LEASES: NEW ACCOUNTING REQUIREMENTS FOR LESSEES

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1. Introduction

1.1 Background information

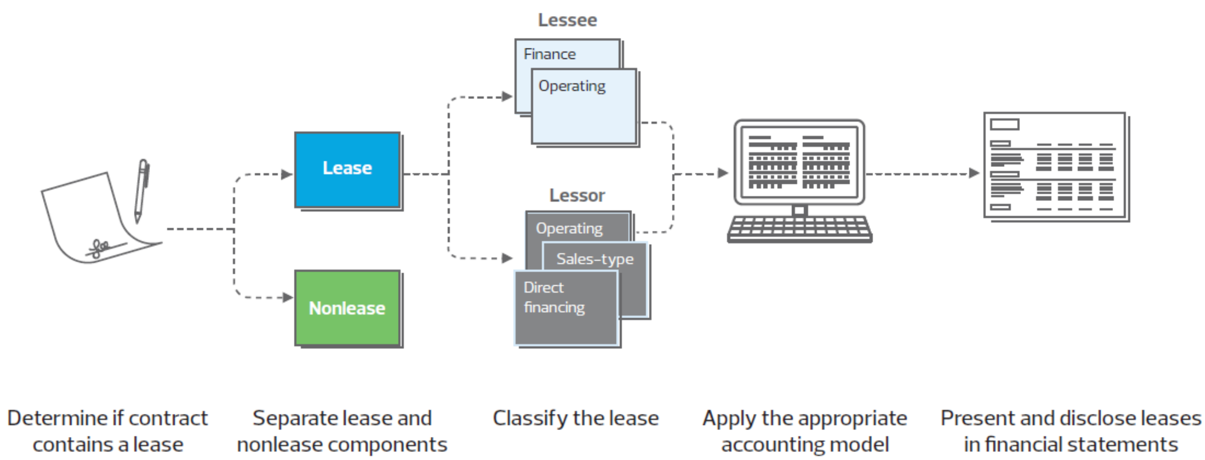
On February 25, 2016, the FASB issued ASU 2016-02, *Leases (Topic 842)*, its long-awaited final standard on the accounting for leases. ASU 2016-02 was issued in three parts: (a) Section A, "Leases: Amendments to the *FASB Accounting Standards Codification*®," (b) Section B, "Conforming Amendments Related to Leases: Amendments to the *FASB Accounting Standards Codification*®," and (c) Section C, "Background Information and Basis for Conclusions." The ASU replaces the legacy U.S. GAAP for leases in ASC 840 with the new lease guidance in ASC 842. For ease of use, definitions for acronyms and titles for ASC topics and subtopics referred to in this white paper are included in Section 1.2.

The most significant change to lessee accounting resulting from the new requirements in ASC 842 is the recognition of ROU assets and lease liabilities for all leases other than those that meet the definition of short-term leases (see Section 7.1.1). This change will result in lessees recognizing ROU assets and lease liabilities for most leases currently 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 the new lease guidance could be seriously compromised. It is possible that the only remedy available in this situation may be to modify the debt agreement.

This white paper discusses the scope of ASC 842 and the requirements in ASC 842 related to the following activities undertaken by a lessee in its accounting for a lease:



In addition, this white paper also discusses accounting for sale-leaseback transactions, ASU 2016-02's effective date and transition requirements and differences between how lessees account for leases under ASC 842 and IFRS 16, *Leases*. The following two appendices are also included in this white paper: (a) Appendix A, "Disclosure checklist," and (b) Appendix B, "Transition requirements."

Even though the FASB provided a significantly deferred mandatory effective date for ASU 2016-02, lessees should begin familiarizing themselves with the new lease guidance soon so as to better understand its potentially significant financial reporting consequences. Reading this white paper is a good first step in that process.

1.2 Acronyms and literature references

Several acronyms are used throughout this white paper and numerous references are made to specific topics and subtopics in the ASC. Provided in this section are: (a) an acronym legend, which lists the acronyms used throughout this white paper and their corresponding definitions and (b) a literature listing, which lists the topics and subtopics referred to throughout this white paper and the corresponding titles.

Acronym legend

Acronym	Definition
ASC	FASB's Accounting Standards Codification
ASU	Accounting Standards Update
FASB	Financial Accounting Standards Board
GAAP	Generally accepted accounting principles
IASB	International Accounting Standards Board
IFRS	International Financial Reporting Standards
ROU (asset)	Right-of-use (asset)
SEC	Securities and Exchange Commission

Literature listing

ASC topic or subtopic	Title
210-20	Balance Sheet – Offsetting
250	Accounting Changes and Error Corrections
250-10	Accounting Changes and Error Corrections – Overall
310-10	Receivables – Overall
360-10	Property, Plant, and Equipment – Overall
410-20	Asset Retirement and Environmental Obligations – Asset Retirement Obligations
420	Exit or Disposal Cost Obligations
460	Guarantees
606	Revenue from Contracts with Customers
606-10	Revenue from Contracts with Customers – Overall
805	Business Combinations
810-10	Consolidations – Overall
815-10	Derivatives and Hedging – Overall
815-15	Derivatives and Hedging – Embedded Derivatives
820	Fair Value Measurement
830-10	Foreign Currency Matters – Overall
840	Leases

ASC topic or subtopic	Title
840-30	Leases – Capital Leases
842	Leases
842-10	Leases – Overall
842-20	Leases – Lessee
842-30	Leases – Lessor
842-40	Leases – Sale and Leaseback Transactions
850-10	Related Party Disclosures – Overall
958-810	Not-for-Profit Entities – Consolidation

2. Scope

ASC 842 applies to all leases (as defined), including subleases. Based on the definition of a lease included in Section 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. However, rights to use equipment used in exploring for nonregenerative resources are included in the scope of ASC 842, as are rights to use land to explore for these resources if the land can be used for more than exploration.

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 5.5.4).

A lessee may apply 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.

3. Determine if the contract contains a lease

The definition of a lease in ASC 842 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 contains a lease at contract inception.

Whether a contract is or contains a lease is only reassessed if the contract's terms and conditions are changed.

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.

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.
- **Decision point 2:** The contract conveys the right to control the identified asset.

The need to consider these decision points is to differentiate a lease from a supply or service contract.

For the contract to convey the right to control the identified asset (which is the second decision point), both of the following must be true:

- **Decision point 2A:** The customer has the right to obtain substantially all of the economic benefits from using the identified asset over the period of use.
- **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 (which is decision point 2B), 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.
- **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 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.

Considerable guidance is provided in ASC 842 related to each of these decision points, including the ten examples (addressing application of these decision points to 16 different scenarios) provided in ASC 842-10-55-41 through 130. The following table includes each of the decision points and additional information specific to each decision point. Those scenarios in ASC 842-10-55 that are specifically referenced in the table, 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 illustrative scenarios and the effects those differences could have on the analysis as to whether a lease exists.

<table>
<tr><td rowspan="2">Decision point 1: Does the contract include an identified asset?</td><td>If not, the contract does not contain a lease.</td></tr>
<tr><td>If so, continue to the next decision point.</td></tr>
<tr><td colspan="2">• Explicit identification of asset. In many cases, the asset subject to the right of use (e.g., a truck, network equipment, a building) is explicitly identified in the contract.</td></tr>
</table>

- *Implicit identification of 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. Example 8 (starting at ASC 842-10-55-100) 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.
- *Supplier substitution rights*. If the supplier has substantive substitution rights throughout the period of use, the contract does not include an identified asset. For a substitution right to be substantive: (a) the supplier must have the practical ability to substitute the asset with an alternative asset throughout the period of use and (b) the supplier's exercise of the substitution right would have to be economically beneficial to it (i.e., the economic benefits of exercising the substitution right outweigh the related costs). 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. 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 (starting at ASC 842-10-55-48) 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 (starting at ASC 842-10-55-92) 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.
- *Capacity portion of an 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, which in turn results in the customer obtaining substantially all of the economic benefits from the asset's use. Case A of Example 3 (starting at ASC 842-10-55-55) addresses a situation in which the right to use a portion of the capacity of a fiber-optic cable should be considered an identified asset because three physically distinct fibers in the cable have been explicitly designated for the customer's use. Conversely, Case B of Example 3 (starting at ASC 842-10-55-60) 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.

Decision point 2A: Does the contract provide the customer with the right to obtain substantially all of the economic benefits from using the identified asset over the period of use?	If not, the contract does not contain a lease. If so, continue to the next decision point.

- *Economic benefits from use of the identified asset should reflect the contract terms*. Only economic benefits resulting from the customer's use of the identified asset in accordance with the contract (which may include using, holding or subleasing the identified asset) should be considered in the economic benefits analysis. For example, if the customer is limited to using the identified asset in a particular area, only the economic benefits related to use of the asset in that particular area should be considered in the analysis.
- *Exclusive use*. If the customer's right to use an identified asset is exclusive, it 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 is often explicitly provided for in the contract. However,

sometimes that right is implicitly provided. To determine if that is the case, the capacity of the identified asset must be considered. Case A of Example 6 (starting at ASC 842-10-55-79) 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 (starting at ASC 842-10-55-100) 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 only takes up a fraction of the factory's capacity and the supplier is free to use the excess capacity to fulfill contracts with other customers.

- *Nature of economic benefits*. 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. Case A of Example 9 (starting at ASC 842-10-55-108) 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 that case, the tax credits are not considered an economic benefit related to *using* the solar farm because they are earned as a result of *owning* the solar farm. In contrast, the renewable energy credits in that case are considered economic benefits from using the solar farm because they are a by-product of that use.
- *Payments to supplier based on use of the identified asset*. The economic benefits that accrue to the customer for purposes of assessing whether the customer has the right to obtain substantially all of the economic benefits from use of an identified asset should include any payments subsequently made to the supplier for use of the asset. 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 percent of its net sales to the supplier. The requirement to remit an amount equal to 20 percent 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 flow to the supplier, those cash flows represent consideration that the customer pays the supplier for the use of that space.

Decision point 2B1: Does the contract provide the customer or the supplier with the right to direct how and for what purpose the identified asset is used over the period of use or are the relevant decisions about how and for what purpose the identified asset is used over the period of use predetermined?	If the customer has the right to direct how and for what purpose the identified asset is used, the customer has the right to direct the use of the asset and the contract contains a lease.
	If the supplier has the right to direct how and for what purpose the identified asset is used, the customer does not have the right to direct the use of the asset and the contract does not contain a lease.
	If the relevant decisions about how and for what purpose the identified asset is used are predetermined, continue to the next decision point.

- *Decision-making rights*. Whether the customer has the right to direct how and for what purpose the identified asset is used over the period of use means the customer must have the right to make decisions that can *change* how and for what purpose the asset is used over the period of use. The decision-making rights that are relevant for this purpose are those rights that affect the economic benefits to be derived from use of the identified asset. In addition, only the most relevant decision-making rights should be considered in the assessment.

- 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, depending on the facts and circumstances, the right to change the following about the output: (a) the type of output produced by the identified asset (e.g., mix of products to be sold in a retail unit), (b) when the output is produced (e.g., when a piece of machinery will be used to produce a widget), (c) where the output is produced (e.g., the destination of a truck) and (d) 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 (starting at ASC 842-10-55-55) 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. Case B of Example 10 (starting at ASC 842-10-55-127) explains 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 network server will be used over the period of use (e.g., how the customer's data is transported using the server, whether the server needs to be reconfigured and whether the server should be used for a different purpose).

- *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 (starting at ASC 842-10-55-85) 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.
- *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 discussed in decision points 2B2(a) and 2B2(b), 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.

<table>
<tr><td>Decision point 2B2(a): Does the customer have the right to operate the identified 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?</td><td>If so, the customer has the right to direct the use of the identified asset and the contract contains a lease.
If not, continue to the next decision point.</td></tr>
<tr><td colspan="2">Operating decisions. Understanding whether the customer or the supplier is responsible for making operating decisions related to the identified asset is only relevant if neither the customer nor the supplier have the right to direct how and for what purpose the asset is used, which is the case when how and for what purpose the asset is used is predetermined. This is important to understand because, as discussed earlier, operating decisions related to 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 (starting at ASC 842-10-55-72) 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, Case B of Example 9 (starting at ASC 842-10-55-112) 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.</td></tr>
<tr><td>Decision point 2B2(b): Did the customer design the identified asset (or specific aspects of the identified asset) in a way that predetermines how and for what purpose the asset will be used over the period of use?</td><td>If so, the customer has the right to direct the use of the identified asset and the contract contains a lease.
If not, the customer does not have the right to direct the use of the identified asset and the contract does not contain a lease.</td></tr>
<tr><td colspan="2">Predetermined by customer design. 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. Case A of Example 9 (starting at ASC 842-10-55-108) addresses a situation in which the customer has the right to direct 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.</td></tr>
</table>

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 (e.g., a contract for network services, the purchase of an asset with a put option that the customer has a significant economic incentive to exercise) may not be what it is in substance (e.g., a lease for network servers, a lease [instead of the purchase] of an asset). As such, great care should be taken in understanding the terms of a contract and applying the definition of a lease to that contract.

4. Separate lease and nonlease components

Once the lessee has determined that a contract is or contains a lease, it must determine the units of account present in the contract. To do so, the lessee must:

- Determine whether two or more contracts should be combined for accounting purposes
- Identify the separate lease components in the contract (or combined contracts)
- Determine whether the separate lease components in the contract should be separated from or combined with any related nonlease components (e.g., maintenance on a leased asset)

After identifying the units of account, the lessee must allocate the consideration in the contract to each unit of account.

4.1 Identify the units of account

4.1.1 Combine contracts

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

- At least one of the contracts is or contains 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:
  - 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).
  - 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 4.1.2) and, as a result, represent a single lease component.

While the discussion in this white paper 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.

4.1.2 Identify the separate lease components

To determine whether there is one or more separate lease components within the contract, the lessee must first identify each right to use an underlying asset in the contract. If there is only one right to use an underlying asset in the contract, then it is the only separate 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.

If a contract includes the right to use land and the right to use another asset, the right to use land should be accounted for as a separate lease component unless the effects of doing so would be insignificant. Determining whether accounting for the right to use land as a separate lease component is insignificant is broader than just evaluating the significance of the amount that would be recognized for the right to use land if it were accounted for as a separate lease component. The lessee should also 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.

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: (a) 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.

Example 4-1 (which is included after Section 4.2.5) illustrates the analysis that must be performed to identify the separate lease components in a contract.

4.1.3 Separate or combine lease components and 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. If the lessee does not elect this accounting policy, the nonlease components are accounted for 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 payments that would otherwise be attributable to the nonlease components are included in determining the ROU asset and lease liability recognized by the lessee. In other words, 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 (which is included after Section 4.2.5) illustrates the effects of adopting the accounting policy to not separate lease components from nonlease components.

4.2 Allocate contract consideration

4.2.1 Elements of contract consideration

Contract consideration includes everything included in lease payments (see Section 5.5) and any other of the following payments required under the contract that are not already included in the lease payments (e.g., payments for nonlease components such as monthly maintenance service charges): (a) fixed payments, (b) in-substance fixed payments and (c) variable payments that depend on an index or rate, measured initially by reference to the index or rate at the commencement date. Contract consideration should be reduced for any incentives paid or payable to the lessee that have not already been included as a reduction to lease payments.

4.2.2 Identifying nonlease components

Contract consideration is allocated to the separate lease and nonlease components of a contract. Nonlease components transfer 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 utilities and cleaning services for the common areas, such as the building lobby and parking lot. The following are generally not considered nonlease components:

- *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*. 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.
- *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. Whether reimbursements of or payments for the lessor's costs are included in contract consideration depends on the facts and circumstances, including whether the amount of a reimbursement or payment is fixed or variable. In general, if the reimbursement or payment is variable, it would be treated as a variable lease payment.

Because the foregoing are not considered nonlease components, no contract consideration is allocated to them.

4.2.3 Allocation of contract consideration to components using relative standalone prices

If the lessee does not elect the accounting policy to combine separate lease components with the related nonlease components, the contract consideration is allocated to the separate lease components and the nonlease components based on their relative standalone prices.

If the lessee elects the accounting policy to combine separate lease components with the related nonlease components, the contract consideration is allocated to each combined unit of account (consisting of a separate lease component and the nonlease components related to it) based on their relative standalone prices.

Example 4-1 (which is included after Section 4.2.5) illustrates the allocation of contract consideration both when the lessee does and does not elect the accounting policy to combine separate lease components with the related nonlease components in the contract.

If observable standalone prices 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 component. If observable standalone prices are not available, 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 component is highly variable or uncertain.

4.2.4 Allocation of variable payments not included in contract consideration

Guidance on how variable payments in a contract that are not included in the contract consideration (see Sections 7.2.2.1 and 7.2.3.1) should be allocated between the contract's units of account is not explicitly provided in ASC 842. However, Example 14 (starting at ASC 842-10-55-150) 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 percent to the lease component and 20 percent to the maintenance component, when a variable payment not included in the contract consideration is recognized by the lessee, 80 percent is attributed to the lease component and 20 percent is attributed to the maintenance component. We believe the approach used in Example 14 would be a reasonable approach to apply in many other situations. Ultimately, though, the approach used should be reasonable and rational in the context of each situation's specific facts and circumstances and should be consistently applied in similar situations.

4.2.5 Remeasuring and reallocating contract consideration

Contract consideration should be remeasured and reallocated only if: (a) the lease liability is remeasured as otherwise required by ASC 842 (see Section 7.2.1) or (b) there is a contract modification that is not accounted for as a separate contract (see Section 7.2.5.1).

Example 4-1: Identifying the units of account and allocating contract consideration

Lessee enters into a contract with Lessor under which it will lease 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. 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 x 12 months x three years] + $108,000 for Printer Y [$3,000 per month x 12 months x three 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 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 or suppliers of 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 x 54%)
Lease of Printer Y	112,000	32% (112,000/350,000)	92,160 (288,000 x 32%)
Printer X maintenance services	28,000	8% (28,000/350,000)	23,040 (288,000 x 8%)
Printer Y maintenance services	21,000	6% (21,000/350,000)	17,280 (288,000 x 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 x 63%)
Lease of Printer Y and related maintenance services	125,800	37% (125,800/340,000)	106,560 (288,000 x 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 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 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.

5. Key inputs to classifying and accounting for a lease

5.1 Commencement date

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). A lease commences on the date the lessor makes the underlying asset available to the lessee for its use. The timing of when lease payments begin does not affect the determination of the commencement date.

Consider a situation in which a lessee enters into a ground or building lease with the lessor and the lessee undertakes construction activities that need to be completed before the lessee begins using the land or building for its intended purpose. In this situation, the commencement date is the date the lessor makes the land or building available to the lessee for its use, which includes making the land or building available to the lessee for construction activities.

A master lease agreement may give rise to multiple commencement dates. For example, if a lessee plans 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.

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. 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. 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 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 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. The fact that there is a three-month delay in Lessee moving into the office building to allow for the installation of 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.

5.2 Discount rate

The discount rate used by a lessee is the rate implicit in the lease, if that rate is readily determinable. If that rate is not readily determinable, the lessee's incremental borrowing rate 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. If elected, this policy applies to all of a lessee's leases.

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.

The lessee's incremental borrowing rate is the interest rate the lessee would be charged for a loan that: (a) is collateralized, (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.

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 (i.e., durations), (b) a stable interest rate environment and (c) the lessee maintains a stable credit rating.

5.3 Lease term

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. In addition, the lease term may also need to reflect periods covered by an option to extend or terminate a lease.

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 the next section.

5.3.1 Options to extend or terminate a lease

Whether options to extend or terminate a lease should affect the lease term depends on whether the option rests with the lessee or lessor. If the option to extend or terminate a lease rests with the lessee, the lease term is affected as follows:

- The period covered by an option to extend the lease is included in the lease term if the lessee is reasonably certain to exercise the option.
- The period covered by an option to terminate the lease is included in the lease term if the lessee is reasonably certain not to exercise the option.

In contrast, if the option to extend or terminate a lease rests with the lessor, the periods covered by an option to extend or not terminate the lease should be included in the lease term regardless of the likelihood of the lessor exercising the option.

The factors that should be considered in determining whether a lessee is reasonably certain to exercise an option to extend a lease, or reasonably certain not to exercise an option to terminate a lease, 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 include the following:

- *How do the lease payments in the period covered by an option to extend the lease compare to current market rates?* If lease payments in the period covered by an option to extend the lease are significantly less than current market rates, then the likelihood that the lessee will exercise the option would increase.
- *Has the lessee constructed significant leasehold improvements that will still have economic value to the lessee during the period covered by an option to extend the lease?* If so, then the likelihood that the lessee will exercise the option would increase.
- *Would the lessee incur significant costs as a result of exercising an option to terminate the lease?* If so, then the likelihood that the lessee will not exercise the option would increase.
- *How important is the underlying asset to the lessee's operations?* If the underlying asset is critical to the lessee's operations, then the likelihood that the lessee will not exercise an option to terminate the lease, or will exercise an option to extend the lease, would increase.

These are examples of factors that should be considered and not an all-inclusive list. Whether the increased likelihoods referred to 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 an option to extend the lease or reasonably certain not to exercise an option to terminate the lease.

Example 5-3: Determining the lease term when options to extend or terminate the lease 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 options to extend or terminate the lease.

Scenario	Lease term
Lessee has the option to extend the lease by two years and Lessee is reasonably certain to exercise the option	Six years
Lessee has the option to extend the lease by two years and Lessee is not reasonably certain to exercise the option	Four years

Scenario	Lease term
Lessee has the option to terminate the lease after three years and Lessee is reasonably certain not to exercise the option	Four years
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
Lessor has the option to extend the lease by two years (regardless of the likelihood of Lessor exercising its option)	Six years
Lessor has the option to terminate the lease after three years (regardless of the likelihood of Lessor exercising the option)	Four years

5.3.2 Fiscal funding clauses

A lease may include a clause that 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. This type of clause is referred to as a fiscal funding clause. When such a clause is included in the lease, the lessee must determine if 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 not (i.e., exercise of the clause is less than remote), the fiscal funding clause does not affect the determination of the lease term.

5.3.3 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 an option to extend the lease, or not exercise an option to terminate the lease, changes directly as a result of a significant event or significant change in circumstances that was within the lessee's control (e.g., constructing significant leasehold improvements, significantly modifying or customizing the underlying asset, subleasing the underlying asset). Example 5-4 (which is included after Section 5.5.2) illustrates the effects of reassessing the lease term.
- 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 an option when it had previously concluded it was not reasonably certain to do so (e.g., the lessee exercises an option to extend a lease when it had previously concluded it was not reasonably certain to do so).
- The lessee does not exercise an option when it had previously concluded it was reasonably certain to do so (e.g., the lessee does not exercise an option to extend a lease 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.

Example 5-4 (which is included after Section 5.5.2) illustrates the effects of reassessing the lease term.

5.4 Purchase options

Purchase options provide the lessee with the option to purchase the underlying asset. For example, the lessee may have the option to purchase the underlying asset at the end of the lease term for a stated amount. How a purchase option affects the accounting for a lease depends on whether the lessee is reasonably certain to exercise the option. If so, the lease is classified as a finance lease and the option's exercise price is included in lease payments (see Sections 6 and 5.5.1, respectively). If not, the classification of the lease depends on the outcome of assessing the other lease classification criteria and the option's exercise price is not included in lease payments. 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 and are similar to those considered in determining whether a lessee is reasonably certain to exercise an option to extend a lease (see Section 5.3.1).

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 (e.g., the lessee significantly modifies or customizes the underlying asset).
- The contract requires the lessee to either exercise or not exercise the purchase option when a specific event occurs and that event has occurred.
- 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.

Example 23 (starting at ASC 842-10-55-211) and Example 24 (starting at ASC 842-10-55-218) illustrate how a lessee should account for purchase options included in leases.

5.5 Lease payments

5.5.1 Payments included and excluded

Lease payments are used in the lease classification criteria (see Section 6) and in the measurement of the assets and liabilities recognized by lessees when accounting for their leases (see Section 7.1). Lease payments for lessees include the following:

- Fixed payments, including variable payments that are in-substance fixed payments (see Section 5.5.2) reduced by any lease incentives paid or payable to the lessee (see Section 5.5.3)
- Variable lease payments that depend on an index or rate, measured initially by reference to the index or rate at the commencement date (see Section 5.5.2)
- The exercise price of an option that allows the lessee to purchase the underlying asset, but only if it is reasonably certain that the lessee will exercise that option (see Section 5.4)
- The penalty that would be due from the lessee upon termination of the lease, but only if the lease term reflects the lessee exercising the option to terminate the lease (see Section 5.3.1)
- 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)
- Payments under residual value guarantees that are probable of being owed (see Section 5.5.4)
- The stated purchase price of the underlying asset at the end of the lease term when the lessor has the option to require the lessee to purchase the underlying asset (see ASC 842-10-55-35)
- Maintenance deposits, depending on the facts and circumstances (see Section 5.5.5)

In addition, 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 considered lease payments or variable lease payments, depending on the facts and circumstances. In contrast, 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 original condition) (e.g., payments to be made to remove leasehold improvements installed by the lessee) should generally *not* be considered lease payments or variable lease payments. Instead, the obligation to make such payments should likely be accounted for as an asset retirement obligation under ASC 410-20.

Other amounts excluded from lease payments include amounts related to the lessee's guarantee of the lessor's debt and any amounts allocated to the nonlease components of a contract (see Section 4.2). The amounts excluded from lease payments (and, therefore, not accounted for in accordance with ASC 842) should be accounted for in accordance with other applicable U.S. GAAP (e.g., ASC 460, ASC 810-10).

Sections 5.5.2 through 5.5.6 provide additional information about amounts that should be included and excluded from lease payments and when lease payments should be remeasured.

5.5.2 Variable lease payments

Variable lease payments that are in-substance fixed payments (which are included in fixed payments when determining lease payments) include payments that vary based on terms that lack economic substance or payments based on a variable for which a minimum amount is set.

Variable lease payments that vary after the commencement date for reasons other than a change in an index or rate are not included in lease payments. For example, lease payments that vary based on the sales of a retail location are variable lease payments that are not included in lease payments. 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 5.5.6, 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 information about the accounting for variable lease payments that are not included in lease payments is provided in Sections 7.2.2.1 and 7.2.3.1.

Payments that vary solely based on the passage of time are not considered variable lease payments.

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, 20X6. The lease payments on January 1, 20X7 and 20X8 are $100,000 adjusted for the cumulative increase in the Consumer Price Index (CPI) since January 1, 20X6. 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, 20X9 adjusted for the cumulative increase in the CPI since January 1, 20X6. 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. 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, 20X6, 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 over the term of the lease are as follows:

Increase in the CPI from January 1, 20X6 to December 31, 20X6	2.0%
Payment due on January 1, 20X7 ($100,000 + [$100,000 x 2%])	$102,000
Increase in the CPI from January 1, 20X6 to December 31, 20X7	3.5%
Payment due on January 1, 20X8 ($100,000 + [$100,000 x 3.5%])	$103,500

In addition, 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 payments it makes on January 1, 20X7 and 20X8 in the period(s) in which those costs are incurred, which is 20X7 and 20X8, respectively. As a result, Lessee includes additional lease costs of $2,000 and $3,500 in its financial statements for the years ending December 31, 20X7 and 20X8, respectively.

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 $103,500 for January 1, 20X9. If the increase in the CPI from January 1, 20X6 to December 31, 20X8 is 6 percent, Lessee includes additional lease costs of $2,500 ($106,000 payment on January 1, 20X9 less $103,500 payment included in the remeasurement of the lease liability and ROU asset) in its financial statements for the year ending December 31, 20X9.

5.5.3 Lease incentives

Lease incentives paid or payable to the lessee (which are netted against fixed payments when determining lease payments) include payments made to or on behalf of the lessee. If the lessor assumes a lessee's pre-existing lease with a third party, the lessee should estimate the losses the lessor will incur as a result of assuming that pre-existing lease and include that estimate in lease incentives. In estimating the lessor's loss, the lessee will likely need to consider market rental rates for similar underlying assets.

5.5.4 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.

If a lease provision requires the lessee to make a payment to the lessor to address a residual shortfall caused by damage, extraordinary wear and tear or excessive use, that lease provision is not considered a residual value guarantee. Depending on the facts and circumstances, this provision may need to be accounted for as a variable lease payment under ASC 842, 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).

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.

5.5.5 Maintenance deposits

The key issue 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 are substantively and contractually related to maintenance of the underlying asset. If not, the payment does not represent a maintenance deposit. In addition, the lessee must also consider the probability of the maintenance deposit being returned to the lessee for reimbursement of costs to maintain the underlying asset. A deposit asset should only be recognized for the amount of the maintenance deposit that is probable of being returned to the lessee for reimbursement of costs to maintain the underlying asset.

Those maintenance deposits not recognized as a deposit (in whole or in part) (e.g., because return of the deposit is less than probable) should be accounted for in the same manner as variable lease payments.

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.

5.5.6 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 (see Section 7.2.5.1).
- Variable lease payments that did not previously meet the definition of lease payments (because they varied based on something 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 (see Section 5.5.2).
- There is a change in the lease term (see Section 5.3.3), in which case the lease payments are revised to reflect the revised lease term.
- There is a change to the expectations about whether the lessee is reasonably certain to exercise a purchase option (see Section 5.4), in which case the lease payments are revised for that change in expectations.
- There is a change in the probable amount expected to be owed by the lessee under a residual value guarantee (see Section 5.5.4), in which case the lease payments are revised to reflect that change in expectations.

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 using the index or rate on the remeasurement date.

Example 5-4 (which is included after Section 5.5.2) 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]) as either finance or operating leases. There are five criteria that lessees must consider in evaluating whether a lease should be classified as a finance or operating lease. If one or more of these lease classification criteria is 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. However, if the lessee is leasing facilities owned by a government unit or authority, such as facilities at an airport, port or bus terminal, the guidance in ASC 842-10-55-13 must also be applied when determining the appropriate classification of the lease.

The five lease classification criteria lessees must consider are included in the following table along with additional information related to each criterion:

Ownership of the underlying asset transfers to the lessee by the end of the lease term.
• 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, which may include a requirement on the part of the lessee to pay no more than a nominal fee (e.g., a statutory transfer fee). • 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 is evaluated as part of the next criterion.
An option exists under which the lessee may purchase the underlying asset and exercise of that option is reasonably certain.
• Additional information about purchase options, including the factors that should be considered in determining whether exercise of a purchase option is reasonably certain, is provided in Section 5.4.
When the lease does not commence at or near the end of the underlying asset's economic life, the lease term makes up a major part of the underlying asset's remaining economic life.
• For purposes of determining whether the lease commences at or near the end of the underlying asset's economic life, one reasonable approach would be to use a threshold of 25 percent or less of the underlying asset's total economic life. • For purposes of determining whether the lease term makes up a major part of the underlying asset's remaining economic life, one reasonable approach would be to use a threshold of 75 percent or more. • When a unit of account includes more than one lease component because the lease components could not be separated for accounting purposes (see Section 4.1.2), the predominant underlying asset is used for purposes of assessing this criterion. Example 13 (starting at ASC 842-10-55-146) illustrates identifying the predominant underlying asset in a unit of account that includes rights to use a turbine, a building and land.
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 fair value of the underlying asset should be measured in accordance with ASC 820. • The fair value of the underlying asset should not consider any related investment tax credits retained, and expected to be realized, by the lessor. • The fair value of the underlying asset should not include 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). • The residual value guaranteed by the lessee for a portfolio of underlying assets (and not individual underlying assets) should not be considered when evaluating this criterion.

- For purposes of determining what represents substantially all of the underlying asset's fair value, one reasonable approach would be to use a threshold of 90 percent or more.
- 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.
- Section 5.2 provides information about determining the discount rate (for present value purposes) using a portfolio approach.

The underlying asset's specialized nature is expected to result in it not having an alternative use to the lessor at the end of the lease term.

- 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).
- Contractual restrictions only affect whether the underlying asset has an alternative use to the lessor at the end of the lease term if they are substantive. 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.

Examples 7-3, 7-4 and 7-5 (which are included after Section 7.2.5.1), Example 8-1 (which is included after Section 8.3) and Example 8-2 (which is included after Section 8.4) illustrate the application of the lease classification criteria to specific facts and circumstances.

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 pre-existing environmental contamination or environmental contamination caused by the lessee.

While all but the last of the lease classification criteria in ASC 842 are similar in principle to those found in legacy U.S. GAAP, they do not draw any quantitative bright lines. However, as discussed in the context of two of the classification criteria, observations are made in ASC 842's implementation guidance about what might be acceptable approaches as far as establishing quantitative thresholds. Lessees will need to adopt and consistently apply reasonable accounting policies related to their application of the principles-based lease classification criteria in ASC 842.

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 5.3.3) 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).

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 not considered short-term leases. Example 7-2 (which is included after Section 7.2.3.2) and

Example 7-3 (which is included after Section 7.2.5.1) illustrate the lessee's initial accounting for a lease when the short-term accounting policy discussed in Section 7.1.1 is not elected.

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 not included in lease payments (because they are not based on an index or rate) are recognized as lease costs in the period in which they are incurred, consistent with how such payments are recognized when the short-term leases accounting policy is not elected (see Sections 7.2.2.1 and 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 5.3.3) and the remaining lease term is more than 12 months from the end of the previously determined lease term.
- 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 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 extend the lease for an additional year. On January 1, 20X6, Lessee appropriately concludes it is not reasonably certain to exercise the option to extend 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 extend 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).

Section 5.2 provides information about determining the discount rate using a portfolio approach.

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 for: (a) any lease payments made to the lessor (net of any lease incentives received by the lessee) on or before the lease's commencement date (see Section 5.1) and (b) any initial direct costs incurred by the lessee (see Section 7.1.3.1).

7.1.3.1 Initial direct costs

Only incremental costs that a lessee would not have incurred if the lease had not been entered into should be considered initial direct costs of the lease. For example, a payment made to an existing tenant to obtain the lease meets the definition of an initial direct cost. In general, any costs incurred prior to signing a lease 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 entering into leases) and general overheads are not considered initial direct costs of a lease.

To the extent there is more than one lease component in a contract that should be accounted for separately (see Section 4.1.2), the initial direct costs related to the lease components are allocated between them on the same basis as the contract consideration was allocated to the units of account (see Section 4.2.3).

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. Example 7-2 (which is included after Section 7.2.3.2) and Examples 7-3, 7-4 and 7-5 (which are included after Section 7.2.5.1) illustrate the lessee's subsequent accounting for a lease when the short-term accounting policy discussed in Section 7.1.1 was 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 is based on the following:

	Beginning balance of the lease liability
+	Accretion of the lease liability
–	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 Sections 7.2.2.1 and 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, taking into consideration any remeasurement of the lease payments (see Section 5.5.6) and any reassessment of either the lease term (see Section 5.3.3) or the likelihood of the lessee exercising a purchase option (see Section 5.4).

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, determined using the discount rate (see Section 5.2) as of the commencement date (see Section 5.1) or the updated discount rate as discussed in the next paragraph.

When lease payments are remeasured (see Section 5.5.6), the lease liability should be remeasured. In addition, when the lease liability is remeasured, the discount rate should be updated as of the remeasurement date to reflect the remaining lease term and remaining lease payments unless remeasurement of the liability was triggered by one or more of the following:

- A change in the lease term or a change in whether the lessee is reasonably certain to exercise a purchase option and the discount rate already takes into consideration the effects of any lessee options to extend the lease, terminate the lease or purchase the underlying asset.

- A change in the amount of a residual value guarantee that is probable of being owed.
- A change in the variable lease payments that did not previously meet the definition of lease payments (because they varied based on something other than an index or rate) such that they subsequently meet the definition of lease payments for the remainder of the lease term because the underlying contingency has been resolved.

When the lease liability is remeasured to reflect the remeasurement of lease payments, the adjustment to the lease liability should be recognized as an adjustment to the ROU asset. 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, then 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 ROU asset. If the ROU asset is adjusted as a result of the lease liability being remeasured (see Section 7.2.1), amortization of the ROU asset is adjusted prospectively from the remeasurement date. If the ROU asset is adjusted as a result of an impairment, 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 5.5.2) 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.
- *Impairment of the ROU asset.* Any impairment of the ROU asset recognized during the period in accordance with ASC 360-10-35 is included in lease costs.

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, 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 at the end of any given period in which lease payments are not remeasured is based on the following:

	Beginning balance of the net ROU asset
–	Amortization of the ROU asset for the period
–	Impairment losses for the period (if any)
=	Ending balance of the net ROU asset

Information about the effects of remeasuring the lease liability on the ROU asset is provided in Section 7.2.1.

7.2.3 Operating lease

7.2.3.1 Lease costs

Lease costs recognized in any given period for an operating lease include the following components:

- *Single lease cost*. Determination of the single lease cost for an operating lease depends on whether the ROU asset has been impaired.
  - *No impairment*. When the ROU asset has not been impaired, the single lease cost 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 are determined as follows:

	Total lease payments (paid and unpaid) (as adjusted for the remeasurement of lease payments or a lease modification not accounted for as a separate contract)
+	Initial direct costs of the lease
–	Periodic lease costs recognized in prior periods
=	Remaining lease costs

    If there are no lease modifications, no remeasurements of lease payments and no reassessments of the lease term, the single lease cost is the same as taking total lease costs (total lease payments [paid and unpaid] plus initial direct costs of the lease) and dividing it by the lease term when the straight-line amortization method is used.
  - *Impairment*. Single lease cost is the sum of the following: (a) periodic amortization of the remaining ROU asset 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 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).
- *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 5.5.2) 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.

- *Impairment of the ROU asset.* Any impairment of the ROU asset recognized during the period in accordance with ASC 360-10-35 is included in lease costs.

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 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 if the ROU asset was not previously impaired:

Determination of ending balance in ROU asset when not previously impaired	
	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
=	ROU asset at the end of each period if the ROU asset was not previously impaired

Calculation of prepaid or accrued lease payments at year end	
	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 year
=	Cumulative amount of total lease payments to be paid by the lessor that have been reflected in the single lease cost through the end of the year
–	Cumulative lease payments paid to the lessor through the end of the year
=	If positive, accrued lease payments; if negative, prepaid lease payments

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

Information about the effects of remeasuring the lease liability on the ROU asset is provided in Section 7.2.1.

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

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.
- 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's incremental borrowing rate is 8 percent (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 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.

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 in 20X7, $105,000 in 20X8 and $110,000 in 20X9, a lease term of three years and a discount rate of 8 percent, 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 ($20,000) and increasing it for the initial direct costs ($5,000). 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

The balance in the 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 x 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 if 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 divided by three years). The balance of Lessee's net ROU asset over the lease term if 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 if lease is an operating lease

Under the operating lease accounting model, Lessee 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 in 20X7, $105,000 in 20X8 and $110,000 in 20X9) 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 divided by three 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	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
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 x 2/3 in 20X6 and 1/3 in 20X7)	13,333	6,667
Plus unamortized initial direct costs ($5,000 x 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
20X7				
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.

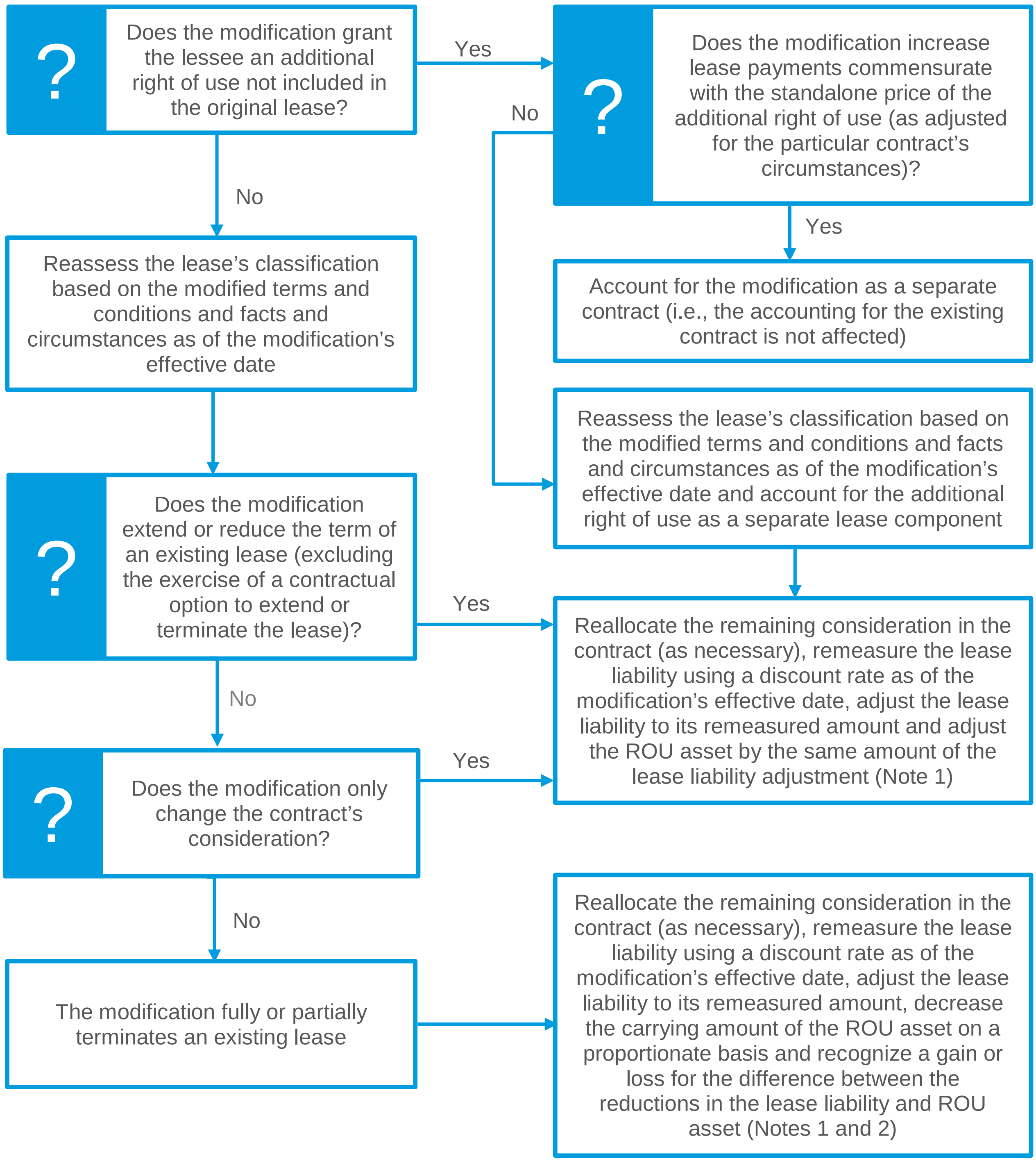
7.2.4 Leasehold improvements

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 7.5.3.

7.2.5 Lease modifications

7.2.5.1 Determining factors and accounting consequences

The numerous factors considered in determining how to account for modifications to a lease, as well as the various accounting consequences for different types of modifications, are captured in the flowchart on the next page.



Note 1: 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 2: Example 18 (starting at ASC 842-10-55-177) 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

Pre-modification facts: Lessee 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 percent.
- 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 percent 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 of the lease liability because Lessee did not: (a) make any lease payments, or receive any lease incentives, on or before January 1, 20X6 and (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 the 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 x 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 multiplied by the 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 percent.
- 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.

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 percent 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 is 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 the 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 (beginning balance x 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 x 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 multiplied by the 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 divided by 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

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 building (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 percent 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 percent (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 percent). 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 divided by 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

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 percent and 7.5 percent, 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.

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 payment 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 percent), 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 percent). 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)
- Reassessing the fourth floor lease component's classification based on the modified terms and conditions and facts and circumstances on the modification date (i.e., January 1, 20Y1)
- Remeasuring the lease liability for the fourth floor lease component using the discount rate as of the modification 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%
Remaining consideration allocated to each lease component ($700,000 x 55.5556% and $700,000 x 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 percent) 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 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 percent 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 is 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)	$102,332	
ROU asset (fourth floor)		$102,332

The following table calculates the balance in the 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 x 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 multiplied by the five-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 divided by five 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 the 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:

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

The following table calculates the balance in the 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 x 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 multiplied by the four-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 divided by four 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 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

When a master lease agreement is modified, whether the lessee should account for obtaining control over the use of an additional underlying asset as a result of that modification depends on whether the master lease agreement committed or permitted the lessee to obtain control over that additional right of use:

- *Committed*. The lessee would be committed to obtaining control over the additional right of use in connection with a master lease agreement if it was obtaining control over that additional right of use to satisfy a minimum number of units or dollar value of underlying assets specified in the master lease agreement. When the lessee is committed to obtaining control over the additional right of use in connection with the master lease agreement, the lessee should not account for obtaining that additional right of use as a modification. Instead, the lessee should apply the unit-of-account guidance to determine: (a) whether the additional right of use should be accounted for as a separate lease component (see Section 4.1.2) and (b) how the contract consideration should be allocated to the units of account identified (see Section 4.2).

- *Permitted*. When the lessee is permitted to obtain control over the additional right of use in connection with the master lease agreement, the lessee should account for obtaining that additional right of use as a modification.

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.

7.2.6 Lease termination

When a lessee terminates a lease before the end of the lease term and does not purchase the underlying asset, it 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 ROU 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 (starting at ASC 842-10-55-211) and Example 24 (starting at ASC 842-10-55-218) 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 Leases denominated in a foreign currency

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 for the lease liability and (b) the exchange rate on the lease's commencement date for the ROU asset.

7.4 Subleases

A sublease exists when a lessee (i.e., 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 intermediate lessor should account for a head lease and a sublease as two separate contracts unless the specific contract combination criteria in ASC 842 are met (see Section 4.1.1).

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

When the intermediate lessor is relieved of its obligations under the head lease, the intermediate lessor 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 intermediate lessor becomes secondarily liable under the sublease (i.e., the intermediate lessor must make payments if the sublessee does not), the intermediate lessor also 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 intermediate lessor is not relieved of its obligations under the head lease, it accounts for the head lease and sublease separately. In other words, the intermediate lessor should continue to account for the head lease as a lessee and account for the sublease as a lessor. The specific accounting consequences to an intermediate lessor 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 intermediate lessor 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 should be used.

The following table highlights the accounting effects of a sublease on the intermediate lessor'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 intermediate lessor's accounting for the head lease**
Finance	Sales-type or direct financing	• *ROU asset related to the head lease*: Derecognize unless the sublease is a sales-type lease and collectibility of the lease payments is not probable (see ASC 842-30-25-3) • *Lease liability related to head lease*: Continue to apply the finance lease accounting model.
Operating	Sales-type or direct financing	• *ROU asset related to the head lease*: Derecognize unless the sublease is a sales-type lease and collectibility of the lease payments is not probable (see ASC 842-30-25-3) • *Lease liability related to head lease*: Account for using the finance lease accounting model
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*: Consider the guidance in ASC 360-10-35 related to testing the asset group that the ROU asset is a part of for impairment if the lease cost for the sublease's term is more than the anticipated sublease income for the sublease's term

With respect to the intermediate lessor's accounting for the sublease, it would apply the guidance in ASC 842-30, which would include evaluating its investment in the sublease for impairment in accordance with ASC 310-10-35-16 through 30. In doing so, the loss allowance on the net investment in the lease should take into consideration the cash flows that the intermediate lessor expects to derive from the underlying asset during the sublease's remaining term.

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 an intermediate lessor). 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.

7.5 Other topics

7.5.1 Related-party leases

Lessees in related-party leasing transactions should classify and account for those leases based on the legally enforceable terms and conditions of the lease. 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.

7.5.2 Leases involving real estate

Legacy U.S. GAAP includes additional guidance lessees must apply in accounting for leases involving real estate. For example, legacy U.S. GAAP provides additional guidance with respect to the classification of a lease involving both land and a building and a lease involving only part of a building. For another example, as discussed in Section 8.2, legacy U.S. GAAP provides additional guidance with respect to accounting for sale-leaseback transactions involving real estate. ASC 842 makes only one distinction in the accounting model applied by lessees to leases involving real estate. That distinction relates to whether it is necessary to account for the rights to use land and another asset (e.g., a building) included in the same contract as separate lease components, which is discussed in detail in Section 4.1.2. Otherwise, lessees account for leases involving real estate by applying the same requirements applicable to all other leases.

7.5.3 Leases acquired in a business combination

The key steps involved in the acquirer's accounting for the acquiree's leases in a business combination accounted for in accordance with ASC 805 when the acquiree is the lessee include the following:

- *Classify the acquiree's leases*. The acquirer should retain the acquiree's lease classification as of the acquisition date (provided the classification was determined in accordance with U.S. GAAP and properly considered the effects of any lease modifications since inception of the lease). In other words, the acquirer should not reassess the classification of the acquiree's leases. 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.

- *Decide 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.

- *Determine 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 bullet point, 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.

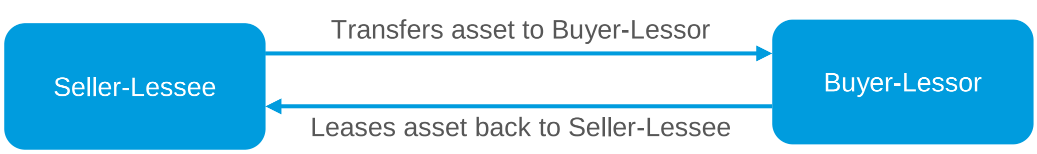
- *Recognize and measure ROU assets and lease liabilities*. For acquired leases with a remaining lease term of more than 12 months, and those short-term leases for which the acquirer has not elected the accounting policy discussed earlier, the acquirer must recognize ROU assets and lease liabilities. The initial measurement of a lease liability is the present value of the remaining lease payments, determined as if the lease were entered into on the acquisition date. The initial measurement of the ROU asset is the lease liability adjusted for the intangible asset or liability arising from the acquired lease having favorable or unfavorable terms compared to market.
- *Establish the amortization period for leasehold improvements*. In any of the following circumstances, the amortization period for leasehold improvements acquired in a business combination should be their 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 useful life 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.

For information about the guidance that should be used to account for leases acquired in a business combination before the effective date of ASU 2016-02, refer to Sections 9.1, 10.11 and 10.16 of our guide, A guide to accounting for business combinations.

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:



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 pre-existing environmental contamination does not mean, in and of itself, that the lessee controlled the underlying asset before it was transferred to the 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. Depending on the facts and circumstances, this contract may represent a sale-leaseback transaction. Whether this or a similar contract represents a sale-leaseback transaction, and how Lessee should account for any costs it incurs related to the construction or design of the building, is discussed in ASC 842-40-55-3 through 5 and BC400, and illustrated in Example 3 (starting at ASC 842-40-55-40).

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 pre-existing 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 pre-existing lease is modified as part of the sale and whether the pre-existing lease is between parties under common control. Additional information about how to account for a sale subject to a pre-existing lease is provided in ASC 842-40-55-8 through 10.

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 new revenue recognition guidance in ASC 606 to determine whether a contract exists (ASC 606-10-25-1 through 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 through 26]). For additional information about ASC 606, refer to our white paper, Revenue recognition: A whole new world.

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

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. In general, it would be very difficult to conclude that the second of these criteria is met when the underlying asset is real estate.
- *Leaseback includes a residual value guarantee*. While a residual value guarantee 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. For example, 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 harder 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 through 17.

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 entity (both the seller-lessee and buyer-lessor, each with respect to their own accounting) must determine whether the sale-leaseback transaction is at fair value. To do so, the entity 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 entity, the sale-leaseback transaction is not at fair value and an adjustment to the sale price (for the seller-lessee) or purchase price (for the buyer-lessor) is required. An adjustment to increase the sale (or purchase) price is essentially a prepayment of rent, and an adjustment to decrease the sale (or purchase) price is essentially additional financing. When the seller-lessee and buyer-lessor are related parties, no consideration is given to whether the sale-leaseback transaction is at fair value. In other words, no adjustments are made to the sale (or purchase) price.

The existence of a variable component in the sale (or purchase) 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 (or purchase) price is needed in those situations, the entity should take into consideration the amount of the variable component that it reasonably expects to be entitled to receive or pay. In doing so, the entity should consider all reasonably available information. In addition, the seller-lessee must consider the guidance on variable consideration in ASC 606-10-32-5 through 9. Treatment of a variable component in the sale (or purchase) 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 (or purchase) price, the seller-lessee and buyer-lessor account for the transaction as follows on the commencement date:

Accounting for…	Seller-lessee	Buyer-lessor
Sale or purchase when sale-leaseback transaction is at fair value or is with a related party	• Recognize the transaction price related to the sale (as determined by applying ASC 606-10-32-2 through 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	• Apply the same U.S. GAAP that applies to purchases of similar assets
Sale or purchase 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)	• Follow the accounting for when the sale-leaseback transaction is at fair value (see previous row) and: – Adjust the purchase price, as appropriate – Recognize an increase in the purchase price as prepaid rent – Recognize a decrease in the purchase 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)
Leaseback	• Apply guidance in ASC 842 applicable to lessees	• Apply guidance in ASC 842 applicable to lessors

Example 8-1, which is included later in this section, illustrates accounting for a sale-leaseback transaction that is not at fair value.

The guidance in legacy U.S. GAAP applicable to sale-leaseback transactions included additional requirements that had to be considered when accounting for sale-leaseback transactions involving real estate. This guidance has been superseded by ASC 842. As a result, sale-leaseback transactions involving real estate (including build-to-suit arrangements that meet the definition of sale-leaseback transactions) are subject to the same requirements as all other sale-leaseback transactions.

Example 8-1: Sale-leaseback transaction in which transfer of the asset is a sale

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's uses its incremental borrowing rate of 6 percent 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 through 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 through 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 the 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 financing 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
Financing 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 represents repayment of principal and interest on the $600,000 of additional financing it received in the sale-leaseback transaction. Using the principal amount of $600,000, the term of 10 years and an incremental borrowing rate of 6 percent, $81,521 of the $120,000 annual payment represents repayment of principal and interest on 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 percent, 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 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 x 6%])	21,486	
Financing liability ($81,521 – [$600,000 x 6%])	45,521	
Interest costs on financing liability ($600,000 x 6%)	36,000	
Cash		$120,000
ROU asset ($38,479 – [$283,210 x 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 (which is included after Section 7.2.3.2) 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 both the seller-lessee and buyer-lessor. As a result, the seller-lessee recognizes a financing liability for any amounts received from the buyer-lessor, and the buyer-lessor recognizes a receivable for any amounts received from the seller-lessee. With respect to the asset involved in the failed sale-leaseback transaction: (a) the seller-lessee should not derecognize it and (b) the buyer-lessor should not recognize it. 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 financing liability not being more than the principal payments 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 financing 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 financing liability should be adjusted until its accounting does produce both of these results.

Example 8-2 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.

Example 8-2: Sale-leaseback transaction in which transfer of asset is not a sale (i.e., failed sale)

Facts: Assume the same facts as Example 8-1, 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: 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 8-1, 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 financing 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	
Financing liability		$2,000,000

For purposes of its ongoing accounting for the financing liability, Seller-Lessee will use its 6 percent 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 financing liability is not more than the principal payments 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 financing 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 percent for accounting purposes because:

- *Interest vs. principal 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 the Buyer-Lessor or Seller-Lessee exercises its repurchase option), while the lease term ends on December 31, 20Y5. Interest on the financing liability using a 6 percent interest rate would be $600,000 over the financing term ($120,000 annual interest costs multiplied by five years), which is not more than the principal payments made over the financing term of $600,000 ($120,000 annual payment multiplied by five years).
- *Carrying amount of land vs. financing 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 divided by the building's 20-year remaining useful life]), which is not more than the carrying amount of the financing liability at January 1, 20Y1 (which would be $2 million given that there is no change in the principal amount of the financing liability over the lease term because the annual payment of $120,000 is equal to the annual interest costs of $120,000 [$2 million multiplied by 6 percent], assuming it remains reasonably certain that Seller-Lessee will not exercise the repurchase option on January 1, 20Y1).

If either (a) and (or) (b) had not resulted, Seller-Lessee would have needed to adjust the interest rate used for accounting purposes until both (a) and (b) would result (see Example 2 [starting at ASC 842-40-55-31] 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 financing liability and (b) annual depreciation expense on the building:

	Debit	Credit
Interest costs ($2,000,000 x 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
Financing 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 financing 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 financing 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
Financing 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 8-1, 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 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 ($505,562, 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 percent 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 $505,562. 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	$505,562	
Lease liability		$505,562

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 ($505,562/5 years)	$101,112	
Lease liability ($120,000 – [$505,562 x 6%])	89,666	
Cash		$120,000
ROU asset ($101,112 – [$505,562 x 6%])		70,778

Seller-Lessee recognizes lease costs of $101,112 per year over the leaseback term (provided there are no lease modifications or ROU asset impairments).

Example 7-2 (which is included after Section 7.2.3.2) 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 7.4).

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 A.

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 financing liability that it would provide for other financing 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 are subject to the same considerations as other financial liabilities. As a result, 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. Classification of ROU assets are subject to the same considerations as other nonfinancial assets. An important consideration in this regard is the nature of the ROU asset, which is strongly influenced by the lease's classification. Depending on the facts and circumstances, it may be appropriate to classify some or all of a ROU asset as a current asset.

9.2 Income statement

Classification of lease costs recognized under ASC 842 on the income statement depends on the classification of the lease. If the lease is classified as a finance lease, classification of the portion of the lease costs related to the amortization of the ROU asset and the portion of the lease costs 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, lease costs 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.

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.

If 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.

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. Many of these disclosure requirements are new when compared to the disclosure requirements for leases under legacy U.S. GAAP. Examples of the information that must be provided to comply with the new disclosure requirements in ASC 842 include:

- Information about significant assumptions and judgments when accounting for leases in accordance with ASC 842, including those significant assumptions and judgments used in determining whether a contract contains 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 A.

10. Effective date and transition

10.1 Effective date

The effective date of the new lease guidance for the following entities is fiscal years beginning after December 15, 2018, including interim periods within those years:

- Public business entities
- Not-for-profit entities that have issued or are conduit bond obligors for securities that are traded, listed or exchanged on an over-the-counter market
- Employee benefit plans that file or furnish financial statements with the SEC

For all other entities, the new lease guidance is effective in fiscal years beginning after December 15, 2019 and interim periods thereafter.

Early adoption is permitted for all entities. In deciding whether to early adopt the new lease guidance, entities should understand that doing so may result in the application of certain aspects of the new revenue recognition guidance when accounting for sale-leaseback transactions (see Section 8.2). For example, the new lease guidance requires use of certain aspects of the new revenue recognition guidance when determining whether or not the transfer of an asset in a sale-leaseback transaction should be accounted for as a sale. The overall principle in the new revenue recognition guidance is different in that it focuses on whether control has transferred to the customer instead of whether the risks and rewards of ownership have transferred to the customer. If the seller-lessee in a sale-leaseback transaction early adopts the new lease guidance before it adopts the new revenue recognition guidance, it will be applying certain aspects of the new revenue recognition guidance to account for a sale-leaseback transaction before it applies that new guidance more broadly to account for revenue from contracts with its customers.

10.2 Transition

10.2.1 Modified retrospective transition method

Lessees will transition to ASC 842 using a modified retrospective transition approach, which is applied as of the beginning of the earliest period presented. Lessees do not have the option to use a full retrospective transition approach.

The specifics of the modified retrospective transition approach differ depending on a number of factors, including the classification of the lease under legacy U.S. GAAP (i.e., ASC 840) and ASC 842. In addition, certain transition reliefs (i.e., practical expedients) are available for use. While the specifics of the modified retrospective transition approach are quite complex, much of that complexity is eliminated when applying the approach to a lease in a situation in which all of the following are true:

- The lessee elects the practical expedients in ASC 842-10-65-1(f) and 1(g) (see Appendix B).
- The lease was not acquired in a business combination accounted for in accordance with ASC 805.
- The lease does not include any options to purchase the underlying asset or extend or terminate the lease or any nonlease components.
- None of the following occur after the beginning of the first comparative period presented by the lessee: (a) modification of the lease (see Section 7.2.5), (b) impairment of the related ROU asset (see Section 7.2.2.2 and Section 7.2.3.2) or (c) remeasurement of the related lease liability (see Section 7.2.1).
- The lessee has not recognized a liability for the lease in accordance with ASC 420.

The effects of applying the modified retrospective transition approach to a lease in this plain-vanilla situation depends on whether application of ASC 840 resulted in the lease being classified as an operating or capital lease. The effects for both classifications are summarized in the table on the next page.

Effects of applying modified retrospective transition approach in plain-vanilla situation to…	
…an operating lease under ASC 840	… a capital lease under ASC 840
• The lessee does not reassess whether the lease meets the definition of a lease in ASC 842. • The lease's classification is not reassessed. As a result, the lease is classified as an operating lease under ASC 842. • A lease liability and ROU asset are recognized for the lease as of the later of the beginning of the earliest period presented and the lease's commencement date (which will be referred to as the transition date). • The lease liability is initially and subsequently measured as the present value of the remaining minimum rental payments under ASC 840 and any amounts probable of being owed by the lessee under a residual value guarantee. The discount rate is determined as of the transition date. • The ROU asset is initially measured by starting with the lease liability and adjusting it for the transition-date carrying amounts of: (a) any unamortized initial direct costs, (b) any prepaid rent or accrued rent liability related to the lease and (or) (c) the remaining balance of any lease incentives. This adjustment is the only one needed upon transition to ASC 842. In other words, no adjustment to equity is necessary. • The ROU asset is subsequently measured in accordance with ASC 842-20-35-3(b) (see Section 7.2.3.2). • Annual lease costs after the transition date are measured in accordance with ASC 842-20-25-6(a) and 8 (see Section 7.2.3.1).	• The lessee does not reassess whether the lease meets the definition of a lease in ASC 842. • The lease's classification is not reassessed. As a result, the lease is classified as a finance lease under ASC 842. • A lease liability and ROU asset are recognized for the lease as of the later of the beginning of the earliest period presented and the lease's commencement date (which will be referred to as the transition date). • The lease liability is initially measured at the carrying amount of the capital lease obligation on the transition date (which is based on the application of ASC 840). • The ROU asset is initially measured at the carrying amount of the lease asset on the transition date (which is based on the application of ASC 840), adjusted to include the transition-date carrying amount of any unamortized initial direct costs related to the lease. This adjustment is the only one needed upon transition to ASC 842. In other words, no adjustment to equity is necessary. • Until the effective date of ASC 842, the lease liability and ROU asset are subsequently accounted for in accordance with ASC 840-30-35. • After the effective date of ASC 842, 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); however, lease payments should not be remeasured for amounts probable of being owed under residual value guarantees as otherwise required by ASC 842-10-35-4(c)(3). • The discount rate used both before and after the effective date of ASC 842 is the discount rate as of lease commencement.

Overall, the most significant effect on the financial statements of applying the modified retrospective transition approach to an operating lease in a plain-vanilla situation is adding the ROU asset and lease liability to the balance sheet. In such a situation, lease costs for the operating lease should generally be the same under ASC 840 and ASC 842. Overall, applying the modified retrospective transition approach to a capital lease in a plain-vanilla situation will generally not have a significant effect on the financial statements given the similarities in accounting for a capital lease under ASC 840 and a finance lease under ASC 842. It is very important to note, however, that the effects of applying the modified retrospective transition approach to something other than a lease in a plain-vanilla situation could be very different from the effects of applying that transition approach to a lease in a plain-vanilla situation.

When applying the modified retrospective transition approach to any lease, the transition requirements in ASC 842-10-65-1 should be carefully considered. Those requirements have been included verbatim in Appendix B of this white paper.

Applying the modified retrospective transition approach to two leases in plain-vanilla situations is illustrated in the example that follows.

Example 10-1: Applying the modified retrospective transition approach

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, 2017. 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 term. 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 the practical expedients in ASC 842-10-65-1(f) upon transition to ASC 842. Lessee does not elect the practical expedient in ASC 842-10-65-1(g) because it is not applicable to either of Lessee's leases.

Analysis of general facts: The effective date of ASC 842 for Lessee is January 1, 2020, 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, 2018. The later of the lease commencement date and the beginning of the earliest comparative period presented by Lessee (i.e., the transition date) is January 1, 2018. As a result of Lessee electing the practical expedients in ASC 842-10-65-1(f) (which it was entitled to do given that both leases were entered into before ASC 842's effective date), Lessee does not do any of the following in applying the modified retrospective transition approach: (a) reassess whether either lease is or contains 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, 2017 and 2018 and (b) $33,000 is due on December 31, 2019, 2020 and 2021.
- 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, 2018 (the transition date) is 6 percent.
- As of January 1, 2018, 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 2017 [which is total lease payments of $161,000 divided by the five-year lease term] minus the $31,000 lease payment in 2017)

and (b) unamortized initial direct costs of $400 ($500 initial direct costs multiplied by four-fifths [portion of lease term remaining]).

- Straight-line amortization is used by Lessee to recognize 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 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, 2018 (the transition date). 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 percent: (a) one payment of $31,000 on December 31, 2018 and (b) three payments of $33,000 each on December 31, 2019, 2020 and 2021. 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 lease liability is subsequently measured as the present value of the remaining minimum rental payments under ASC 840. The ROU asset is subsequently measured in accordance with ASC 842-20-35-3(b). Single lease costs after the transition date are measured in accordance with ASC 842-20-25-6(a) and 8. The following table summarizes the accounting for Lease A after the transition date of January 1, 2018:

Lease liability	**2018**	**2019**	**2020**	**2021**
Beginning balance	$112,462	$88,209	$60,502	$31,132
Plus accretion (beginning balance x 6%) (Note 1)	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				
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, 2018 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 divided by the five-year lease term multiplied by one prior period]). Annual (i.e., single) lease costs over the remaining four-year lease term are $32,300 ($129,200 divided by four 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.

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	**2018**	**2019**	**2020**
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	**2018**	**2019**	**2020**
Total lease payments to be paid to 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 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 2020 financial statements, including those amounts presented for comparative purposes in 2019.

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, 2017 (date of lease commencement) is 6 percent.
- 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, 2018 as determined in accordance with ASC 840 are $128,707, $124,434 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 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, 2018. 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, 2018, which is $128,707. The ROU asset for Lease B is initially measured at $126,834, which is the carrying amount of the lease asset determined in accordance with ASC 840 on January 1, 2018 ($124,434) plus the carrying amount of the unamortized initial direct costs determined in accordance with ASC 840 on January 1, 2018 ($2,400). Until January 1, 2020 (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, 2020, 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 transition date of January 1, 2018:

	ASC 840-30-35		ASC 842-20-35			
Lease liability	**2018**	**2019**	**2020**	**2021**	**2022**	**2023**
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	$126,834	$105,695	$84,556	$63,417	$42,278	$21,139
Minus amortization (Note 3)	21,139	21,139	21,139	21,139	21,139	21,139
Ending balance	$105,695	$84,556	$63,417	$42,278	$21,139	-

Note 1: Accretion is calculated as the beginning balance of the lease liability in each year multiplied by 6 percent.
Note 2: The payment in 2023 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, 2018 ($126,834) 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 2020 financial statements, including those amounts presented for comparative purposes in 2019.

10.2.2 Disclosures

Lessees are required to disclose transition-related information otherwise required by ASC 250 when an entity makes an accounting change, except for the effects of the change on specific financial statement line items, income from continuing operations and net income, and related per-share amounts. The disclosure requirements upon transition have been included in the disclosure checklist included in Appendix A of this white paper.

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:

- Lessees may elect an exception 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 exception 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.
- All leases for which ROU assets and lease liabilities are recognized by lessees are accounted for as finance leases under IFRS 16. 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 Section 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. This is not a reassessment event provided for variable lease payments in ASC 842 (see Section 5.5.6).
- For a sublease, under IFRS 16, the intermediate lessor is required to classify the sublease by reference to the ROU asset related to the head lease, while under ASC 842, the intermediate lessor is required to classify the sublease based on the underlying asset (see Section 7.4).
- 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: Disclosure checklist

The following table lists the disclosure requirements applicable to:

- Initial implementation of ASC 842 (ASC 842-10-65-1(i) and 1(j))
- Lessees (ASC 842-20-50)
- Sale-leaseback transactions (ASC 842-40-50)

Additional information about disclosures required of lessees is provided in Section 9.4. In addition, Example 6 (starting at ASC 842-20-55-53) illustrates how a lessee may meet the quantitative disclosure requirements included in item 3 of this checklist.

842-	Disclosure requirement	Yes/No	Remarks
Initial implementation			
	1. In connection with the initial implementation of ASC 842, the lessee has:		
10-65-1(i)	a. Provided the transition disclosures required by ASC 250 on accounting changes and error corrections, except for the requirements in ASC 250-10-50-1(b)(2).		
10-65-1(j)	b. If it used one or both of the practical expedients in ASC 842-10-65-1(f) and (g), it has disclosed that fact.		
Lessee			
20-50-3	2. 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 its 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 it 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 2(a)(1) through 2(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 with		

842-	Disclosure requirement	Yes/No	Remarks
	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 through 27).		
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 through 32).		
20-50-3(c)(3)	(3) The determination of the discount rate for the lease (as described in ASC 842-20-30-2 through 4).		
20-50-4	3. 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.		
20-50-4(b)	b. Operating lease cost determined in accordance with ASC 842-20-25-6(a) and 7.		
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.		
20-50-4(d)	d. Variable lease cost determined in accordance with ASC 842-20-25-5(b) and 6(b).		
20-50-4(e)	e. Sublease income, disclosed on a gross basis, separate from the finance or operating lease expense.		
20-50-4(f)	f. Net gain or loss recognized from sale-leaseback transactions in accordance with ASC 842-40-25-4.		
20-50-4(g)	g. Amounts for the following items segregated between those related to 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		

842-	Disclosure requirement	Yes/No	Remarks
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	4. 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 statement of financial position.		
20-50-7	5. The lessee has disclosed lease transactions between related parties in accordance with ASC 850-10-50-1 through 6.		
20-50-8	6. A lessee that accounts for short-term leases in accordance with ASC 842-20-25-2 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	7. A lessee that elects the accounting policy in ASC 842-10-15-37 to not separate lease components from nonlease components has disclosed its accounting policy election and to which class or classes of underlying assets it has elected to apply the accounting policy.		
20-50-1	8. The disclosures provided by the lessee (in connection with items 2 through 7 of this		

842-	Disclosure requirement	Yes/No	Remarks
	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 2 through 7 of this checklist to meet that objective.		
20-50-2	b. Aggregated or disaggregated the disclosures in items 2 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.		
Sale-leaseback transactions			
40-50-1	10. If a seller-lessee or a buyer-lessor enters into a sale-leaseback transaction and accounts for that transaction as one in which the transfer of the asset is a sale:		
40-50-1	a. It has provided the disclosures required in items 2 through 9 of this checklist for a seller-lessee or ASC 842-30-50-1 through 13 for a buyer-lessor, as appropriate.		
40-50-2(a)	b. The main terms and conditions of that transaction.		
40-50-2(b)	c. Any gains or losses arising from the transaction separately from gains or losses on the disposal of other assets.		

Appendix B: Transition requirements

The transition requirements included in ASC 842-10-65-1 applicable to lessees are included verbatim in this appendix. Note that the transition requirements included in ASC 842-10-65-1(v) through 1(z) are not included in this appendix because they are applicable to lessors. Example 10-1 (which is included after Section 10.2.1) illustrates how a lessee should apply the transition requirements to an existing capital lease and operating lease when it elects the practical expedients in ASC 842-10-65-1(f).

Transition and Open Effective Date Information

General

> Transition Related to Accounting Standards Update No. 2016-02, *Leases (Topic 842)*

842-10-65-1 The following represents the transition and effective date information related to Accounting Standards Update No. 2016-02, *Leases (Topic 842)*:

a. A **public business entity**, a **not-for-profit entity** that has issued or is a conduit bond obligor for securities that are traded, listed, or quoted on an exchange or an over-the-counter market, and an employee benefit plan that files or furnishes financial statements with or to the U.S. Securities and Exchange Commission shall apply the pending content that links to this paragraph for financial statements issued for fiscal years beginning after December 15, 2018, and interim periods within those fiscal years. Earlier application is permitted.
b. All other entities shall apply the pending content that links to this paragraph for financial statements issued for fiscal years beginning after December 15, 2019, and interim periods within fiscal years beginning after December 15, 2020. Earlier application is permitted.
c. In the financial statements in which an entity first applies the pending content that links to this paragraph, the entity shall recognize and measure **leases** within the scope of the pending content that links to this paragraph that exist at the beginning of the earliest comparative period presented, using the approach described in (i) through (ee).
d. An entity shall adjust equity at the beginning of the earliest comparative period presented, and the other comparative amounts disclosed for each prior period presented in the financial statements, as if the pending content that links to this paragraph had always been applied, subject to the requirements in (h) through (dd).
e. If a **lessee** elects not to apply the recognition and measurement requirements in the pending content that links to this paragraph to **short-term leases**, the lessee shall not apply the approach described in (k) through (s) to short-term leases.

See Examples 28 through 29 (paragraphs 842-10-55-243 through 55-254) for illustrations of the transition requirements.

Practical expedients

f. An entity may elect the following practical expedients, which must be elected as a package and applied consistently by an entity to all of its leases (including those for which the entity is a lessee or a **lessor**), when applying the pending content that links to this paragraph to leases that commenced before the effective date:
    1. An entity need not reassess whether any expired or existing **contracts** are or contain leases.
    2. An entity need not reassess the lease classification for any expired or existing leases (that is, all existing leases that were classified as **operating leases** in accordance with Topic 840 will be classified as operating leases, and all existing leases that were classified as capital leases in accordance with Topic 840 will be classified as **finance leases**).
    3. An entity need not reassess **initial direct costs** for any existing leases.

g. An entity also may elect a practical expedient, which must be applied consistently by an entity to all of its leases (including those for which the entity is a lessee or a lessor) to use hindsight in determining the **lease term** (that is, when considering lessee options to extend or terminate the lease and to purchase the **underlying asset**) and in assessing impairment of the entity's **right-of-use assets**. This practical expedient may be elected separately or in conjunction with the practical expedients in (f).

Amounts previously recognized in respect of business combinations

h. If an entity has previously recognized an asset or a liability in accordance with Topic 805 on **business combinations** relating to favorable or unfavorable terms of an operating lease acquired as part of a business combination, the entity shall do all of the following:
   1. Derecognize that asset and liability (except for those arising from operating leases for which the entity is a lessor).
   2. Adjust the carrying amount of the right-of-use asset by a corresponding amount if the entity is a lessee.
   3. Make a corresponding adjustment to equity at the beginning of the earliest comparative period presented if assets or liabilities arise from leases classified as **sales-type leases** or **direct financing leases** in accordance with Topic 840 for which the entity is a lessor.

Disclosure

i. An entity shall provide the transition disclosures required by Topic 250 on accounting changes and error corrections, except for the requirements in paragraph 250-10-50-1(b)(2).
j. If an entity uses one or both of the practical expedients in (f) and (g), it shall disclose that fact.

Lessees

Leases previously classified as operating leases under Topic 840

k. A lessee should initially recognize a right-of-use asset and a **lease liability** at the later of the beginning of the earliest period presented in the financial statements and the **commencement date of the lease**.
l. Unless, on or after the effective date, the lease is modified (and that modification is not accounted for as a separate contract in accordance with paragraph 842-10-25-8) or the lease liability is required to be remeasured in accordance with paragraph 842-20-35-4, a lessee shall measure the lease liability at the present value of the sum of the following, using a **discount rate for the lease** (which, for entities that are not public business entities, can be a risk-free rate determined in accordance with paragraph 842-20-30-3) established at the later of the beginning of the earliest period presented in the financial statements and the commencement date of the lease:
   1. The remaining minimum rental payments (as defined under Topic 840).
   2. Any amounts **probable** of being owed by the lessee under a **residual value guarantee**.
m. For each lease classified as an operating lease in accordance with paragraphs 842-10-25-2 through 25-3, a lessee shall initially measure the right-of-use asset at the initial measurement of the lease liability adjusted for both of the following:
   1. The items in paragraph 842-20-35-3(b), as applicable.
   2. The carrying amount of any liability recognized in accordance with Topic 420 on exit or disposal cost obligations for the lease.
n. For each lease classified as an operating lease in accordance with paragraphs 842-10-25-2 through 25-3, a lessee shall subsequently measure the right-of-use asset throughout the remaining lease term in accordance with paragraph 842-20-35-3(b). If the initial measurement of the right-of-use asset in (m) is adjusted for the carrying amount of a liability recognized in accordance with Topic 420 on exit or disposal cost obligations for the lease, the lessee shall

apply the recognition and subsequent measurement guidance in Sections 842-20-25 and 842-20-35, respectively, when the right-of-use asset has been impaired.

o. For each lease classified as a finance lease in accordance with paragraph 842-10-25-2, a lessee shall measure the right-of-use asset as the applicable proportion of the lease liability at the commencement date, which can be imputed from the lease liability determined in accordance with (l). The applicable proportion is the remaining lease term at the beginning of the earliest comparative period presented relative to the total lease term. A lessee shall adjust the right-of-use asset recognized by the carrying amount of any prepaid or accrued **lease payments** and the carrying amount of any liability recognized in accordance with Topic 420 for the lease.
p. Any unamortized initial direct costs at the later of the beginning of the earliest period presented in the financial statements or the commencement date of the lease that do not meet the definition of initial direct costs in this Topic shall be written off as an adjustment to equity at the later of the beginning of the earliest period presented in the financial statements and the commencement date of the lease.
q. If a modification to the contractual terms and conditions occurs on or after the effective date, and the modification does not result in a separate contract in accordance with paragraph 842-10-25-8, or the lessee is required to remeasure the lease liability for any reason (see paragraphs 842-20-35-4 through 35-5), the lessee shall follow the requirements in this Topic from the **effective date of the modification** or the remeasurement date.

Leases previously classified as capital leases under Topic 840

r. For each lease classified as a finance lease in accordance with this Topic, a lessee shall do all of the following:
   1. Recognize a right-of-use asset and a lease liability at the carrying amount of the lease asset and the capital lease obligation in accordance with Topic 840 at the later of the beginning of the earliest comparative period presented or the commencement date of the lease.
   2. Include any unamortized initial direct costs that meet the definition of initial direct costs in this Topic in the measurement of the right-of-use asset established in (r)(1).
   3. Write off, as an adjustment to equity, any unamortized initial direct costs at the later of the beginning of the earliest period presented in the financial statements or the commencement date of the lease that do not meet the definition of initial direct costs in this Topic and that are not included in the measurement of the capital lease asset under Topic 840 (unless the lessee elects the practical expedients described in (f)).
   4. Subsequently measure the right-of-use asset and the lease liability in accordance with Section 840-20-35 before the effective date.
   5. Apply the subsequent measurement guidance in paragraphs 842-20-35-4 through 35-5 and 842-20-35-8 after the effective date. However, when applying the pending content in paragraph 842-20-35-4, a lessee shall not remeasure the lease payments for amounts probable of being owed under residual value guarantees in accordance with paragraph 842-10-35-4(c)(3).
   6. Classify the assets and liabilities held under capital leases as right-of-use assets and lease liabilities arising from finance leases for the purposes of presentation and disclosure.
s. For each lease classified as an operating lease in accordance with this Topic, a lessee shall do the following:
   1. Derecognize the carrying amount of any capital lease asset and capital lease obligation in accordance with Topic 840 at the later of the beginning of the earliest comparative period presented or the commencement date of the lease. Any difference between the carrying amount of the capital lease asset and the capital lease obligation shall be accounted for in the same manner as prepaid or accrued rent.

2. Recognize a right-of-use asset and a lease liability in accordance with paragraph 842-20-35-3 if the lease commenced before the beginning of the earliest period presented in the financial statements.
3. Recognize a right-of-use asset and a lease liability in accordance with paragraph 842-20-30-1 at the commencement date of the lease if the lease commenced after the beginning of the earliest period presented in the financial statements.
4. Account for the operating lease in accordance with the guidance in Subtopic 842-20 after initial recognition in accordance with (r)(2) or (r)(3).
5. Write off, as an adjustment to equity, any unamortized initial direct costs at the later of the beginning of the earliest period presented in the financial statements or the commencement date of the lease that do not meet the definition of initial direct costs in this Topic.

t. If a modification to the contractual terms and conditions occurs on or after the effective date, and the modification does not result in a separate contract in accordance with paragraph 842-10-25-8, or the lessee is required to remeasure the lease liability in accordance with paragraph 842-20-35-4, the lessee shall subsequently account for the lease in accordance with the requirements in this Topic beginning on the effective date of the modification or the remeasurement date.

Build-to-suit lease arrangements

u. A lessee shall apply a modified retrospective transition approach for leases accounted for as build-to-suit arrangements under Topic 840 that are existing at, or entered into after, the beginning of the earliest comparative period presented in the financial statements as follows:
1. If an entity has recognized assets and liabilities solely as a result of a transaction's build-to-suit designation in accordance with Topic 840, the entity should derecognize those assets and liabilities at the later of the beginning of the earliest comparative period presented in the financial statements and the date that the lessee is determined to be the accounting owner of the asset in accordance with Topic 840. Any difference should be recorded as an adjustment to equity at that date. The lessee shall apply the lessee transition requirements in (k) through (s) to the lease.
2. If the construction period of the build-to-suit lease concluded before the beginning of the earliest comparative period presented in the financial statements and the transaction qualified as a sale and leaseback transaction in accordance with Subtopic 840-40 before the date of initial application, the entity shall follow the general lessee transition requirements for the lease.

Sale and leaseback transactions before the beginning of the earliest comparative period presented

aa. If a previous sale and leaseback transaction was accounted for as a sale and a leaseback in accordance with Topic 840, an entity shall not reassess the transaction to determine whether the transfer of the asset would have been a sale in accordance with paragraphs 842-40-25-1 through 25-3.

bb. If a previous sale and leaseback transaction was accounted for as a failed sale and leaseback transaction in accordance with Topic 840 and remains a failed sale at the effective date, the entity shall reassess whether a sale would have occurred at any point on or after the beginning of the earliest period presented in the financial statements in accordance with paragraphs 842-40-25-1 through 25-3. The sale and leaseback transaction shall be accounted for on a modified retrospective basis from the date a sale is determined to have occurred, in accordance with the requirements in (cc) through (dd).

cc. An entity shall account for the leaseback in accordance with the lessee and lessor transition requirements in (k) through (y).

dd. If a previous sale and leaseback transaction was accounted for as a sale and capital leaseback in accordance with Topic 840, the transferor shall continue to recognize any deferred gain or loss that exists at the later of the beginning of the earliest comparative period presented in the financial statements or the date of the sale of the underlying asset as follows:

1. If the underlying asset is land only, straight line over the remaining lease term.
2. If the underlying asset is not land only and the leaseback is a finance lease, in proportion to the amortization of the right-of-use asset.
3. If the underlying asset is not land only and the leaseback is an operating lease, in proportion to the recognition in profit or loss of the total lease cost.

ee. If a previous sale and leaseback transaction was accounted for as a sale and operating leaseback in accordance with Topic 840, the transferor shall do the following:

1. Recognize any deferred gain or loss not resulting from off-market terms (that is, where the consideration for the sale of the asset is not at **fair value** or the lease payments are not at market rates) as a cumulative-effect adjustment at the later of the date of initial application (to equity) or the date of sale (to earnings of the comparative period presented).
2. Recognize any deferred loss resulting from the consideration for the sale of the asset not being at fair value or the lease payments not being at market rates as an adjustment to the leaseback right-of-use asset at the date of initial application.
3. Recognize any deferred gain resulting from the consideration for the sale of the asset not being at fair value or the lease payments not being at market rates as a financial liability at the date of initial application.

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