it after impairment using the guidance in ASC 842-20-35-10. [ASC 842-10-65-1(n); ASC 842-20-35-3(b)]
Capital to finance	
Initial accounting for a lease within the scope of this grid	
Lease liability	**ROU asset**
If the application of hindsight in evaluating lease options does not change the lease term, measure at the carrying amount of the lease obligation determined in accordance with ASC 840 on the date of initial application. If the application of hindsight in evaluating lease options changes the lease term, measure the lease liability under ASC 842. [ASC 842-10-65-1(r)(1)]	If the application of hindsight in evaluating lease options does not change the lease term, measure at the carrying amount of the lease asset determined in accordance with ASC 840 on the date of initial application plus unamortized initial direct costs. If the application of hindsight in evaluating lease options changes the lease term, measure the ROU asset under ASC 842. Expense as incurred those initial direct costs incurred after the date of initial application that do not meet the definition of such costs in ASC 842. Use hindsight in assessing impairment of the ROU asset. [ASC 842-10-65-1(r)(1) to 65-1(r)(3)]
Subsequent accounting for leases within the scope of this grid	
Lease liability	**ROU asset**
Apply the subsequent measurement guidance in ASC 842-20-35-4 and 35-5 and ASC 842-20-35-8; except, when applying ASC 842-20-35-4, the lessee should disregard ASC 842-10-35-4(c)(3) related to remeasuring the lease payments for amounts probable of being owed under a residual value guarantee. [ASC 842-10-65-1(r)(5)]	

10.5 Disclosures

Lessees are required to disclose certain transition-related information otherwise required by ASC 250 when an entity makes an accounting change. Lessees must also disclose the transition practical expedients it has elected (if any). In addition, lessees that have elected Transition Method B must provide the disclosures required by ASC 840 for those comparative periods included in the financial statements for which ASC 840 was applied to account for leases. These disclosure requirements and other disclosures required upon transition have been included in the disclosure checklist included in Appendix D of this guide.

11. Differences between ASC 842 and IFRS 16

A long-standing joint project between the FASB and IASB resulted in the issuance of ASU 2016-02 and IFRS 16. While ASC 842 and IFRS 16 are converged in many important respects (such as requiring lessees to recognize ROU assets and lease liabilities for most of their leases), there are significant differences between the two. For example:

- ASC 842 applies to leases that provide the customer with a right to use property, plant or equipment (see Section 2.1 and Section 3.1). IFRS 16 applies to leases that provide the customer with a right to use a broader population of assets than just property, plant or equipment, including leases of intangible assets (unless they would be considered the license of intellectual property within the scope of IFRS 15).
- Lessees may elect an exemption under IFRS 16 that allows them to disregard the recognition and measurement of ROU assets and lease liabilities for leases of assets with values of less than $5,000. This exemption is not provided in ASC 842. However, as is the case with any guidance in the ASC, the guidance in ASC 842 need not be applied to immaterial items.
- A short-term lease is defined under IFRS 16 as a lease: (a) with a lease term of 12 months or less and (b) without a purchase option. In other words, a lease with a purchase option is precluded from being considered a short-term lease under IFRS 16, regardless of the likelihood that the purchase option will be exercised by the lessee. Under ASC 842, a short-term lease with a lease term of 12 months or less may have a purchase option, but the lessee must not be reasonably certain to exercise that option (see Section 7.1.1).
- In calculating the present value of the lease liability, the payments on which the lessee's incremental borrowing rate are based under IFRS 16 is the amount the lessee would have to borrow to fund the acquisition of an asset with a similar value as the ROU asset. Under ASC 842, the payments on which the lessee's incremental borrowing rate is based is the amount the lessee would have to borrow to fund the lease payments (see Section 5.2.2).
- Under ASC 842, a lessee that is not a public business entity is permitted to make an accounting policy election to use the risk-free rate as the discount rate on a class-of-asset basis instead of its incremental borrowing rate (see Section 5.2.3). IFRS 16 does not provide the same election or exemption.
- Under IFRS 16, all leases for which ROU assets and lease liabilities are recognized by lessees are accounted for using the same model, which is similar to the finance lease accounting model under ASC 842. In other words, there is no need for lessees to consider lease classification criteria under IFRS 16. Under ASC 842, leases for which ROU assets and lease liabilities are recognized by lessees are classified and accounted for as operating or finance leases, depending on the facts and circumstances (see Chapter 6).
- Lessees reassess variable lease payments that depend on an index or rate under IFRS 16 when there is an adjustment to the amount paid or to be paid. This is not a reassessment event provided for lease payments in ASC 842 (see Section 5.5.13).
- For a sublease, under IFRS 16, the sublessor is required to classify the sublease by reference to the ROU asset related to the head lease, while under ASC 842, the sublessor is required to classify the sublease based on the underlying asset (see Section 7.5).
- For sale-leaseback transactions, IFRS 16 provides less application guidance than ASC 842 with respect to whether the transfer of the asset should be accounted for as a sale. In addition, IFRS 16 includes a limitation on the gain that should be recognized when the transfer of the asset is considered a sale, while ASC 842 does not include such a limitation (see Sections 8.2 and 8.3).

For additional information about the differences between ASC 842 and IFRS 16, refer to pages 7 through 9 of the "Summary" in ASU 2016-02.

Appendix A: Acronyms and literature references

Several acronyms are used throughout this guide and numerous references are made to specific ASUs, topics and subtopics in the ASC and other guidance. Provided in this section are: (a) an acronym legend, which lists the acronyms used throughout this guide and their corresponding definitions and (b) a literature listing, which lists the ASUs, topics and subtopics in the ASC and other guidance referred to throughout this guide and their corresponding titles.

Acronym legend

Acronym	Definition
ASC	FASB's Accounting Standards Codification
ARO	Asset retirement obligation
ASU	Accounting Standards Update
FASB	Financial Accounting Standards Board
GAAP	Generally accepted accounting principles
IASB	International Accounting Standards Board
IFRS	International Financial Reporting Standards
IT	Information technology
PV	Present value
ROU (asset)	Right-of-use (asset)
SAB	SEC Staff Accounting Bulletin
SEC	U.S. Securities and Exchange Commission

ASC topics and subtopics

ASC topic or subtopic	Title
210-20	Balance Sheet – Offsetting
250	Accounting Changes and Error Corrections
250-10	Accounting Changes and Error Corrections – Overall
270	Interim Reporting
270-10	Interim Reporting – Overall
310-10	Receivables – Overall
326	Financial Instruments—Credit Losses
326-20	Financial Instruments—Credit Losses – Measured at Amortized Cost
330	Inventory
340-40	Other Assets and Deferred Costs – Contracts with Customers
350-30	Intangibles—Goodwill and Other – General Intangibles Other than Goodwill
360	Property, Plant, and Equipment
360-10	Property, Plant, and Equipment – Overall
410	Asset Retirement and Environmental Obligations
410-20	Asset Retirement and Environmental Obligations – Asset Retirement Obligations

ASC topic or subtopic	Title
420	Exit or Disposal Cost Obligations
460	Guarantees
460-10	Guarantees – Overall
606	Revenue from Contracts with Customers
606-10	Revenue from Contracts with Customers – Overall
805	Business Combinations
805-20	Business Combinations – Identifiable Assets and Liabilities, and Any Noncontrolling Interest
805-50	Business Combinations – Related Issues
815-10	Derivatives and Hedging – Overall
815-15	Derivatives and Hedging – Embedded Derivatives
820	Fair Value Measurement
830-10	Foreign Currency Matters – Overall
835-20	Interest – Capitalization of Interest
840	Leases
840-30	Leases – Capital Leases
840-40	Leases – Sale-Leaseback Transactions
842	Leases
842-10	Leases – Overall
842-20	Leases – Lessee
842-30	Leases – Lessor
842-40	Leases – Sale and Leaseback Transactions
848	Reference Rate Reform
850	Related Party Disclosures
850-10	Related Party Disclosures – Overall
853	Service Concession Arrangements
853-10	Service Concession Arrangements – Overall
958-810	Not-for-Profit Entities – Consolidation

Other literature and guidance

Other literature	Issued by	Title
ASU 2016-02	FASB	Leases (Topic 842)
ASU 2017-13	FASB	Revenue Recognition (Topic 605), Revenue from Contracts with Customers (Topic 606), Leases (Topic 840), and Leases (Topic 842): Amendments to SEC Paragraphs Pursuant to the Staff Announcement at the July 20, 2017 EITF Meeting and Rescission of Prior SEC Staff Announcements and Observer Comments

Other literature	Issued by	Title
ASU 2018-01	FASB	Leases (Topic 842): Land Easement Practical Expedient for Transition to Topic 842
ASU 2018-10	FASB	Codification Improvements to Topic 842, Leases
ASU 2018-11	FASB	Leases (Topic 842): Targeted Improvements
ASU 2018-20	FASB	Leases (Topic 842): Narrow-Scope Improvements for Lessors
ASU 2019-01	FASB	Leases (Topic 842): Codification Improvements
ASU 2019-10	FASB	Financial Instruments—Credit Losses (Topic 326), Derivatives and Hedging (Topic 815), and Leases (Topic 842): Effective Dates
ASU 2020-02	FASB	Financial Instruments—Credit Losses (Topic 326) and Leases (Topic 842): Amendments to SEC Paragraphs Pursuant to SEC Staff Accounting Bulletin No. 119 and Update to SEC Section on Effective Date Related to Accounting Standards Update No. 2016-02, *Leases (Topic 842)*
ASU 2020-04	FASB	Reference Rate Reform (Topic 848): Facilitation of the Effects of Reference Rate Reform on Financial Reporting
ASU 2020-05	FASB	Revenue from Contracts with Customers (Topic 606) and Leases (Topic 842): Effective Dates for Certain Entities
ASU 2021-05	FASB	Leases (Topic 842): Lessors—Certain Leases with Variable Lease Payments
ASU 2021-09	FASB	Leases (Topic 842): Discount Rate for Lessees That Are Not Public Business Entities
IFRS 15	IASB	Revenue from Contracts with Customers
IFRS 16	IASB	Leases
Regulation S-X, Rule 3-05	SEC	Financial Statements of Businesses Acquired or to Be Acquired
SAB Topic 11M	SEC staff	Miscellaneous Disclosure – Disclosure of the Impact That Recently Issued Accounting Standards Will Have on the Financial Statements of the Registrant When Adopted in a Future Period
SEC staff speech (Pidgeon 2018)	SEC staff	Remarks before the 2018 AICPA Conference on Current SEC and PCAOB Developments, Andrew W. Pidgeon, Professional Accounting Fellow, Office of the Chief Accountant
SEC staff speech (Berrigan 2017)	SEC staff	Remarks before the 2017 AICPA Conference on Current SEC and PCAOB Developments, Michael P. Berrigan, Professional Accounting Fellow, Office of the Chief Accountant

Appendix B: Accounting policy, practical expedient and transition elections

Portfolio approach (see Section 2.7 and Section 5.2.4)	• Advantage: Reduces costs and level of effort. • Disadvantage: Requires supporting its use and having processes to create and monitor portfolios both initially and on an ongoing basis.
Separating lease and nonlease components accounting policy election (see Section 4.4)	• Advantage: Eliminates complexity and reduces level of effort. • Disadvantage: Increases amount of lease liabilities and ROU assets recognized.
Discount rate accounting policy election (only entities other than public business entities) (see Section 5.2.3)	• Advantage: Reduces costs and level of effort. • Disadvantage: Results in the recognition of higher ROU assets and lease liabilities (although the disadvantage is somewhat mitigated by the available election to apply the risk-free rate on a class-of-asset basis).
Short-term leases accounting policy election (see Section 7.1.1)	• Advantage: Decreases amount of lease liabilities and ROU assets recognized. • Disadvantage: Requires separately tracking and disclosing leases.
Transition: Alternative method (see Transition Method B in Section 10.2)	• Advantage: Reduces costs and level of effort. • Disadvantage: Results in lack of comparability to prior years.
Transition: Package of transition practical expedients (see Section 10.3.1)	• Advantage: Reduces costs and level of effort. • Disadvantage: Lease modification reduces benefits.
Transition: Hindsight practical expedient (see Section 10.3.2)	• Advantage: Reduces the impact of modifications after the effective date. • Disadvantage: Increased cost and level of effort.
Transition: Land easement practical expedient (see Section 10.3.3)	• Advantage: Reduces costs and level of effort. • Disadvantage: Potential lack of comparability between the accounting for preexisting land easements and new land easements.

Appendix C: Reassessment and remeasurement events

The table below summarizes when certain assessments and measurements under ASC 842 must be reassessed or remeasured. To fully understand when a reassessment or remeasurement is necessary, and to obtain additional important information about that reassessment or remeasurement, refer to the relevant paragraph(s) in ASC 842, as well as the relevant sections in the guide, both of which are noted in the table.

	Reassess or remeasure					
	Whether contract is or includes a lease	**Contract consideration and reallocate between units of account**	**Lease term and purchase options**	**Lease payments and lease liability**	**Discount rate**	**Lease classification**
Relevant paragraph(s) in ASC 842-	10-15-6	10-15-36	10-35-1	10-35-4, 5 20-35-4	20-35-5	10-25-1
Relevant section in the guide	3.7	4.5.4	5.3.5 5.4.2	5.5.13 7.2.1.1	5.2.5	6.7
Reassessment or remeasurement event						
1. Lessee modifies terms and conditions of the contract.	X	Note 1	Note 1	Note 1	Note 1	Note 1
2. Lessee's assessment about whether it is reasonably certain to exercise a renewal or purchase option, or not exercise a termination option, changes directly as a result of a significant event or change in circumstances within its control.		X	X	X		X
3. Lessee is required by the contract to either exercise or not exercise an option to extend or terminate the lease when a specific event occurs and that event has occurred.		X	X	X		X
4. Lessee exercises a renewal, termination or purchase option when it had previously concluded it was not reasonably certain to do so.		X	X	X		X
5. Lessee does not exercise a renewal, termination or purchase option when it had previously concluded it was reasonably certain to do so.		X	X	X		X
6. Lessee modifies the contract and the modification is not accounted for as a separate contract.		X	Note 1 Note 2	X	X	X
7. Variable lease payments based on other than an index or rate that did not previously meet the definition of lease payments (because they were based on other than an index or rate) subsequently meet the definition of lease payments for the remainder of the lease term because the underlying contingency has been resolved.		X		X		
8. Lessee's expectations about whether it is reasonably certain to exercise a purchase option change.		X	Note 2	X		X

	Reassess or remeasure					
	Whether contract is or includes a lease	Contract consideration and reallocate between units of account	Lease term and purchase options	Lease payments and lease liability	Discount rate	Lease classification
9. Lessee's assessment of the amount it is probable of owing under a residual value guarantee changes.		X		X		
10. The lease payments were remeasured due to a change in the lease term caused by a change in the assessment of a renewal or termination option and the discount rate did not already reflect the option to extend or terminate the lease					X	
11. There is a change in the lessee's assessment of whether it is or is not reasonably certain to exercise a purchase option and the discount rate did not already reflect the option.					X	

Note 1: Whether a contract modification results in a reassessment or remeasurement covered by the column depends on the facts and circumstances and applying the contract modification guidance in Section 7.2.5.1. Also, see Event 6.

Note 2: Whether Event 6 or 8 results in a reassessment of the lease term or the exercise of a purchase option depends on whether the event also meets Event 2.

Appendix D: Disclosure checklist

The following table lists the disclosure requirements applicable to:

- Lessees (ASC 842-20-50)
- Sale-leaseback transactions (ASC 842-40-50)
- Initial implementation of ASC 842 (ASC 842-10-65-1(i), 65-1(j) and 65-1(jj))

Additional information about disclosures required of lessees is provided in Section 9.4. In addition, Example 6 in ASC 842-20-55-53 illustrates how a lessee may meet the quantitative disclosure requirements included in Item 2 of this checklist.

While the disclosures required by ASC 842-20-50 and ASC 842-40-50 are only required on an annual basis, when a lessee applies ASC 842 in its interim financial statements for one or more interim periods before it applies ASC 842 in its annual financial statements, the lessee must provide all the required annual disclosures in those interim financial statements (see Section 9.4.2). In addition, ASC 842-10-65-1(i) requires additional transition-related disclosures in those interim financial statements within the year of adoption. Whether a lessee is required to disclose information about its leases in its interim financial statements after its first annual financial statements in which ASC 842 has been applied depends on the facts and circumstances (see Section 9.4.1).

842-	Disclosure requirement	Yes/No	Remarks
Lessee			
20-50-3	1. The lessee has disclosed all of the following:		
20-50-3(a)	a. Information about the nature of its leases, including:		
20-50-3(a)(1)	(1) A general description of the leases.		
20-50-3(a)(2)	(2) The basis and terms and conditions on which variable lease payments are determined.		
20-50-3(a)(3)	(3) The existence and terms and conditions of options to extend or terminate the lease, including a narrative discussion about those options that are recognized as part of the lessee's ROU assets and lease liabilities and those that are not.		
20-50-3(a)(4)	(4) The existence and terms and conditions of residual value guarantees the lessee has provided.		
20-50-3(a)(5)	(5) The restrictions or covenants imposed by leases (e.g., those related to dividends or incurring additional financial obligations).		
20-50-3(a)	(6) For each of items 1(a)(1) through 1(a)(5) of this checklist, the information included therein related to subleases (as applicable).		
20-50-3(b)	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		

842-	Disclosure requirement	Yes/No	Remarks
	with the construction or design of the underlying asset.		
20-50-3(c)	c. Information about significant assumptions and judgments made in applying the requirements of ASC 842, which may include the following:		
20-50-3(c)(1)	(1) The determination of whether a contract contains a lease (as described in ASC 842-10-15-2 to 15-27 [see Chapter 3]).		
20-50-3(c)(2)	(2) The allocation of the consideration in a contract between lease and nonlease components (as described in ASC 842-10-15-28 to 15-32 [see Section 4.5]).		
20-50-3(c)(3)	(3) The determination of the discount rate for the lease (as described in ASC 842-20-30-2 to 30-4 [see Section 5.2]).		
20-50-4	2. For each period presented in the financial statements, the lessee has disclosed the following amounts related to its 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 U.S. GAAP) and the cash flows arising from lease transactions:		
20-50-4(a)	a. Finance lease cost, segregated between the amortization of the ROU assets and interest on the lease liabilities (see Section 7.2.2.1).		
20-50-4(b)	b. Operating lease cost determined in accordance with ASC 842-20-25-6(a) and ASC 842-20-25-7 (see Section 7.2.3.1).		
20-50-4(c)	c. Short-term lease cost, excluding expenses related to leases with a lease term of one month or less, determined in accordance with ASC 842-20-25-2 (see Section 7.1.1).		
20-50-4(d)	d. Variable lease cost determined in accordance with ASC 842-20-25-5(b) and ASC 842-20-25-6(b) (see Sections 5.5.3.2 and 5.5.3.3).		
20-50-4(e)	e. Sublease income, on a gross basis, separate from the finance or operating lease expense (see Section 7.5).		
20-50-4(f)	f. Net gain or loss recognized from sale-leaseback transactions in accordance with ASC 842-40-25-4 (see Section 8.3).		
20-50-4(g)	g. Amounts for the following items segregated between those related to		

842-	Disclosure requirement	Yes/No	Remarks
	finance leases and those related to operating leases:		
20-50-4(g)(1)	(1) Cash paid for amounts included in the measurement of lease liabilities.		
20-50-4(g)(2)	(2) Supplemental noncash information on lease liabilities arising from obtaining ROU assets.		
20-50-4(g)(3) 20-55-11	(3) Weighted-average remaining lease term (calculated on the basis of the remaining lease term and the lease liability balance for each lease as of the reporting date).		
20-50-4(g)(4) 20-55-12	(4) Weighted-average discount rate (calculated based on both: (a) the discount rate for the lease that was used to calculate the lease liability balance for each lease as of the reporting date and (b) the remaining balance of the lease payments for each lease as of the reporting date).		
20-50-6	3. The lessee has disclosed:		
20-50-6	a. Separate maturity analyses for its finance lease liabilities and its operating lease liabilities, showing the undiscounted cash flows on an annual basis for a minimum of each of the first five years and a total of the amounts for the remaining years.		
20-50-6	b. A reconciliation of the undiscounted cash flows in the maturity analyses to the finance lease liabilities and operating lease liabilities recognized in the balance sheet.		
20-50-7	4. The lessee has disclosed lease transactions between related parties in accordance with ASC 850-10-50-1 to 50-6.		
20-50-8	5. A lessee that accounts for short-term leases in accordance with ASC 842-20-25-2 (see Section 7.1.1) has disclosed:		
20-50-8	a. The fact that it accounts for short-term leases in accordance with ASC 842-20-25-2.		
20-50-8	b. If the short-term lease expense for the period does not reasonably reflect the lessee's short-term lease commitments, that fact and the amount of its short-term lease commitments.		
20-50-9	6. A lessee that elects the accounting policy in ASC 842-10-15-37 to not separate lease components from nonlease components (see Section 4.4) has disclosed its accounting		

842-	Disclosure requirement	Yes/No	Remarks
	policy election and to which class or classes of underlying assets it has elected to apply the accounting policy.		
20-50-10	7. A lessee that makes the accounting policy election in ASC 842-20-30-3 to use a risk-free rate as the discount rate has disclosed its election and the class or classes of underlying assets to which the election has been applied.		
20-50-1	8. The disclosures provided by the lessee (in connection with items 1 through 7 of this checklist) achieve the disclosure objective in ASC 842-20-50, which is to enable users of financial statements to assess the amount, timing and uncertainty of cash flows arising from leases, by providing qualitative and quantitative information about all of the following: (a) the lessee's leases, (b) the significant judgments made in applying the requirements in ASC 842 to those leases and (c) the amounts recognized in the financial statements relating to those leases.		
20-50-2	9. The lessee has:		
20-50-2	a. Considered the level of detail necessary to satisfy the disclosure objective (see item 8 in this checklist) and how much emphasis to place on each of the various requirements in items 1 through 7 of this checklist to meet that objective.		
20-50-2	b. Aggregated or disaggregated the disclosures in items 1 through 7 of this checklist so that useful information is not obscured by including a large amount of insignificant detail or by aggregating items that have different characteristics.		
20-45-1	10. The lessee has disclosed the following when (a) and (b) have not been separately presented from each other and from other assets and liabilities on the face of the balance sheet (see Section 9.1):		
20-45-1(a)	a. Finance lease ROU assets and operating lease ROU assets separate from each other.		
20-45-1(b)	b. Finance lease liabilities and operating lease liabilities separate from each other.		
20-45-2	c. The lines in the balance sheet in which the finance lease and operating lease ROU assets and lease liabilities have been included.		

842-	Disclosure requirement	Yes/No	Remarks
Sale-leaseback transactions (see Chapter 8)			
40-50-1	11. If a seller-lessee enters into a sale-leaseback transaction and accounts for that transaction as one in which the transfer of the asset is a sale, it has provided the disclosures required in items 1 through 10 of this checklist (as appropriate).		
	12. The seller-lessee has disclosed		
40-50-2(a)	a. The main terms and conditions of the sale-leaseback transaction.		
40-50-2(b)	b. Any gains or losses arising from the sale-leaseback transaction separately from gains or losses on the disposal of other assets.		
Initial implementation of ASC 842 (see Chapter 10)			
250-10-50-1(a) 250-10-50-2 842-10-65-1(i)	13. The lessee has disclosed both of the following in the fiscal interim (if applicable) and annual periods in which the lessee initially applies ASC 842 (or, if there is not a material effect in the fiscal interim and annual periods of initial application, but it is reasonably certain there will be a material effect in later fiscal interim and annual periods, the lessee has disclosed both of the following in the later fiscal interim and annual periods): a. The nature of the change in accounting principle. b. The fact that the change was prescribed by the FASB in ASC 842.		
250-10-50-1 and 50-2 842-10-65-1(i)	14. The lessee has disclosed the following information in the fiscal interim (if applicable) and annual periods in which it initially applies ASC 842:		
250-10-50-1(b) and 50-4 842-10-65-1(i)	a. A description of the method used to apply the change in accounting principle.		
250-10-50-1(b)(1) 842-10-65-1(i)	b. A description of the prior-period information subjected to retrospective adjustment (if any).		
250-10-50-1(b)(3) 842-10-65-1(i)	c. The cumulative effect of the change on retained earnings (or other comparable caption on the balance sheet) as of the beginning of the earliest period presented if the lessee elected Transition Method A (see Section 10.2) or as of the beginning of the period of adoption if the lessee elected Transition Method B (see Section 10.2).		

842-	Disclosure requirement	Yes/No	Remarks
250-10-50-1(c) 842-10-65-1(i)	d. If any indirect effects of changing to ASC 842 are recognized, both of the following: • A description of the indirect effects including the amounts that have been recognized in the current period, and the related per-share amounts, if applicable. • Unless impracticable, the amount of the total recognized indirect effects of changing to ASC 842 and the related per-share amounts (if applicable) that are attributable to each prior period presented.		
842-10-65-1(j)	15. If the lessee elected one or more of the practical expedients in ASC 842-10-65-1(f) (see Section 10.3.1), ASC 842-10-65-1(g) (see Section 10.3.2) and ASC 842-10-65-1(gg) (see Section 10.3.3), it has disclosed that fact.		
842-10-65-1(jj)	16. If the lessee elected Transition Method B (see Section 10.2), it has provided all of the disclosures required by ASC 840 for periods that continue to be accounted for in accordance with ASC 840.		

Appendix E: Examples

The following is a list of the examples in this guide:

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