FORVIS

ASC 842, Leases

July 2022 Update

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FORV/S

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Update

The COVID-19 pandemic has caused unprecedented challenges in all aspects of daily life. In June 2020, FASB issued Accounting Standards Update (ASU) 2020-05, which provides nonpublic entities and not-for-profits (NFP) additional time to implement Accounting Standards Codification (ASC) 842, *Leases*.

For NFP organizations that have issued—or are a conduit bond obligor for—securities that are traded, listed, or quoted on an exchange or an over-the-counter market, the delay is only effective if the organization has not yet issued or made available for issuance its GAAP financial statements. The ASU also clarifies that interim financial information posted to the Electronic Municipal Market Access (EMMA) system—non-GAAP financial information that does not include full disclosures—would not disqualify an entity from taking advantage of this lease deferral.

This document has been refreshed to incorporate all subsequent standard setting and implementation guidance issued by FASB.

Background

This is the first major overhaul of lease accounting since 1973. The new guidance requires lessees to recognize substantially all leases on their balance sheets as lease liabilities with a corresponding right-of-use (ROU) asset. Bright-line tests have been eliminated and management judgment will increase. FASB has updated the lease definition, and some contracts that are not currently accounted for as leases may be considered leases under ASC 842. Less dramatic—but substantial—changes were made to the lessor accounting model to align it with changes to the lessee model and the new revenue recognition standard ASC 606. Leveraged lease accounting has been eliminated, although grandfathered for existing arrangements. The guidance on related-party leases has changed—under ASC 840, related-party leases are based on the substance of the arrangement, whereas ASC 842 bases them on the legally enforceable terms and conditions.

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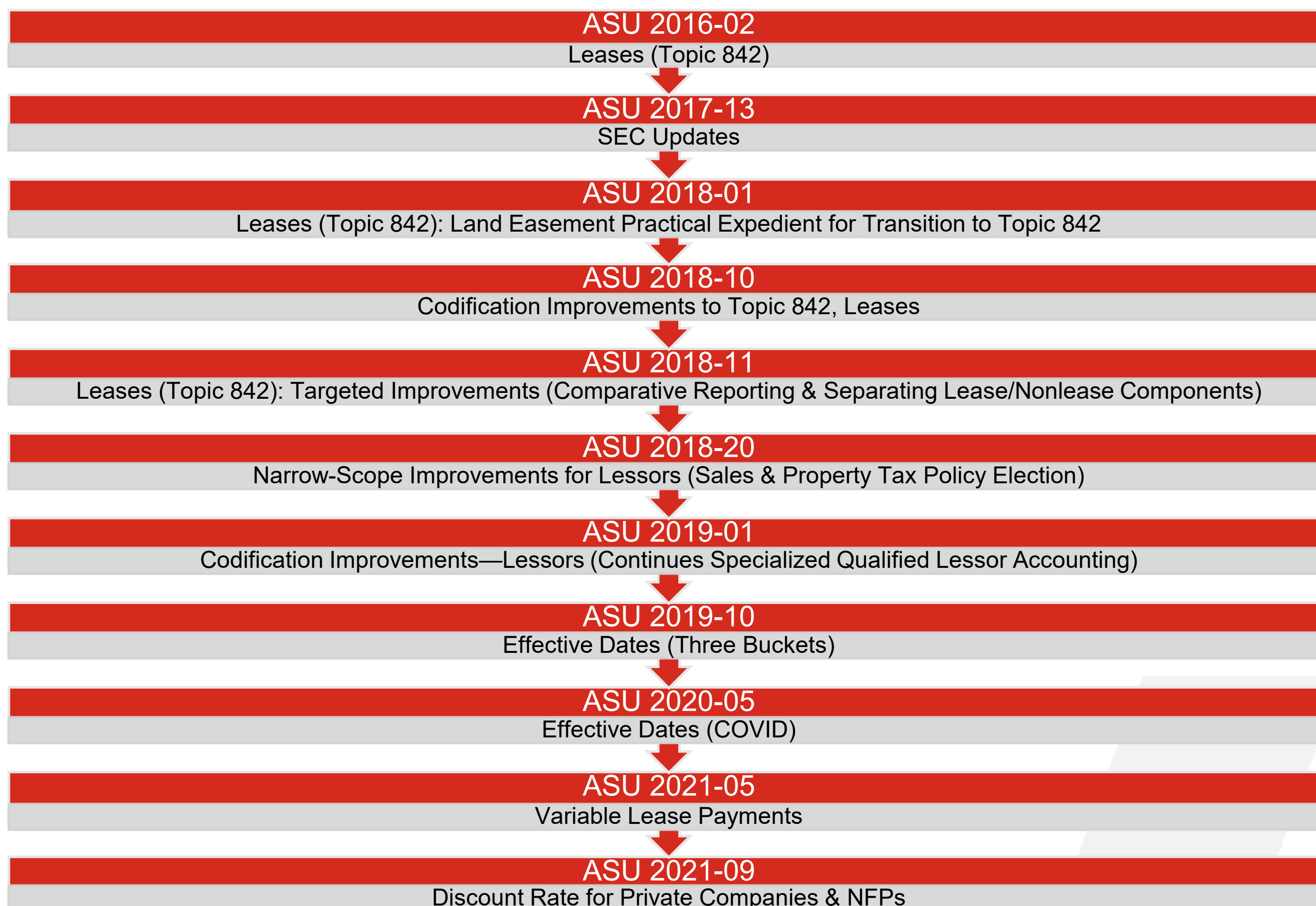
Early adopters and large public companies found several operational challenges in implementing the standard as written. In response, FASB finalized additional relief and technical corrections to clarify certain aspects of the new model. This paper reviews key aspects of the new guidance, including all subsequent amendments noted in the following table.



FASB acknowledged the challenge of updating long-standing accounting guidance for organizations with a sizable lease portfolio. The initial standard and subsequent amendments provide substantial relief. Most publicly traded companies are taking advantage of several of these optional reliefs. The most popular relief elected was the optional transition method, followed by the practical expedient package and option not to separate lease and nonlease components. Several of the optional reliefs come with certain reporting implications or disadvantages, however. For example, using the discount rate policy election and not separating lease and nonlease components likely would result in larger lease liabilities. Careful consideration of each optional relief is necessary at the start of the implementation process.

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Optional Relief	
Transition Elections	Accounting Policy Elections
Expedient package – Identification, classification, initial direct costs (ASU 2016-02)	Separation of lease and nonlease components for both lessee (ASU 2016-02) and lessor
Hindsight (ASU 2016-02)	Portfolio approach (ASU 2016-02)
Land easements (ASU 2018-02)	Short-term leases (ASU 2016-02)
Prior-period presentation (ASU 2018-11)	Discount rate (non-PBEs only) (ASU 2016-02 & ASU 2021-09)
	Presentation of taxes (ASU 2018-20) (lessor only)
	Variable lease payments (ASU 2021-05)

Scope

The scope of ASC 842 is substantially the same as ASC 840. The new model applies to all leases, including subleases, of property, plant, and equipment (PP&E). The following items are explicitly excluded from ASC 842:

- Leases of intangible assets (covered by ASC 350, *Intangibles—Goodwill and Other*)
- Leases to explore for or use minerals, oil, natural gas, and similar nonregenerative resources (covered by ASC 930, *Extractive Activities—Mining*, or ASC 932, *Extractive Activities—Oil and Gas*)
- Leases of biological assets, including timber (covered by ASC 905, *Agriculture*)
- Leases of inventory (covered by ASC 330, *Inventory*)
- Leases of assets under construction (covered by ASC 360, *Property, Plant and Equipment*)

Consequential amendments address interaction with other guidance. Updates to ASC 853, *Service Concession Arrangements*, clarify the right to use the infrastructure in a service concession arrangement is not in ASC 842's scope. Residual value guarantees (RVG) subject to ASC 842 are not subject to the guidance in ASC 815, *Derivatives and Hedging*.

Short-Term Leases

A lessee can elect (by asset class) not to record on the balance sheet a lease whose term is 12 months or less and does not include a purchase option that the lessee is reasonably certain to exercise. If elected, the lease would be treated like an operating lease under current GAAP—payments would be recognized on a straight-line basis over the lease term. When determining whether the lease qualifies for this election, the lessee would include renewal options only if they are considered part of the lease term, *i.e.*, those options the lessee is reasonably certain to exercise. If the lease term increases to more than 12 months, or if it is reasonably certain the lessee will exercise a purchase option, the lessee would no

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longer be able to apply this practical expedient and would apply ASC 842 guidance. This is a formal policy election that must be disclosed along with certain other information about the short-term lease.

Example – Short-Term Lease Exception Permitted

ABC enters into a contract to lease a piece of construction equipment for a six-month period, with the option to extend the term for up to 12 additional months (in three-month increments). Considering the nature of the project, ABC determines that it expects to use the equipment for only nine months and is reasonably certain it will exercise only one of the four renewal options.

Since the lease term is not more than 12 months, ABC would be able to elect the short-term lease exception.

Example – Short-Term Lease Exception Not Permitted

ABC enters into a contract to lease a piece of construction equipment for a six-month period, with the option to extend the term for up to 12 additional months (in three-month increments). The equipment is to be used in a project expected to take 18 months. ABC expects to use the equipment for 18 months and is reasonably certain to exercise all four renewal options.

The expected lease term is greater than 12 months, so ABC would not be able to elect the short-term lease exception.

Internal controls should be developed around the evaluation of the lease term in assessing the applicability of this exception.

Lease Definition

FASB has updated the definition of a lease. A lease only is present when a contract—or part of a contract—conveys the **right to control** the use of an **identified asset** for a period of time in exchange for consideration. A period of time may be described in terms of the amount of use of an identified asset (the example used in the standard is “the number of production units that an item of equipment will be used to produce”).

Entities will need to determine at contract inception whether a contract is or contains a lease by assessing whether—throughout the period of use—the lessee has the right to direct an asset’s use and

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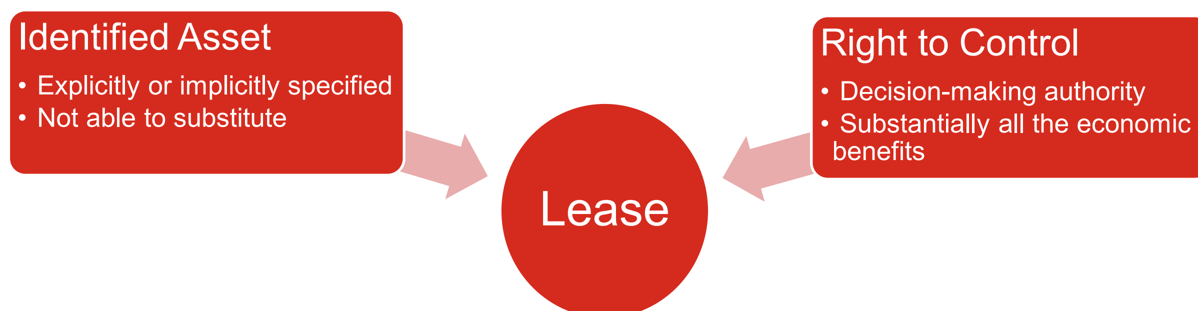
substantially obtain all the economic benefits from directing its use. See the Appendix for a flowchart on identifying a lease.



Identified Asset

An identified asset must be specifically identifiable in the contract either explicitly, *e.g.*, by serial number, or implicitly, *e.g.*, the only asset available to satisfy the lease contract, at the time the asset is made available for use by the customer. An asset that is a portion of a larger asset is an identified asset if it is physically distinct, *e.g.*, a floor of a building or segment of a pipeline that connects a single customer to the larger pipeline. A capacity or other portion of an asset that is not physically distinct, *e.g.*, a capacity portion of a fiber-optic cable, is not an identified asset, unless it represents substantially all the asset's capacity and thereby provides the customer with the right to obtain substantially all the economic benefits from use of the asset.

> *An entity will need to use significant judgment in distinguishing between a lease and a capacity contract.*

Substantive Substitution Rights

Even if an asset is specified, a customer/lessee may not meet the criteria for having the right to use the identified asset. This occurs when the supplier/lessor has the substantive right to substitute an asset throughout the use period. If a supplier has a substantive right to substitute, then the supplier—not the customer—controls the asset's use. A substantive right occurs when the supplier has the **practical ability** to substitute alternative assets throughout the use period and would **economically benefit** from exercising its right. An entity should evaluate whether a supplier/lessor's substitution right is substantive based on facts and circumstances at contract inception, excluding consideration of future events that, at inception, the entity did not consider likely to occur. This assessment will require management judgment, and the standard provides a few examples:

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- An agreement by a future customer to pay an above-market rate for use of the asset
- The introduction of new technology that is not substantially developed at contract inception
- A substantial difference between the customer's asset use or the asset's performance and the use or performance considered likely at contract inception
- A substantial difference between the market price of the asset during the period of use and the market price considered likely at contract inception

If a customer cannot readily determine if the supplier has a substantive substitution right, the customer shall presume any substitution right is not substantive.

Right to Control

A contract conveys the right to control an identified asset's use if, throughout the use period, the customer has the ability to obtain substantially all the economic benefits from the asset's use and decision-making authority to direct how and for what purpose the asset is used. Entities will make this assessment considering all relevant facts and circumstances and may conclude the customer has the right to control an identified asset's use for only a portion of the contract term. In that case, the contract would contain a lease for that portion of the term.

In assessing the ability to direct how and for what purpose the asset is used, decision-making rights are relevant when they affect the economic benefits to be derived from use. For example, a customer has the right to direct an identified asset's use throughout the use period if—within the scope of its right of use defined in the contract—it can change how and for what purpose the asset is used throughout that period. The ASU includes examples of decision-making rights that may grant the right to direct how and for what purpose an asset is used, within the defined scope of the customer's right of use. Some factors to consider in making this evaluation include whether the customer has the right to change the type of output produced by the asset and when, where, or whether output is produced.

Protective rights represent terms and conditions designed to protect the supplier/lessor's interest in the asset, protect its personnel, or ensure the supplier's compliance with laws or regulations. Although protective rights typically define the scope of the customer's right of use, they do not, in isolation, prevent the customer/lessee from having the right to direct an asset's use.

The **right** to obtain substantially all the economic benefits from the identified asset's use throughout the period of use is met, for example, by having exclusive use of the asset throughout the period. A customer can obtain economic benefits from an asset's use directly or indirectly, *e.g.*, by using, holding, or subleasing the asset, which includes the asset's primary output and byproducts, including potential cash flows derived from these items, and other economic benefits from using the asset that could be realized from a commercial transaction with a third party.

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For a lease to be in place, a customer must have **both** the power to direct the asset's use and the ability to obtain the benefits from its use. Current GAAP only includes the benefits component. FASB made a change to the standard by adding the control criterion to align with the new revenue recognition standard, which focuses on whether the lease effectively transfers control of the underlying asset **to the lessee** (rather than whether the **lessor** has relinquished control). A general rule of thumb is that a lease exists when the customer controls an identified asset's use, and a service exists when the supplier controls an asset's use.

Determining when a customer has the right to direct an identified asset's use may require significant judgment, and FASB has included implementation examples in the standard. Determining whether a contract contains a lease is elevated in importance, since all leases will require recognition of an asset and a liability.

If neither the customer nor the supplier controls how and for what purpose the asset is used throughout the period of use, the customer is considered to have the right to direct the identified asset's use in **either** of the following circumstances:

- The customer has the right to operate the asset or direct others to operate the asset in a manner that it determines (with the supplier having no right to change those operating instructions)
- The customer designed the asset—or caused the asset to be designed—in a way that predetermines during the period of use the most relevant decisions about how and for what purpose the asset will be used

Entities are required to reassess whether a contract is or contains a lease only if the terms and conditions of the contract are changed. Changes to assumptions such as market-based factors do not trigger a reassessment.

Contract Combinations

An entity should combine two or more contracts entered into at or near the same time with the same counterparty and consider the contracts as a single transaction when at least one of the contracts contains a lease and any of the following criteria are met:

- The contracts are negotiated as a package with the same commercial objective
- The amount of consideration to be paid in one contract depends on the price or performance of the other contract
- The rights to use underlying assets conveyed in the contracts (or some of the rights of use conveyed in the contracts) are a single lease component

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This is similar to the revenue guidance in ASC 606. If a combination of contracts is determined to contain a lease, the same combined transaction should be used for lease classification, recognition, and measurement under ASC 842.

Under ASC 840, operating leases were not recorded on the balance sheet and many companies did not evaluate leases embedded in service agreements; as a result, one of the biggest challenges for early adopters was identifying and inventorying all contracts that may contain leases. Early adopters frequently found that real estate and equipment arrangements were stored in different systems. To help with identification, these companies examined their current rent expense.

Contracts with Multiple Components

Previous GAAP provided limited guidance on how to separate lease and nonlease components. ASC 842 provides expanded guidance on how entities should account for such contracts. Identifying separate lease components in a lease is similar to the identification of performance obligations in a revenue contract. An entity must determine whether a lessee is contracting for a number of separate outputs or for a single output that incorporates a number of inputs.

Lease Component	Nonlease Component	Not a Separate Component
• A separate right to use an asset • Lessee can benefit from the ROU of the underlying asset either on its own or together with other readily available resources. The use is neither highly dependent on nor interrelated with other assets • **Payments accounted for as a separate lease**	• An activity that transfers a separate good or service to the customer • Includes maintenance services • **Allocated payments are nonlease period expense**	• Related to administrative tasks to initiate the lease and payment of lessor costs that do not transfer a separate good or service separate from the ROU asset • Includes payments for insurance or property taxes • **Payments are only allocated to lease and nonlease components**

Lease Versus Nonlease Components

An arrangement may contain lease and nonlease components that are subject to different accounting models and, therefore, must be identified and separated. This distinction also is important because it is

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not always appropriate to record an asset and liability for nonlease components. An activity is a separate nonlease component if it transfers a separate good or service to the lessee. Only items that contribute to securing the asset's output are lease components. Examples of a nonlease component include common area maintenance in real estate and maintenance service included with an equipment lease.

As issued, ASC 842 required lessors to record gross revenues and expenses associated with activities or costs that do not transfer a good or service to the lessee, e.g.*, real estate taxes or insurance, regardless of whether they are embedded in fixed lease payments, paid by the lessee directly to the taxing authority or service provider, or paid by the lessor and subsequently reimbursed by the lessee. This would have resulted in many lessors recording higher gross revenues and expenses than they do under ASC 840 whereby they are accounted for as executory costs. In August 2018, FASB released ASU 2018-20 to provide lessor relief. The ASU requires a lessor to exclude from variable payments lessor costs paid by a lessee directly to a third party when the amounts are not readily determinable by the lessor. Any costs that the lessee reimburses the lessor for are readily determinable and should be recognized as a variable lease payment. Lessors will need to evaluate the facts and circumstances of each arrangement to determine which lessor costs would be excluded from variable payments.*

ASC 842 provides specific lessee and lessor guidance on how consideration should be allocated to each contract component. ASC 842 directs lessors to ASC 606 guidance to allocate between lease and nonlease components. A lessee would first determine the relative standalone price of the lease and nonlease components. If observable standalone prices are not readily available, the lessee could estimate the standalone prices, maximizing the use of observable information. Estimates must be applied consistently across similar arrangements and like assets. A residual estimation approach may be appropriate if the standalone price is highly variable or uncertain. The consideration would then be allocated to the separate lease and nonlease components.

Variable Consideration

Allocation of variable consideration is treated differently under ASC 606 and 842. Under ASC 842, variable payments—other than those that depend on an index or rate—are recognized only as they are earned. Variable consideration under ASC 606 is estimated (subject to constraint) and included in the initial allocation of consideration.

For a lessor, variable payments should be considered if they relate solely to nonlease goods and services. If they do, the variable payments should be estimated and included in the consideration allocated to nonlease components. For variable payments that relate to a lease component, even partially, the lessor shall recognize those payments as income in profit or loss in the period when the changes in facts and circumstances on which the variable payment is based occur.

As originally written, ASC 842 requires lessors to recognize certain variable payment amounts in profit or loss in the period when the changes in facts and circumstances on which the variable payment is based occur, regardless of whether the payment partially relates to nonlease components. This could result in a

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lessor recognizing revenue for a nonlease component in a different period than when control of the nonlease component is transferred under ASC 606. ASU 2018-20 clarifies that after any uncertainty is resolved, the variable payments are first allocated between lease and nonlease components under ASC 842, and then other relevant guidance is applied for recognizing amounts allocated to the nonlease component.

Practical Expedient – Lessee

Lessees have a practical expedient—by class of underlying assets—to not separate lease and nonlease components. If elected, a lessee is required to account for the lease and nonlease components as a single lease component with special disclosures. The election must be applied to all leases in a class.

> *While the expedient eliminates the pricing allocation process, it will increase the total lease liability recorded on the balance sheet. The initial and subsequent measurement of the lease liability and ROU assets is greater than if the policy election was not applied, which could have an effect on a lease's impairment analysis.*

Practical Expedient – Lessor

Subsequent amendments in ASU 2018-11 extend this expedient to lessors. However, the lessor practical expedient is limited to circumstances in which both:

- The timing and pattern of revenue recognition are the same for the nonlease and related lease components
- The combined single lease component would be classified as an operating lease

If the nonlease component or components associated with the lease component are the predominant component of the combined unit of account, an entity must account for the combined component under ASC 606. Otherwise, the entity must account for the combined component as an operating lease under ASC 842. Lessors electing this practical expedient—including an entity that accounts for the combined component entirely in ASC 606—are required to disclose the following by class of underlying asset:

- The fact that it elected the expedient
- Which class(es) of underlying asset the lessor made the election to
- The nature of the lease and nonlease component(s) that was combined as a result of applying the practical expedient and any nonlease components that were not eligible for the practical expedient and not combined
- The topic the entity applies to the combined component (Topic 606 or 842)

In determining the predominant component, a lessor must consider whether the lessee would be reasonably expected to ascribe more value to the nonlease components than to the lease components.

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Lessors would not have to perform a detailed quantitative analysis or a theoretical allocation to each component.

Separate Rights of Use

An entity also must identify multiple lease components for a contract's different underlying assets. For contracts with multiple rights of use, entities must identify and account for each separate component as an operating lease or finance lease if both of the following criteria are met:

- The lessee can benefit from the ROU either on its own or together with other readily available resources
- The ROU is neither highly dependent on nor highly interrelated with the other right(s) to use underlying assets in the contract

An entity must account for the right to use land and other assets, *e.g.*, a building, separately, unless the effect of doing so would be insignificant to the overall accounting for the transaction.

Lease Classification

ASC 842 makes several changes from ASC 840 in determining the classification of a lease, including:

- When the classification of a lease is determined
- How the classification criteria are applied
- How lease payments are determined
- The effect of collectibility and future costs on lease classification by a lessor
- Determining the interest rate implicit in the lease
- Determining the incremental borrowing rate

Under ASC 840, lease classification determined both how lease expense was recorded and whether a lessee was required to record an asset and a liability on the balance sheet. Under ASC 842, virtually all leases will require balance sheet recognition; lease classification will only affect the amount and timing of lease income and expense. Lease classification will now be determined at the commencement date. The classification criteria apply to both lessees and lessors, and evaluation focuses on whether control of the underlying asset is effectively transferred to the lessee.

Lessee

Lessees will classify leases in accordance with the principle in existing lease requirements by determining whether the lease is effectively an installment purchase. Today's capital leases will be classified as finance leases, and today's operating leases will retain their classification. Lease

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classification criteria are similar to ASC 840, but there are differences. The "bright-line" tests are gone (75 percent remaining economic life and 90 percent of the leased asset's fair value) but may be used as a reasonable approach to assessing the economic life and fair value classification criteria.

Under ASC 842, if a lease meets any of the conditions below, the lease substantially transfers all risks and rewards incidental to ownership and will be classified as a finance lease (from a lessee's standpoint) and a sales-type lease (from a lessor's standpoint). A lease that does not meet any of the following criteria does not effectively transfer control to the lessee and would be classified as an operating lease by the lessee and as either an operating lease or direct financing lease by the lessor.

- Ownership is transferred at the lease's end
- The lease grants the lessee an option to purchase the underlying asset that the lessee is reasonably certain to exercise
- The lease term is for the major part of the economic life of the underlying asset; if the commencement date falls at or near the end of the leased asset's economic life, this criterion shall not be used to classify the lease
- The present value of minimum lease payments and RVGs is equal to or more than substantially all the fair value of the leased asset
- The underlying asset has no alternate use to the lessor at the end of the lease term because of its specialized nature

The fifth criterion is a new consideration for lessors and lessees under ASC 842. In assessing whether an underlying asset has an alternative use to the lessor at lease termination, an entity should consider the effects of substantive, *i.e.*, enforceable, contractual restrictions and practical limitations on the lessor's ability to readily direct the asset for another use, *e.g.*, selling or leasing it to an entity other than the lessee. A practical limitation on a lessor's ability to direct an underlying asset for another use exists if the lessor would incur significant economic losses to do so.

The assessment of alternative use may be made in conjunction with the assessment of the second criterion (bargain purchase option). For example, a lessor may be practically limited from redirecting assets that either have unique lessee design specifications or are located in remote areas. In these cases, the terms and conditions of a purchase option that is exercisable at the end of an extension period may be set at a rate that is significantly discounted from the expected market value. Thus, the lessee may be reasonably certain to exercise the purchase option.

> *Unlike current guidance to qualify as a sales-type lease, ASC 842 does not require title to automatically transfer to the lessee by the end of the lease term. Eliminating that requirement could result in more real estate or integral equipment leases qualifying as sales-type leases under ASC 842.*

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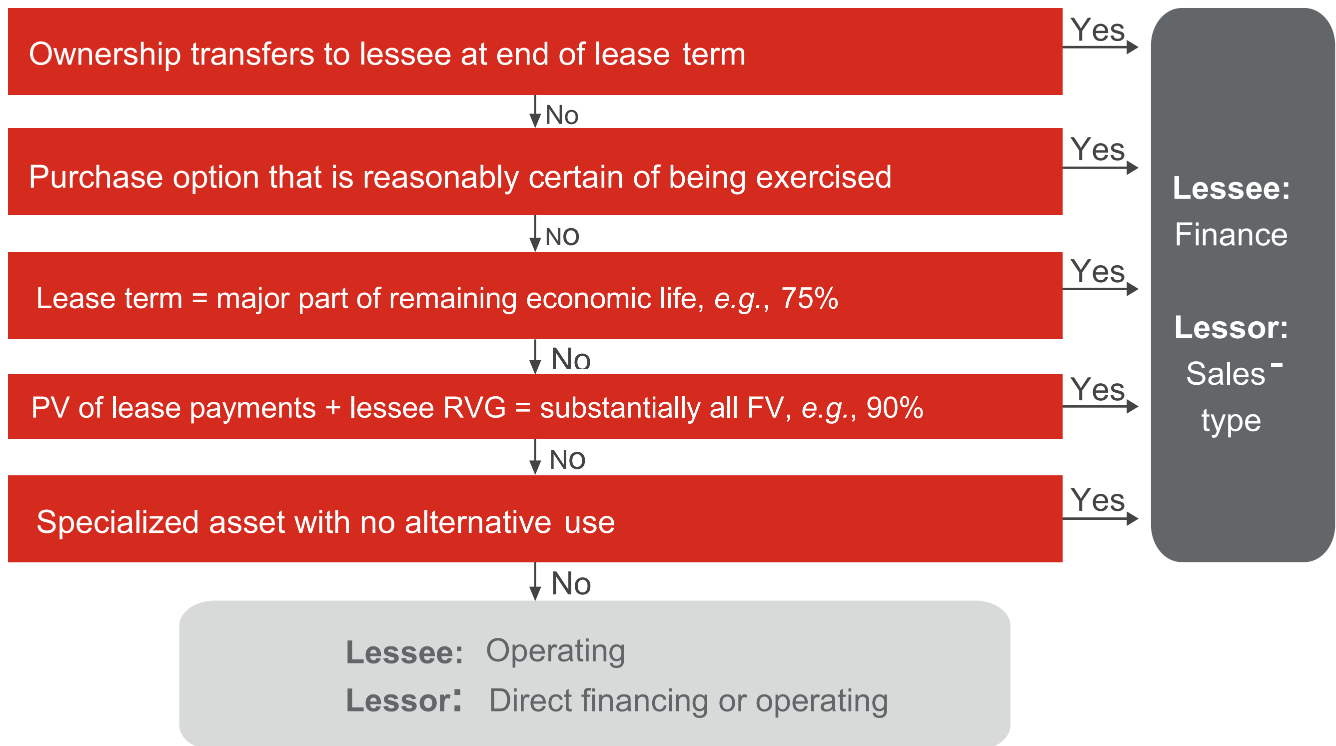


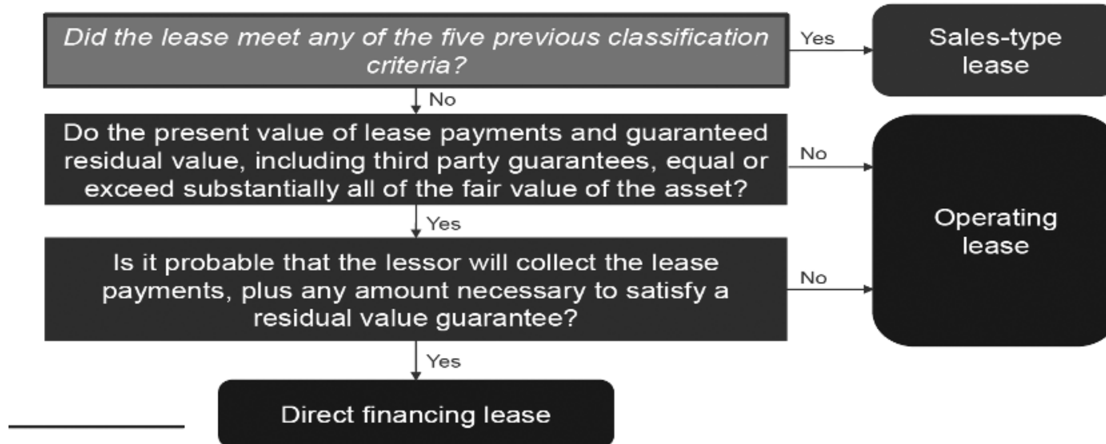
Lessor

Lessors have three types of leases—operating, direct financing, or sales-type. Leveraged lease accounting has been eliminated, although grandfathered for existing arrangements. ASC 842's classification assessment is based on transfer of control versus a risk and rewards basis under ASC 840. The criteria to determine if a lease is a sales-type lease are the same as the five lessee criteria noted above. If none of these criteria are met, the lease is classified as a direct financing lease if both of the following criteria are met:

- The present value of the lease payments and any third-party RVG equals or substantially exceeds all the fair value of the underlying asset

- It is probable[1] the lessor will collect the lease payments and any amounts due under an RVG. The RVG may be entirely provided by a third party or by the lessee along with a third party

If neither of the two above criteria are met, the lease should be classified as an operating lease.



Sales-Type Leases with Variable Lease Payments

ASC 842 requires that a lessor determine whether a lease should be classified as a sales-type lease at lease commencement based on specific criteria. A lessor is not permitted to estimate most variable payments and must exclude variable payments that are not estimated and do not depend on a reference index or a rate from the lease receivable. The excluded variable payments are recognized entirely as lease income when the changes in facts and circumstances on which those variable payments are based occur.

Consequently, the lease receivable for some sales-type leases with variable payments that do not depend on a reference index or a rate may be less than the carrying amount of the underlying asset derecognized at lease commencement, resulting in the lessor recognizing a loss at lease commencement—a day-one loss—even if the lessor expects the arrangement to be profitable overall. Some stakeholders feel that recognizing a day-one loss for these leases does not represent the underlying economics either at lease commencement or over the lease term. These arrangements are most prevalent in the energy industry. Under previous ASC 840 guidance, lessors did not recognize an immediate loss because of the longstanding practice to account for leases with substantial variable

[1] *The term* probable *generally is interpreted as a 75 percent to 80 percent likelihood.*

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payments as operating leases based on an interpretation of ASC 840's classification criterion. That classification criterion was not retained in ASC 842 as originally drafted.

In July 2021, FASB issued ASU 2021-05, which allows a lessor to classify a lease with variable lease payments that do not depend on an index or rate as an operating lease at lease commencement if:

- The lease would have been classified as a sales-type lease or direct financing lease under ASC 842 classification criteria
- The lessor would have recognized a selling loss at lease commencement

FASB acknowledges the change to address the day-one loss issue will result in a lessor classifying more leases as operating, as opposed to a sales-type lease. When a lease is classified as operating, the lessor would not recognize a lease receivable, would not derecognize the underlying asset, and would not recognize a selling profit or loss. FASB also acknowledged that more contracts being classified as operating leases may result in more sale and leaseback transactions accounted for by buyer-lessors as successful asset purchases. A buyer-lessor is not considered to have obtained control of the underlying asset if the leaseback is classified as a sales-type lease but is considered to have obtained control if the leaseback is classified as operating.

RVG

An RVG is defined as "a guarantee made to a lessor that the value of an underlying asset returned to the lessor at the end of a lease will be at least a specified amount." Lessors also may secure an RVG from a third party to reduce or eliminate their residual value risk. The full amount of the potential payment payable under an RVG should be included when evaluating lease classification. A lessor should not include RVGs as a lease payment on a lease portfolio (unless they represent a single lease component) because the classification analysis is performed on an asset-by-asset basis, and it is not possible to determine the amount of the RVG for each individual asset.

A key difference between the sales-type and direct financing lease classification tests is the treatment of third-party RVGs. A lessor is required to include the full amount of a lessee-provided RVG in its evaluation of whether a lease is a sales-type lease. However, if a lease does not qualify as a sales-type lease, a lessor includes the full amounts of all RVGs—both lessees and third party—in its evaluation of the "substantially all" criterion of the lease classification test to determine whether a lease is a direct financing lease.

The RVG classification requirements differ from the measurement guidance, which requires that lessees and lessors consider only the present value of any payment under a lessee RVG that is probable of being owed. The probability of having to satisfy an RVG is not considered for lease classification but must be considered when measuring the lease liability. Under ASC 840, a lessee includes in its minimum lease payments the entire amount of the RVG; under ASC 842, the lessee only includes the probable amount it will be owed under the RVG at the end of the lease term.

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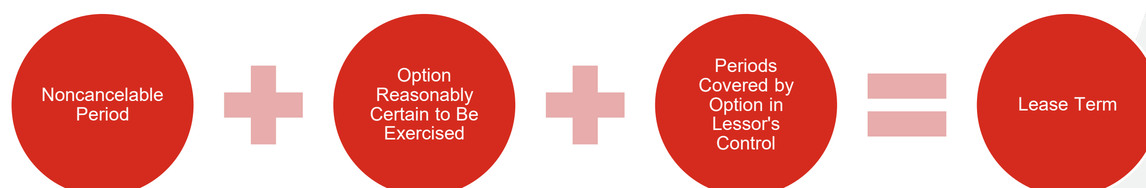
Collectibility

Under ASC 842, lessors are required to assess the collectibility of lease payments for purposes of lease classification, recognition, and measurement. The collectibility assessment aligns with ASC 606. To classify a lease where the lessor has relinquished control as a direct financing lease, collection of lease payments and amounts due under an RVG must be probable. A lessor's collection probability assessment should be performed at lease commencement and reflect both the lessee's ability and intent to pay as amounts become due considering all relevant facts and circumstances. The collectibility assessment does not affect the classification of a lease that meets the criteria in ASC 842 to be a sales-type lease; it only affects when the lessor recognizes the sales-type lease.

Initial Measurement

Lease Term & Options

When determining the lease term, an entity should consider all relevant factors that create an economic incentive to exercise an option to extend or not terminate a lease; this should include contract, asset, and market factor. A lease term is the noncancelable lease period plus any optional periods if it is reasonably certain—after considering all relevant factors—the lessee will exercise a renewal option or not exercise a termination option. The lease term also includes optional periods if the lessor controls the exercise of the option.



Lease Commencement

Lease commencement is the date a lessor makes an underlying asset available for use to a lessee. It also is the date for classification, recognition, and initial measurement. The determination of whether a contract is a lease or contains a lease is performed at the lease inception date, which generally is the date of the agreement containing the lease.

Under ASC 840, the lease is recorded at the lease inception date, whereas under ASC 842, the lease is recorded as of the date the lessor makes the underlying asset available for use to a lessee.

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Lease Commencement vs. Lease Inception		
Date	Definition	Application
Lease inception	The date of the lease agreement or commitment, if earlier	Determination of whether or not a contract is, or contains, a lease
Lease commencement	The date on which a lessor makes an underlying asset available for use by a lessee, *i.e.*, the date the lessee gains control of the underlying asset	Lease classification Lease recognition Lease measurement

Lease Payments

Lease payments are made by a lessee to a lessor for the right to use an identified asset during the lease term. Amounts used in the calculation of a lessee's lease obligation and ROU asset, and a lessor's net investment in the lease, may consist of the following:

Lease Payments					
Fixed lease payments	Certain variable payments	Purchase options	Termination penalties	Lessee-paid SPE structuring fees	Probable RVGs (lessee only)

Fixed Lease Payments

Fixed lease payments consist of the lease payments per the lease agreement plus in-substance lease payments less lease incentives paid or payable to the lessee. In-substance fixed lease payments are payments that may, in form, appear to contain variability but are effectively unavoidable. Examples include payments resulting from clauses that do not have economic substance and are genuinely not variable and payments where a lessee has a choice of what set of payments to make, in which at least one set must be made.

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Variable Lease Payments

Lease payments can be variable, *i.e.*, a payment adjusted for changes in inflation or interest rate or based on a percentage of sales or usage. Entities will exclude most variable lease payments in measuring lease assets and liabilities, except for those that depend on an index or rate or are in-substance fixed payments. Variable lease payments that depend on an index or rate meet the definition of an asset (for the lessor) and a liability (for the lessee) because they are unavoidable and, therefore, economically similar to fixed lease payments. The only uncertainty relates to the measurement and not the existence of the asset or liability. Variable lease payments should be calculated at lease commencement using the index or rate at lease commencement, and no future changes in the rate or index should be estimated. If the payments change as the result of a change in an index or rate subsequent to lease commencement, the difference is recognized in the income statement in the period in which the change occurs.

Only variable lease payments that depend on an index or rate or that are in-substance fixed lease payments should be included in lease payments for lease classification and measurement.

Remeasurement of Lease Liability

ASC 842 **prohibits** a lessee from remeasuring its lease liability solely for a change in a reference index or a rate used to calculate some or all of a variable lease payment; any change in future payments resulting from changes in a reference index or a rate is accounted for as a variable lease cost that would be recognized in the period in which the payment obligation is incurred. However, international accounting guidance in International Financial Reporting Standards (IFRS) 16, *Leases*, **requires** a lessee to remeasure the lease liability in subsequent periods when a change to the lease payments resulting from a change in a reference index or a rate takes effect. The diverged guidance has resulted in increased costs and complexity for dual reporting entities due to the preparation and maintenance of separate analyses and schedules for GAAP and IFRS reporting purposes. In initial deliberations, FASB prohibited remeasurement in these cases because the benefits of remeasuring a lease liability for a rate or index change did not justify the associated costs.

In October 2020, FASB issued an exposure draft that would provide lessees with an option to make an entitywide accounting policy election to remeasure lease liabilities for changes in a reference index or a rate affecting future lease payments at the date that those changes take effect. This optional election (rather than mandatory requirement) would permit each entity to select the option that is most cost-effective for its particular circumstances. Feedback was mixed and FASB decided to drop this project. While this flexibility would have helped at initial transition for international companies, a change after implementation would cause additional costs and lack of comparability across companies.

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Purchase Options & Termination Penalties

If a lessee is reasonably certain to exercise a purchase option, the exercise price is included in lease payments. A lease termination penalty is excluded from lease payments if it is reasonably certain a lessee will not terminate a lease. Whether to include or exclude a purchase option or termination penalty depends on whether it is reasonably certain to be exercised, focusing on whether the lessee has an economic incentive. All relevant facts and circumstances that create an economic incentive should be considered, such as:

- Contractual terms and conditions for the optional periods compared with market rates
- Significant leasehold improvements undertaken over the contract term that are expected to have significant economic benefits for the lessee
- Lease termination costs
- Importance of the underlying asset to the lessee's operations

RVG

The probability of having to satisfy an RVG is not considered for lease classification but must be considered when measuring the lease liability. For measurement, an entity would consider only the present value of any payment under a lessee RVG that is probable of being owed. (Under ASC 840, a lessee includes in its minimum lease payments the entire amount of the RVG.)

Fees Paid by Lessee to Structure SPEs

Any fees paid by the lessee to the owners of a special-purpose entity (SPE)—usually the lessor or its affiliate—for structuring the transaction are included in lease payments. For classification, these fees are not included in the fair value of the underlying asset.

Lease Incentives

Lease incentives include both of the following:

- Payments made to or on behalf of the lessee
- Losses incurred by the lessor as a result of assuming a lessee's pre-existing lease with a third party

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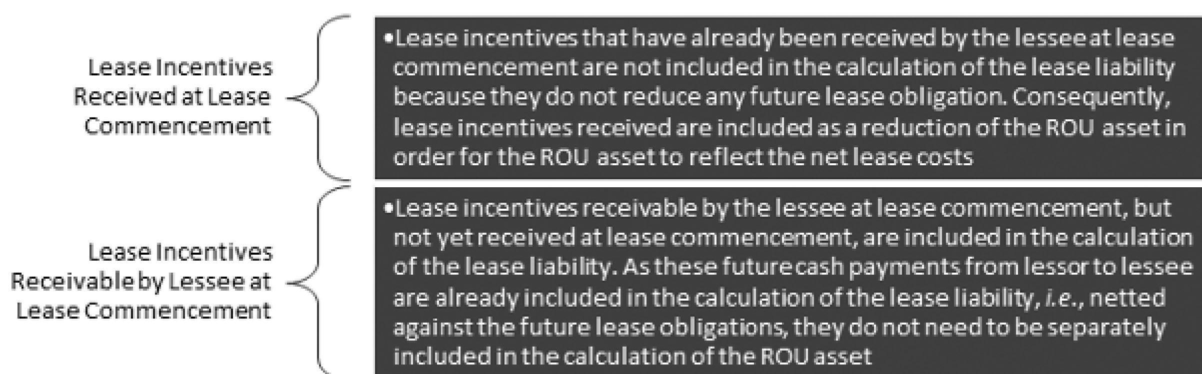

Lease incentives not "received or receivable" at lease commencement, but that are based on future events, *i.e.*, contingent lease incentives, are not specifically addressed in ASC 842. Those that have already adopted ASC 842 have taken several approaches. An entity should apply the approach to contingent lease incentives consistently through adoption of an accounting policy.

Discount Rate

The discount rate used can materially affect the valuation of the lease liability and asset recognized and will be one of the most challenging aspects of implementation. The higher the discount rate is, the lower the lease liability will be; the lower the discount rate is, the higher the lease liability will be. Determining the discount rate will be a significant area of judgment that will require supporting documentation and may necessitate new internal controls. FASB has provided substantial relief for private companies and NFPs, which many are likely to take advantage of.

Rate Implicit in the Lease

The discount rate used by the lessee and lessor is the rate implicit in the lease at the lease commencement date. For lessees, determining the rate implicit in the lease is challenging because that rate is a lessor-specific internal measure that is rarely disclosed. To determine the implicit rate, a lessee must know both the lessor's estimate of the residual value of the underlying asset and the amount of initial direct cost the lessor will defer for the lease. The residual value is most easily determined if there is a provision to convey the asset to the lessee at the end of the lease term through a bargain purchase option or a title transfer provision.

For a lessor to calculate an implicit interest rate, a market value is needed for the related property, space, or land. For some asset types, equipment, or office space in a downtown building, market data are not too difficult to obtain. For other specialized asset types, the market value will be more challenging. A valuation specialist might be needed to apply a cost, income, or market approach—or some combination of these approaches—to arrive at a lease's supportable implicit rate.

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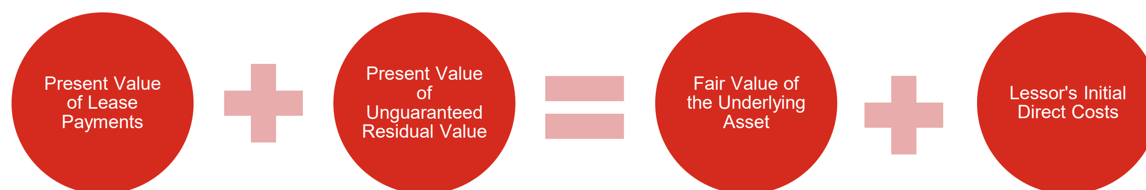
As clarified in a set of technical corrections, the rate implicit in the lease cannot be less than zero. For certain sales-type leases with significant variable payment, a day-one loss is the intended accounting outcome, and accordingly, the use of a negative rate implicit in the lease is not appropriate.



Incremental Borrowing Rate

Consistent with current guidance, if the lease's implicit interest rate is not readily determinable, the lessee's estimated incremental borrowing rate (IBR) should be used. Determining the IBR entails estimating the interest rate the lessee would be charged for borrowing the lease payment amounts during the lease term. ASC 842 has an updated IBR definition. ASC 840 did not require the use of a secured rate. Under ASC 840, a lessee could use a weighted average rate that considered secured and unsecured funding if certain loan-to-value criteria were met. ASC 842 requires a lessee to use a secured rate. This presents operational challenges as most companies borrow on an unsecured basis.

The IBR is the rate at which a lessee could borrow for a similar amount from their lending institution. ASC 842 provides a policy election for all leases to use either:

- The lease term used for accounting purposes
- A rate that also reflects the renewal options

Incremental Borrowing Rate	
ASC 840	ASC 842
The rate the lessee would have incurred to borrow, over a similar term, the funds necessary to purchase the leased asset	The rate of interest a lessee would have to pay to borrow on a collateralized basis, over a similar term, an amount equal to the lease payments in a similar economic environment

Discount Rate Relief

Non-PBEs are permitted to make an accounting policy election to use the risk-free rate when measuring their lease obligations; once elected, it must be used consistently for all leases.

> *A lower discount rate will lead to a higher lease liability. The discount rate also affects the allocation of total expense between depreciation and interest expense—a higher discount rate will reduce depreciation and increase interest expense each period in the lease term.*

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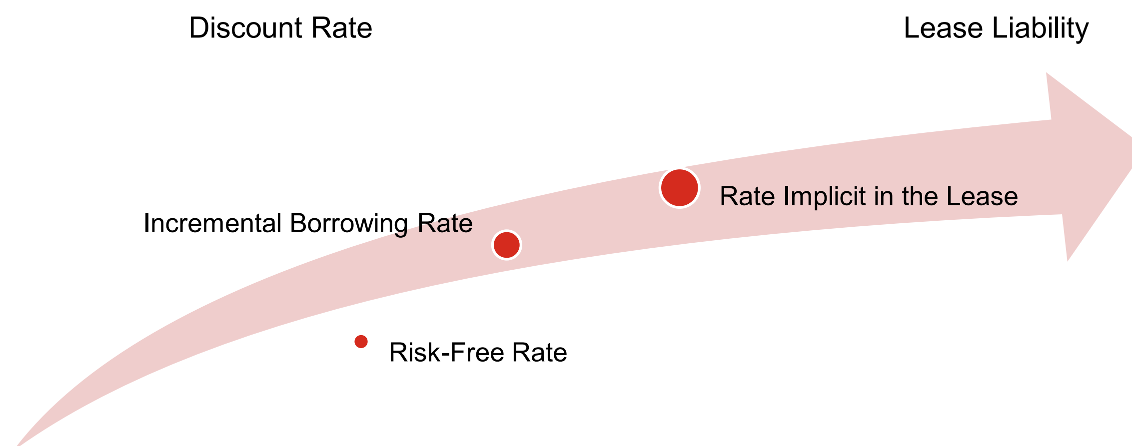

Additional Relief

Private companies and NFPs have expressed reluctance to the risk-free rate accounting election on all leases due to the historically low interest rates in the current economic environment. The current proxy for the risk-free rate—a 10-year U.S. Treasury rate—is so low as to be comparable to using undiscounted cash flows, which could significantly overstate the lease liability and ROU assets. It also could cause leases that would otherwise be classified as operating leases to be classified as financing leases.

In November 2021, FASB issued ASU 2021-09, providing relief to private companies, all NFP entities (whether or not they are conduit bond obligors), and all employee benefit plans in determining the discount rate to use under the new lease guidance in ASC 842. The ASU addresses two issues:

- Changing the existing accounting policy election to use a risk-free rate from entitywide to asset class
- Clarifying that a lessee using the discount rate accounting policy election must use the rate implicit in the lease when it is readily determinable instead of the risk-free rate

Portfolio Approach

Lessees and lessors may apply a single discount rate to a portfolio of leases if they can conclude its application does not create a material difference when compared to individually determined discount rates applied to each of the leases in the portfolio. While a reporting entity is not required to quantitatively demonstrate immateriality, it should be able to demonstrate the leases in the portfolio have similar characteristics, such that it is reasonable to expect the application of the portfolio-level discount rate will not materially differ from the application of discrete discount rates at the individual lease level.

> *If this approach is elected, an entity will need to establish internal controls to determine and monitor the portfolio composition.*

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Initial Direct Costs

ASC 842 significantly changes current practice for accounting for initial direct costs. ASC 842 narrows the definition of initial direct costs, and some costs incurred in negotiating and arranging a lease that are now capitalized under ASC 840, *i.e.*, legal fees and internal allocated costs, will now be expensed as incurred. Initial direct costs are capitalized for both lessees and lessors and only include those costs that are incremental to the arrangement and would not have been incurred if the lease had not been obtained. Costs that would have been incurred regardless of whether the lease was obtained are not initial direct costs.

Initial direct costs usually are more significant for a lessor because they generally solicit lessees as part of their sales activities, engage attorneys to prepare the legal documents, and pay commissions incurred in connection with execution of a lease.

Initial Direct Costs	
Included	Excluded
Commissions	Fixed employee salaries
Legal fees resulting from the execution of the lease	Internal engineering costs
Lease document preparation costs incurred **after** the execution of the lease	Legal fees for services rendered **before** the execution of the lease
Certain payments to existing tenants to terminate a lease	Negotiating lease term and conditions
Consideration paid for a guarantee of a residual asset by an unrelated third party	Advertising
	Other origination efforts
	Depreciation
	Costs related to an idle asset

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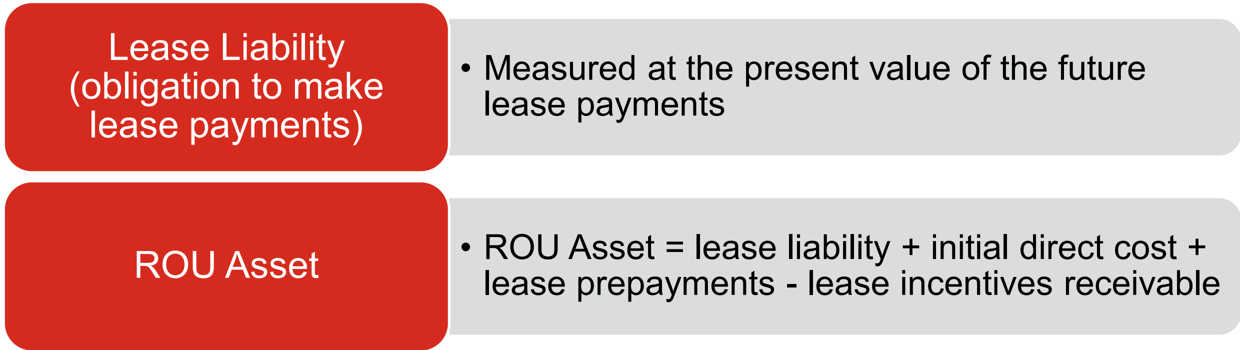
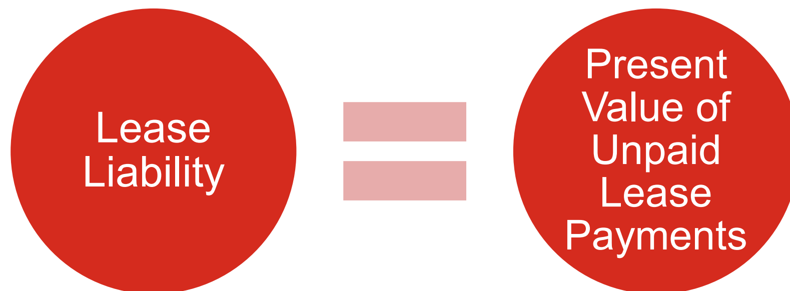
Lessee Accounting



At lease commencement, lessees will measure the lease asset at the same amount as the lease liability (the present value of lease payments), adjusted for initial direct costs directly related to entering the lease, accrued or prepaid rent paid to the lessor at or before lease commencement, and lease incentives.

The amounts initially recorded on the balance sheet will be the same for both financing and operating leases. The accounting difference between operating leases and finance leases occurs in the subsequent recognition of lease-related expense and measurement of the lease asset.



Operating Leases

Lessees will recognize a single lease expense generally on a straight-line basis over the lease term, unless another systematic basis is more representative of the pattern in which the lessee expects to consume the asset's remaining economic benefits, or unless the ROU asset has been impaired (see ROU Asset Impairment section below). The straight-line expense amount for each period is calculated by taking total payments over the lease's life, net of any lessor incentives, plus initial direct costs, divided by the lease term.

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The lessee will allocate lease payments between the finance charge and the reduction of the outstanding liability to produce a constant periodic rate of interest on the remaining balance of the liability. The lease liability for any period is measured at the present value of the lease payments not yet paid, discounted using the discount rate for the lease established at the commencement date (unless the rate has been updated after the commencement date). Unless impaired, the ROU asset for any period is measured at the amount of the lease liability, adjusted for prepaid or accrued lease payments, the remaining balance of lease incentives received, unamortized direct costs, and any impairment.

To avoid presenting operating leases as a financing transaction and to achieve a straight-line expense pattern over the lease term, interest on the lease obligation is added to the ROU asset balance (versus presenting it on the income statement). The straight-line expense pattern is achieved by adjusting the amortization of the ROU asset each period after considering the interest on the lease liability (calculated by using the discount rate for the lease).

For operating leases, lessees will present lease expense as one line item on the financial statements rather than as separate interest and amortization charges. Since the asset still has to be amortized by an amount that excludes the interest portion of expense, this essentially requires the lessee to calculate the straight-line expense amount and deduct the interest portion based on the effective interest rate method to obtain a "plug" figure that constitutes ROU amortization and reduces the asset balance by that plug amount.

Finance Leases

Finance leases are accounted for similar to today's capital leases. For leases already recorded on the balance sheet, *e.g.*, existing sales-type/direct financing leases, and new financing leases, a lessee will recognize amortization of the ROU asset separately from interest on lease liabilities in the income statement over the lease term. Similar to operating leases, a lessee will use the effective interest rate method to subsequently account for the lease liability. The carrying amount of the liability is reduced each period to reflect the principal portion of the lease payments made during the period that were included in the initial measurement of the ROU asset and lease liability.

Lessees will amortize the ROU asset generally on a straight-line basis over the lease term in a manner similar to that used for other nonfinancial assets, unless another systematic method would be appropriate. However, if the lessee is reasonably certain to exercise an option to purchase the equipment, the lessee would amortize the ROU asset over the expected life of the equipment in a manner similar to its owned assets, rather than over the lease term. The ROU asset for any period is measured at its cost, less any accumulated amortization and accumulated impairment losses.

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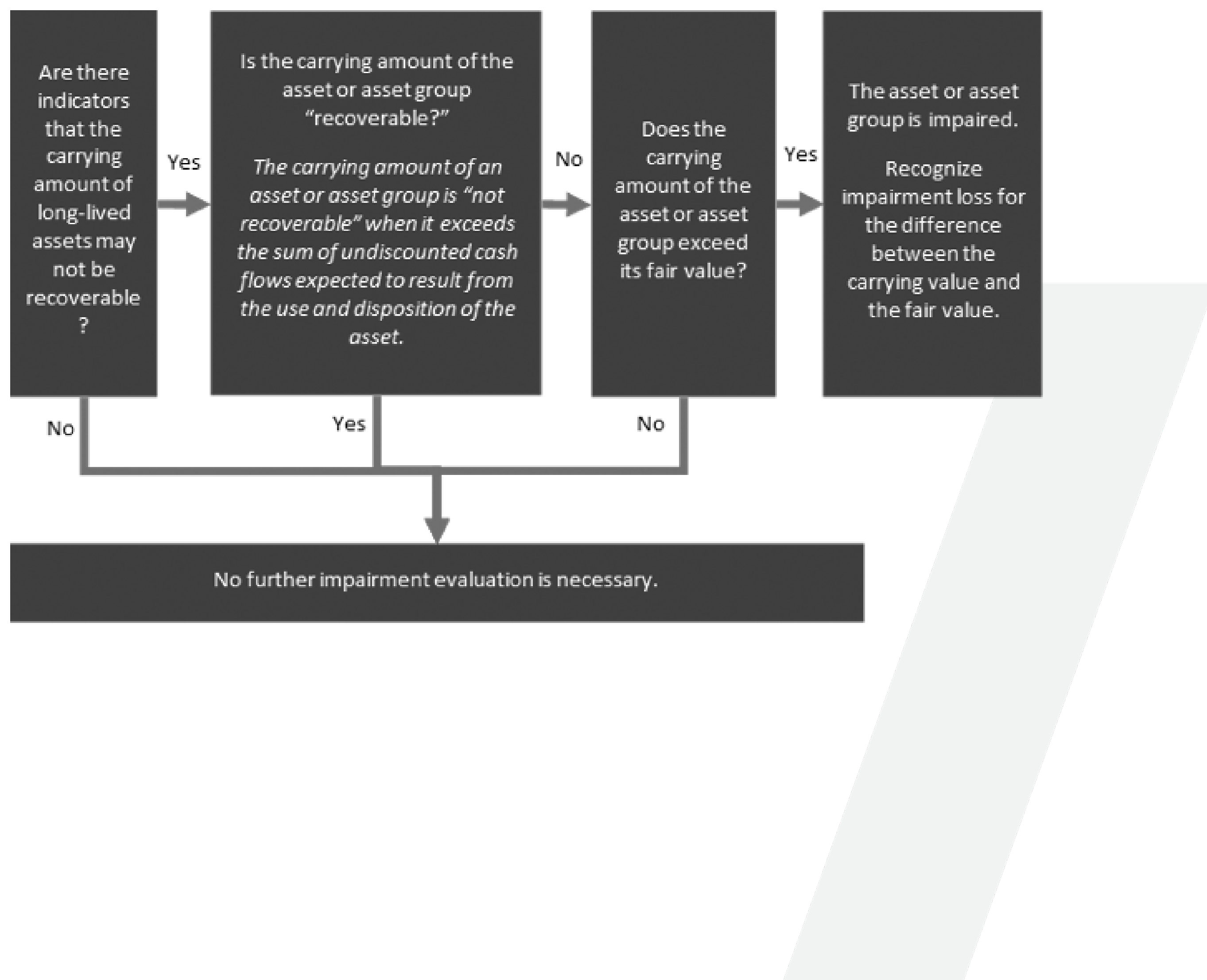
Together, the amortization and interest expense result in a front-loaded expense pattern similar to today's capital leases. Lessees also will recognize in the income statement variable lease payments not included in the lease liability in the period the obligation to make those payments is incurred and any impairment on the ROU asset.

ROU Asset Impairment

Lessees should test ROU assets for impairment and recognize any impairment loss in accordance with ASC 360 on impairment or disposal of long-lived assets. A lessee is required to change the subsequent accounting for an ROU asset classified as an operating lease that is impaired. After impairment, the remaining ROU asset is amortized under the measurement requirements for a finance lease—evenly over the remaining lease term unless another systematic method is more appropriate.

The below diagram summarizes the model in ASC 360 for evaluating impairment of long-lived assets.



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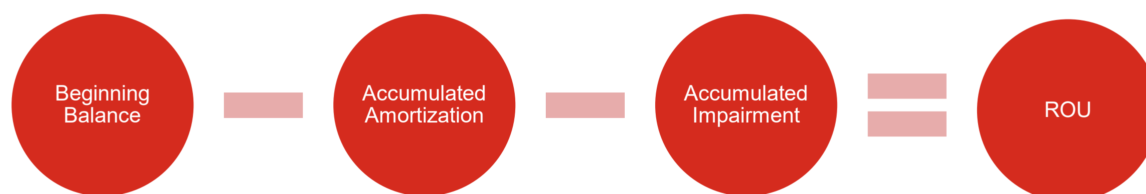

Lessor Accounting

Lessor accounting generally follows today's accounting model for sales-type, direct financing, and operating leases, but ASC 842 makes targeted improvements to better align with the revenue guidance in ASC 606. Consistent with ASC 606, lessor accounting guidance does not differentiate between leases of real estate and leases of other assets.

Operating Leases

An operating lease is neither a sale nor an asset financing; therefore, a lessor will continue to reflect the lease arrangement's underlying asset in its balance sheet. A lessor would generally recognize lease income on a straight-line basis over the lease term, unless another systematic basis would be more representative of the pattern in which income is earned from the underlying asset over the lease term. Any initial direct costs—those that are incremental and would not have been incurred if the lease would not have been obtained—would be deferred and expensed over the lease term consistent with the method of lease income recognition. A lessor should record an unbilled rent receivable—the cumulative amount by which straight-line rental revenue exceeds rents currently billed in accordance with the lease terms.

Collectibility

The initial recognition and measurement for an operating lease are not affected by the collectibility of the lessee's payments. The lessor continues to recognize the underlying asset on its balance sheet and to depreciate the asset based on its useful life. However, subsequent to initial recognition, if collectibility is in question, lease income is limited to the lesser of the straight-line rental income (or other systematic methodology) or the lessee's payments. When the collectibility subsequently becomes probable, the lessor should recognize the difference between the cumulative lease income recognized to date and the amount that would have been recognized had the lessor followed the measurement guidance for an operating lease without the limitation. The amount is recorded as an adjustment to lease income in the period in which collectibility is first deemed probable.

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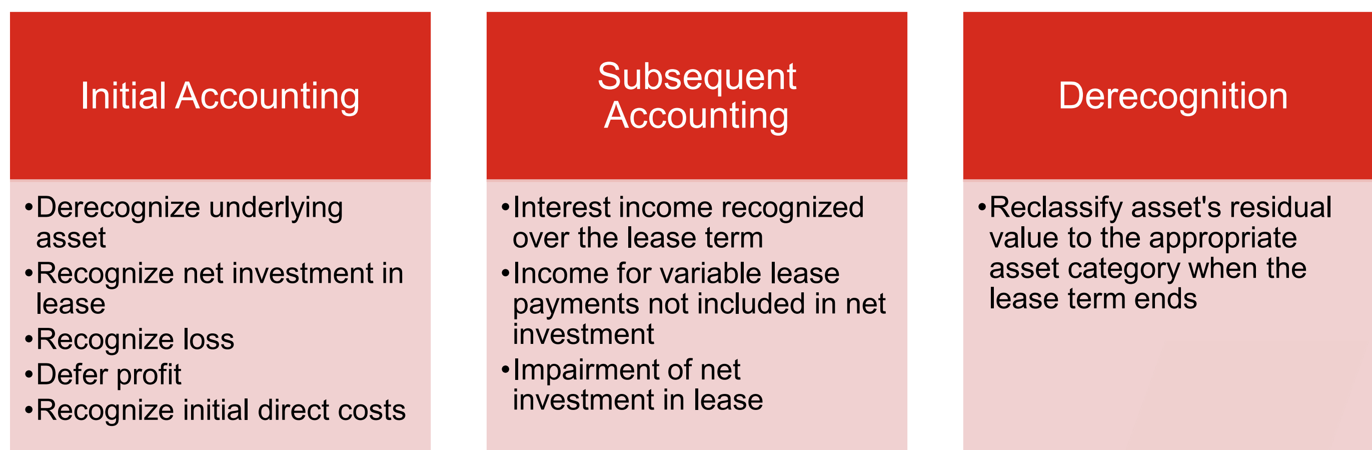
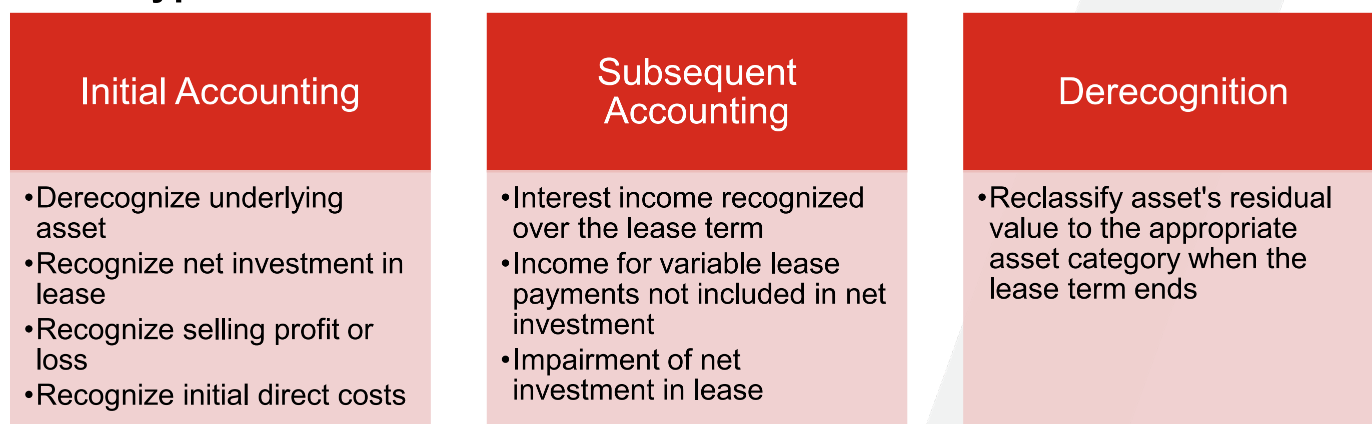
Direct Financing & Sales-Type Leases

For financing arrangements (direct financing or sales-type leases), the lessor will derecognize the underlying asset and recognize a net investment in the lease, representing the sum of the lease receivable (present value of lease payments and RVG) and the present value of the unguaranteed residual asset. For sales-type leases, lessors will recognize any resulting profit or loss and initial direct costs at lease commencement, unless there is no selling profit or loss. When there is no selling profit or loss, the lessor would defer and amortize initial direct costs over the lease term. For a direct financing lease, the lessor will reduce the net investment in the lease by any selling profit and initial direct costs and amortize these items into income over the lease term. Deferred initial direct costs are amortized to interest expense. Lessors will recognize interest income from the lease receivable over the lease term.

Direct Financing Leases



Sales-Type Leases



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Lessor Relief for Variable Leases

As originally issued, ASC 842 required that a lessor determine whether a lease should be classified as a sales-type lease at lease commencement based on specific criteria. A lessor was not permitted to estimate most variable payments. Lessors had to exclude variable payments from the lease receivable that were not estimatable and did not depend on a reference index or a rate. The excluded variable payments are recognized entirely as lease income when the changes in facts and circumstances on which those variable payments are based occur. Consequently, the lease receivable for some sales-type leases with variable payments that do not depend on a reference index or a rate may be less than the carrying amount of the underlying asset derecognized at lease commencement, resulting in the lessor recognizing a loss at lease commencement—a day-one loss—even if the lessor expects the arrangement to be profitable overall.

Some stakeholders felt that recognizing a day-one loss for these leases does not represent the underlying economics either at lease commencement or over the lease term. These arrangements are most prevalent in the energy industry, particularly solar and wind generation companies. Under previous ASC 840 guidance, lessors did not recognize an immediate loss because of the long-standing practice to account for leases with substantial variable payments as operating leases based on an interpretation of ASC 840's classification criterion. That classification criterion was not retained in ASC 842.

FASB's intention during deliberations was not to change lessor accounting; however, the final codification had the unintended consequence of changing long-standing practice. Under ASU 2021-05, a lessor would classify a lease with variable lease payments that do not depend on an index or rate as an operating lease at lease commencement if:

- The lease would have been classified as a sales-type lease or direct financing lease under ASC 842 classification criteria
- The lessor would have recognized a selling loss at lease commencement

Collectibility

Treatment of payment when collectibility is uncertain is consistent with ASC 606. If collectibility is not probable at the commencement date, the lessor shall not derecognize the underlying asset but shall recognize lease payments received—including variable lease payments—as a deposit liability until the earlier of either of the following:

- Collectibility of the lease payments, plus any amount necessary to satisfy a lessee-provided RVG, becomes probable
- Either of the following events occur:
  - The contract has been terminated, and the lease payments received from the lessee are nonrefundable

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

When collectibility subsequently becomes probable, a lessor should derecognize the carrying amount of the underlying asset and deposit liability from its balance sheet and recognize the net investment in the lease as well as any selling profit or loss. After making these adjustments, a lessor should follow the subsequent measurement guidance for a sales-type lease.

Impairment

A lessor shall determine impairment related to the net investment in the lease and shall recognize any impairment in accordance with ASC 310, *Receivables*. When determining the loss allowance for a net investment in the lease, a lessor should consider the collateral relating to the net investment in the lease. The collateral relating to the net investment in the lease represents the cash flows the lessor would expect to receive (or derive) from the lease receivable and the unguaranteed residual during and following the end of the remaining lease term.

The net investment in the lease is a single unit of account in determining the loss allowance. Lessors would evaluate the net investment in the lease using the cash flows the lessor expects to receive from the lease receivable and the unguaranteed residual asset during the remaining lease term. The amount the lessor expects to derive from the unguaranteed residual asset would be based on the expected value of the residual asset following the end of the lease term (excluding any amounts guaranteed by the lessee or any other third party unrelated to the lessor because those expected cash flows would already be considered as part of the lease receivable), effectively incorporating residual asset risk into the loss allowance analysis, together with credit risk.

Subleases

Subleases of ROU assets are within the scope of ASC 842 and should be accounted for in the same way as other leases.

Lessors and lessees will treat subleases as transactions separately from the original lease. The original lessee that becomes the lessor in a sublease would account for the original lease and the sublease as separate transactions as a lessee and lessor, respectively.

Build-to-Suit Transactions

Sometimes a lessee may be involved in the construction or design of an underlying asset prior to lease commencement, which is referred to as a build-to-suit (BTS) lease. Current guidance often resulted in

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the lessee being considered the asset's owner during construction for accounting purposes, and any lessor-provided construction funding was recorded by the lessee as debt.

Under ASC 842, a lessee is the deemed owner of an asset under construction only if the lessee controls the asset during the construction period. Control can be obtained in a variety of ways. Judgment will be required in assessing control. The standard includes examples of scenarios when the lessee may control the asset during construction:

- The lessee has the right to obtain the partially constructed underlying asset at any point during the construction period, *e.g.*, by making a payment to the lessor
- The lessor has an enforceable right to payment for its performance to date, and the asset does not have an alternative use to the owner-lessor
- The lessee legally owns either (a) both the land and the property improvements that are under construction or (b) the nonreal estate asset that is under construction
- The lessee controls the land that property improvements will be constructed on and does not lease the land to the lessor—or another unrelated third party—before construction starts for a period (including renewals) that is for substantially all the economic life of the property improvements
- The lessee is leasing the land that property improvements will be constructed on for a period (including lessee renewal options) that is for substantially all of the economic life of the property improvements, and does not sublease the land to the lessor—or another unrelated third party—before construction starts for a period (including renewals) that is for substantially all of the economic life of the property's improvements

If the lessee controls the asset under construction during the construction period, consistent with today's accounting, the lessee would reflect the asset under construction and a liability for the amounts financed by the lessor on its balance sheet. The lessor also would reflect the amounts it finances for constructing the asset as a loan to the lessee during the construction period. This is different from today's accounting. Sale and leaseback accounting would apply when control passes from the lessee to the lessor (typically once construction is complete and the lease commences). If the requirements under the sale and leaseback model are not met, the transaction would be accounted for as a financing by both the lessee and lessor.

If a lessee does not have control of the asset under construction, judgment may be required to determine how to account for construction costs. If such costs relate to leasehold improvements, the lessee generally should account for those costs in accordance with ASC 360, *Property, Plant, and Equipment*. Payments made by the lessee for the right to use the asset should be accounted for as lease payments regardless of when the payments occur or the payment form. For example, if the lessee pays for (or contributes) construction materials to construct the lessor's asset, such payments should be included in lease payments and treated as prepaid rent.

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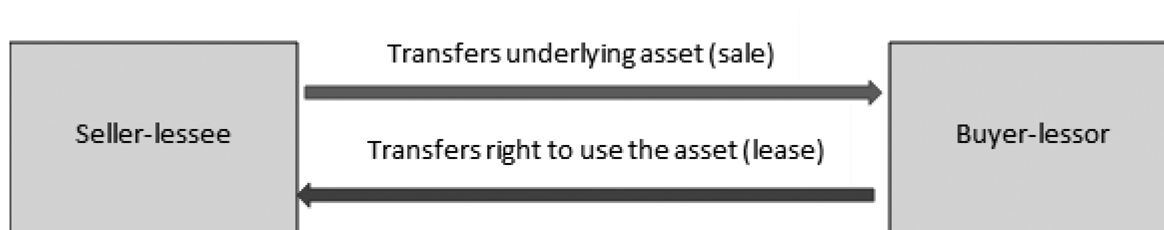
Since ASC 842 is based on control, it is likely there will be fewer instances of the lessee being the accounting owner of the asset under construction, and fewer BTS arrangements will need to be evaluated under the sale and leaseback guidance. In cases where a lessee is deemed to be the accounting owner of an asset under construction, the changes to the sale-leaseback guidance generally make it easier for lessees to remove real estate assets recognized during the construction period from their balance sheets.

Sale-Leaseback Transactions

In a sale and leaseback transaction, one party (the seller-lessee) sells an asset it owns to another party (the buyer-lessor) and simultaneously leases back all or a portion of the same asset for all or part of the asset's remaining economic life. The seller-lessee transfers legal ownership of the asset to the buyer-lessor in exchange for consideration and then makes periodic rental payments to the buyer-lessor to retain the use of the asset. Existing sale and leaseback guidance is replaced with a new model applicable to both lessees and lessors and is now the same for real estate and all other assets. Different accounting outcomes can exist depending on the transaction's structure. Determining whether a sale has occurred is a critical conclusion and determines the initial and subsequent accounting.



A seller-lessee and buyer-lessor will use ASC 606, *Revenue from Contracts with Customers*, to determine whether a sale has occurred by evaluating whether a transaction meets the contract definition, as well as determining when an entity satisfies the performance obligation and control of the assets is transferred. ASC 606's concepts are used even if the seller-lessee and the buyer-lessor have not yet adopted the new revenue recognition standard.

Transactions previously accounted for as a sale and leaseback under ASC 840 do not have to be reassessed at transition under ASC 842's transition guidance.

Determining Whether a Sale Has Occurred

A transaction would qualify for sale-leaseback accounting only if it qualifies as a sale under ASC 606 and the leaseback is not a financing lease. An option for the seller-lessee to repurchase the asset from the

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buyer-lessor also disqualifies sale accounting when the asset is specialized, and the option's exercise price does not equal the asset's fair value on the option exercise date.

Upon adoption of ASC 842, an entity will not need to re-evaluate sale-leaseback transactions completed under ASC 840. However, failed sales under ASC 840 will need to be re-evaluated under guidance in ASC 842 upon adoption of the new standard.

Contract Existence Criteria

Control

ASC 606 provides five indicators that a customer has obtained control of an asset:

- Present right to payment – A buyer-lessor's present obligation to pay could indicate the seller-lessee has transferred the ability to direct the use of the asset and the buyer-lessor has obtained substantially all the remaining benefits from the asset. The seller's motivation in a typical sale and leaseback transaction is to generate liquidity. The buyer-lessor typically pays the agreed-upon purchase price for the asset upfront, in which case this indicator would be satisfied. In instances where the buyer-lessor does not make an upfront payment, the seller-lessee will need to further evaluate whether a present right to payment exists
- Legal title – The party with legal title typically is the party that can direct the use of and receive the benefits from an asset. The benefits of holding legal title include the ability to sell an asset, exchange it for another good or service, or use it to secure or settle debt, all of which indicate the holder has control

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- Physical possession – Physical possession typically gives the holder the ability to direct the use of and obtain benefits from that asset; therefore, it is an indicator of which party controls the asset. Physical possession does not on its own determine which party has control. A reporting entity should consider the facts and circumstances of each arrangement to determine whether physical possession coincides with the transfer of control
- Significant risks and rewards of ownership – Both parties to the arrangement will need to determine whether control has transferred in the event the seller-lessee has retained some of the risks or rewards of ownership
- Asset accepted – The determination of the buyer-lessor acceptance should be viewed from the buyer-lessor's perspective and should be taken into consideration along with the other indicators that control has been obtained by the buyer-lessor

Not all the indicators need to be met for a reporting entity to conclude control has transferred; the factors should be evaluated collectively to determine whether the buyer-lessor has obtained control. This assessment should be focused primarily on the buyer-lessor's perspective. Judgment will be required to determine whether a sale has occurred. The conclusion will be based on the facts and circumstances of the transaction.

Qualified Sale

If a sale is completed, the sale and leaseback portions of a transaction will be accounted for as separate sale and lease transactions, and the entire gain on the transaction would be recognized.

When the sale of an asset is not at fair value or the lease payments are not at market rates, the seller-lessee and buyer-lessor should make adjustments, so the sale is recognized at fair value. To determine whether the sale is at fair value, an entity shall use either of the following, whichever is more readily determinable:

- The asset's sale price and fair value
- The present value of the lease payments and market rental payments

If the sale and leaseback transaction is **not** at fair value, the entity must adjust the asset's sale price as follows:

- Any increase to the sale price of the asset as a prepayment of rent
- Any reduction of the sale price of the asset as additional financing provided by the buyer-lessor to the seller-lessee. The seller-lessee and buyer-lessor shall account for the additional financing in accordance with other topics

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A sale and leaseback transaction is not off market solely because the sale price or lease payments include a variable component. In determining whether the sale and leaseback transaction is at fair value, the entity should consider those variable payments it reasonably expects to be entitled to (or to make) based on all the information—historical, current, and forecast—that is reasonably available to the entity. For a seller-lessee, this would include estimating any variable consideration to which it expects to be entitled.

Failed Sale

When a sale and leaseback transaction does not qualify for sale accounting, the transaction must be accounted for as a financing transaction by the seller-lessee and a lending transaction by the buyer-lessor. To account for a failed sale and leaseback transaction as a financing arrangement, the seller-lessee does not derecognize the underlying asset; the seller-lessee continues depreciating the asset as if it were the legal owner. A financial liability should be recognized for the sales proceeds received from the buyer-lessor. A seller-lessee will make rental payments under the leaseback. These payments should be allocated between interest expense and principal repayment of the financial liability. To determine the amount allocated to interest expense, the seller-lessee should use its incremental borrowing rate. However, a seller-lessee may need to adjust the interest rate initially or during the leaseback term to ensure both of the following apply:

- Interest on the financial liability is not greater than the principal payments on the financial liability over the shorter of the lease term and the financing term. The financing term may be shorter than the lease term because the transfer of an asset that does not qualify as a sale initially may qualify as a sale at a point in time before the end of the lease term
- The asset's carrying amount does not exceed the carrying amount of the financial liability at the earlier of the end of the lease term or the date at which control of the asset will transfer to the buyer-lessor, *e.g.*, the date at which a repurchase option expires if that date is earlier than the end of the lease term

Related Parties

ASC 842 significantly modifies the treatment of related-party leases. While ASC 840 forced entities to look at substance over form in evaluating the existence of a lease, ASC 842 acknowledges many related-party transactions are not documented and not at arm's length. Leases between related parties should be classified in accordance with the lease classification criteria applicable to all other leases based on the lease's **legally enforceable** terms and conditions. In the separate financial statements of the related parties, the classification and accounting for the leases should be the same as for leases between unrelated parties. Lessees and lessors should follow the disclosure requirements in ASC 850, *Related Party Disclosures*, the nature of the relationships, and a description of the transactions, including

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information deemed necessary to understand the effects of the transactions on the financial statements. These disclosures should not imply a transaction is at arm's length unless such an assertion can be substantiated.

Application of the related-party guidance in ASC 842 requires careful consideration to avoid unintended consequences. For example, if an entity were to lease a building from a related party and determine that the arrangement does not constitute a lease under ASC 842 (because there is no legally enforceable contract), any leasehold improvements would need to be expensed as incurred (because the amortization period of leasehold improvements is the shorter of their useful life and the lease term— and there is no lease term). In addition, entities should consider tax, legal, or banking effects of having—or not having—a legally enforceable contract for related-party leasing arrangements.

Reassessment

Under ASC 840, an entity generally could set key factors at lease inception and not have to reconsider those decisions over the lease term unless a contract was modified or an option exercised. Under ASC 842, a lessee should remeasure the lease liability and adjust the ROU asset if any of the following occur:

- The lease is modified, and the modification is not accounted for as a new, separate contract
- A contingency is resolved such that some or all variable payments become fixed. A change in a reference rate or index for variable lease payments does not constitute the resolution of a contingency
- Changes in:
  - Lease term
  - Assessment of whether the lessee will exercise or not exercise a purchase option
  - Probable amount the lessee will owe under an RVG

Lessees generally are required to use an updated discount rate when remeasuring the lease liability and ROU asset. Lessees do not have to update the discount rate for changes in probable RVG amounts, contingency resolution on variable lease payments that become fixed, or change in the lease term.

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Lease Modification & Reassessment				
	Reallocate contract consideration and remeasure the lease	Reassess classification	Update discount rate	Reassess if contract contains a lease
Lease modification	★	★	★	★
An event occurs that gives the lessee a significant economic incentive to exercise/not exercise a **renewal or termination option**	★	★	★	
An event occurs that gives the lessee a significant economic incentive to exercise/not exercise a **purchase option**	★	★	★	
Variable payments become fixed	★			
Amounts due under an RVG become probable of being owed	★			
Lessors are not subject to these reassessment requirements				

An entity may need to develop new processes and internal controls to identify when reassessment is required.

Lease Modification

A lease modification is any change to a contract's terms and conditions that results in a change in a lease's scope or consideration. A lease modification generally requires remeasurement of the lease liability and ROU asset by a lessee using a discount rate determined at the modification's effective date.

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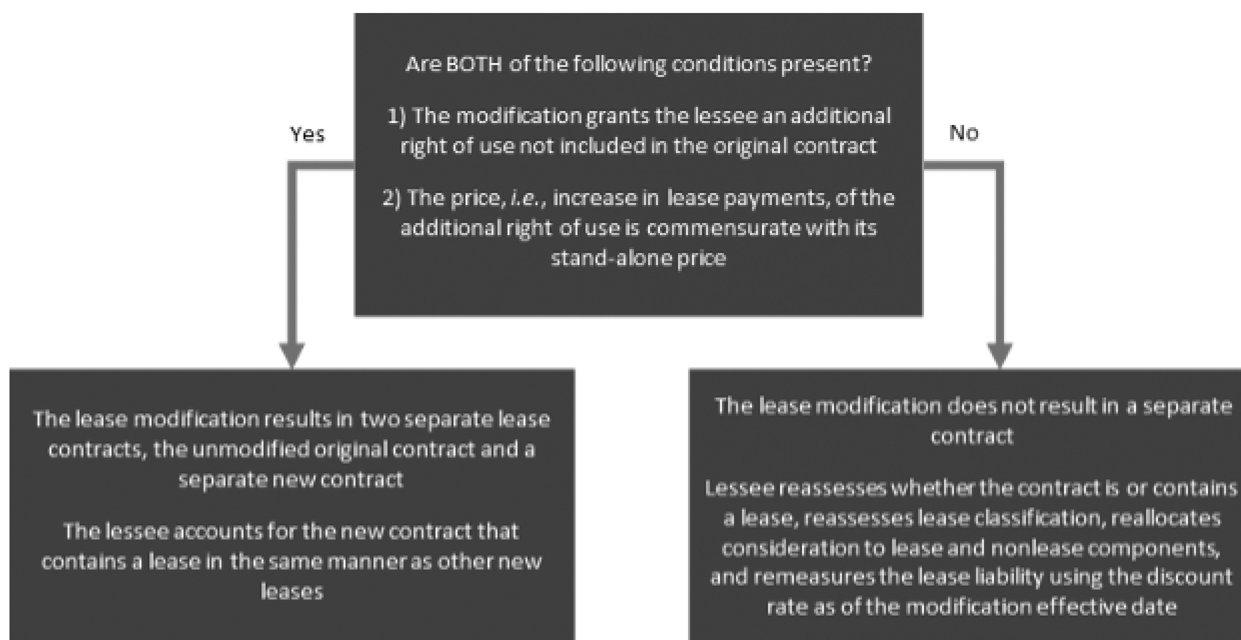

A lessee should reallocate the remaining consideration in the contract and remeasure the lease liability using a discount rate as of the effective date of the modification if:

- The contract modification grants the lessee an additional ROU not included in the original contract (and that modification is not accounted for as a separate contract)
- The contract modification extends or reduces the term of an existing lease, other than through the exercise of a contractual option to extend or terminate the lease
- The contract modification fully or partially terminates an existing lease, *e.g.*, reduces the assets subject to the lease
- The contract modification only changes the contract consideration

For modifications that decrease the lease's scope, the lessee would reduce the carrying values of the lease liability and lease asset with any difference recognized as a gain or loss in the income statement. Both the lessee and lessor are required to reassess variable lease payments when the lease is remeasured due to a lease modification.

An entity should account for a lease modification as a separate contract when the modification grants the lessee an additional ROU not included in the original lease and the additional ROU is priced commensurate with its standalone price (in the context of that particular contract). Lessors also are required to reallocate consideration when a contract modification does not result in a new, separate contract, requiring remeasurement of the lease receivable and adjusting the related residual asset, as applicable.

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Modifications Reducing the Scope of a Lease Contract

ASC 842 currently requires a lessee and lessor to reconsider the lease classification and update inputs to adjust the accounting for a master lease's remaining lease components if a modification terminates some assets early. The accounting update is required regardless of whether the remaining lease components are economically affected by the early termination. Financial statement preparers have pointed to the cost and complexity of reconsidering the inputs for classification and measurement, such as the economic life and fair value of the underlying asset and the discount rate. Preparers also highlighted that reassessment of lease classification only for a change in the number of units leased could result in financial reporting that does not represent an arrangement's economics.

> *In October 2020, FASB issued an exposure draft that would exempt entities from applying modification accounting to the remaining lease components within a lease contract for transactions in which one or more lease components are terminated before the end of the lease term and that early termination does not economically affect the remaining lease components. While comment letter feedback generally supported this update, many other concerns around modifications were raised. Rather than addressing each piecemeal, FASB decided to wait for the full results of the post-implementation review process to address modification issues in a holistic manner.*

Reallocation of Contract Components

Lessees are required to reallocate consideration to multiple lease components when they remeasure the lease liability. Both lessees and lessors are required to reallocate contract consideration as of the effective date of a contract modification that is not accounted for as a new, separate contract.

COVID-19 Lease Modification Guidance

COVID-19 is expected to result in many lease modifications and concessions, some of which include required forbearance mandated by the federal government. Guidance in ASC 840 and 842 includes analysis to determine if the modifications result in a new lease or a continuation of the existing lease on a contract-by-contract basis. This includes reviewing if enforceable rights and obligations are created or are consistent with the original contract terms. This guidance was intended for routine, negotiated modifications and did not contemplate the size, scale, and temporary nature of COVID-19 changes.

FASB has concluded that companies can make special elections for COVID-19-related lease concessions. Companies can elect to treat COVID-19 modifications as though enforceable rights and obligations for those concessions existed under the original contract. Companies will not have to review each contract separately and can elect not to apply lease modification guidance under either ASC 840 or 842.

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Classification Reassessment

Lessors and lessees are required to reassess the classification of a lease when the lease is substantially modified and the modification is not accounted for as a separate contract, when there is a change in the lease term or there is a change in the assessment of exercising an option to purchase the underlying asset. When reassessing lease classification, the entity shall use the modified terms and conditions as of the date the reassessment is required (option exercise certainty) or the effective date of a lease modification, using the fair value and the remaining economic life of the underlying asset.

Lease Term Reassessment

A lessee is required to reassess the lease term when a significant event or change in circumstances that is within the lessee's control will affect whether the lessee would be reasonably certain to exercise an option to extend the lease, purchase the underlying asset, or terminate the lease. A lessee also would reassess the lease term when it elects to exercise a renewal option that it had previously determined was not reasonably certain to be exercised, or elects not to exercise a termination option that it had previously determined was reasonably certain to be exercised. Examples of significant events or significant changes in circumstances a lessee should consider include, but are not limited to, constructing significant improvements that are expected to have significant value for the lessee when the option becomes exercisable or making significant modifications or customizations to the underlying asset. As a result of a change in lease term, lessees will reassess lease classification and remeasure the lease liability and ROU asset to reflect the cost of the additional rights. FASB's technical corrections note that the lessee will remeasure variable lease payments based on an index at the remeasurement date.

A lessor is not required to reassess the lease term or a lessee purchase option after initial determination unless the lease is modified and the modified lease is not a separate contract. When a lessee exercises an option to extend the lease or purchase the underlying asset the lessor previously determined the lessee was not reasonably certain to exercise, or exercises an option to terminate the lease the lessor previously determined the lessee was reasonably certain not to exercise, the lessor shall account for the exercise of that option in the same manner as a lease modification.

Short-Term Leases

If a change occurs in the lease term that causes the term to extend more than 12 months from the end of the previously determined lease term, or if the exercise of a purchase option becomes reasonably certain, the lease is no longer a short-term lease and must be accounted for under the regular lease guidance with the date of the change in circumstances as of the commencement date.

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RVG

When there is a change in the amount that is probable to be owed by the lessee under an RVG, the lessee is required to remeasure the lease payments and adjust the lease liability and ROU asset.

Exercise of Purchase Option During the Lease Term

If a lessee purchases a leased asset during the lease term, the lessee should settle the lease liability. If the ROU asset was not previously presented together with PP&E, the lessee should reclassify the ROU and apply Topic 360 to the equipment beginning on the date the purchase option is exercised. The lessee would record any difference between the purchase price and the carrying amount of the lease liability as an adjustment of the carrying amount of the asset with no gain or loss recognized.

Presentation

The new lease standard has specific financial statement presentation requirements for leasing activity. FASB has retained previous GAAP for most aspects of the lessor accounting model.

Lessee

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

Balance Sheet

ASC 842 requires each type of lease—operating or financing—to be reported separately in the balance sheet. The related ROU assets must be presented separately from other assets, as well as from each other. Lease liabilities follow the same separation requirements. If not presented separately, an entity would disclose in the notes what line items on the balance sheet include finance lease ROU assets and what line items include operating lease ROU assets.

A lessee would present lease assets on the balance sheet either together with owned PP&E or as their own line item(s) if that were relevant to understanding the lessee’s financial position. Many lessees use owned and leased assets for the same purpose and derive similar economic benefit from their use.

Lease assets and liabilities would be broken out on the balance sheet as current or noncurrent using the same requirements as other nonfinancial assets and financial liabilities, based on the timing of payments.

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An entity should classify the portion of its lease liabilities that is expected to be paid within the year (or the entity's operating cycle) as a current liability.

For entities with significant off-balance sheet leases under ASC 840, the most significant change will be to key financial metrics derived from the company's assets, liabilities, and equity, e.g., *leverage and performance ratios. The carrying amount of lease assets typically will reduce more quickly than the carrying amount of lease liabilities. This will result in a reduction in reported equity compared to today for lessees with material off-balance sheet leases classified as finance leases under ASC 842. This effect on equity is similar to the effect on reported equity today from financing the purchase of an asset, either through a capital lease or loan.*

We expect most analysts and lenders will use the lease commitment disclosures currently required to estimate an entity's leverage, cash flow, and cost impact. Any effect on the cost of borrowing is most likely to result from differences arising from more accurate information about lease liabilities—not the change in accounting for existing financial commitments—and the lender's ability to better understand and price an entity's credit risk.

Income Statement

Finance Lease

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

ASC 842 is silent on the appropriate classification of variable lease payments for finance leases. There are two acceptable approaches that have evolved in practice to present as either:

- Lease expense
- Interest expense

If variable lease payments are material, entities should disclose their presentation approach.

Operating Lease

A lessee should present the lease expense of an operating lease as a single operating expense in income from continuing operations.

Lessee Income Statement Presentation	
Finance Leases	Operating Leases
Amortization expense	Lease expense
Interest expense	

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Cash Flow Statement

Finance Lease

Finance of the principal portion of finance leases is classified as financing activities, and related interest expense is classified similarly as interest paid.

Operating Lease

Operating lease payments, including variable and short-term lease payments, are classified as operating activities, except for expenditures to make the asset ready for use, *i.e.*, moving and related setup costs, which would be classified as investing activities.

Lessee Statement of Cash Flows Presentation – Finance Leases	
Principal portion of lease payment	Financing activities
Interest portion of lease payment	• Operating activities (already included in net income) • Supplemental disclosure of interest paid
Amortization expense	Noncash addback in operating activities
Variable lease payments	Operating activities (already included in net income)
Obtaining an ROU asset in exchange for a lease liability	Noncash investing and financing activities
Changes to lease balances from lease modification or reassessment events	Noncash activities

Lessee Statement of Cash Flows Presentation – Operating Leases	
Reduction in ROU asset	Noncash addback in operating activities (noncash lease expense)
Change in operating lease liability	Operating activities (change in operating liabilities section)
Variable lease payments	Operating activities (already included in net income)
Costs to bring another asset to condition and location necessary for intended use	Investing activities
Obtaining an ROU asset in exchange for a lease liability	Noncash activities
Changes to lease balances from lease modification or reassessment events	Noncash activities

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Lessee Presentation Summary			
	Balance Sheet	**Income Statement**	**Statement of Cash Flows**
Finance Leases	**ROU Assets** Separate line item; or within another line item, separate from where operating lease ROU assets are presented **Lease Liabilities** Separate line item; or within another line item, separate from where operating lease liabilities are presented	**ROU Asset Amortization** Consistent with presentation of depreciation or amortization of similar assets **Interest Expense on Lease Liability** Consistent with presentation of other interest expense	**Principal Repayments** Financing activities **Interest Payments** In accordance with ASC 230 (usually in operating activities) **Variable Lease Payments** Operating activities
Operating Lease	**ROU Assets** Separate line item; or within another line item, separate from where finance lease ROU assets are presented **Lease Liabilities** Separate line item; or within another line item, separate from where finance lease liabilities are presented	**Lease Expense** Included in lessee's income from continuing operations (operating expense)	**Lease Payments** Operating activities, unless payments are for costs to put another asset in service **Variable Lease Payments** Operating activities

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Lessor

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

Balance Sheet

Sales-Type & Direct Financing Leases

In a sales-type or direct financing lease, the lessor derecognizes the leased asset and recognizes a lease investment on its balance sheet. A lessor's aggregate net investment should be presented separately from other assets on the lessor's balance sheet. Lease assets should be classified as current or noncurrent.

Operating Lease

A lessor should classify assets subject to operating leases as PP&E, *e.g.*, within buildings, or as a separate line item on the balance sheet, *e.g.*, assets subject to operating leases. As with other fixed assets, property subject to operating leases may be presented net of accumulated depreciation on the balance sheet, but the accumulated depreciation should be shown on the face of the balance sheet or disclosed in the notes to the financial statements. For operating leases with rents that change over time, the requirement to recognize rental income on a straight-line basis may generate a rent receivable or deferred rent revenue on the lessor's balance sheet. A lessor also may need to recognize a prepaid asset on the balance sheet arising from initial direct costs that the lessor will recognize as an expense over the lease term. Lessors should present a rent receivable, deferred rent, or prepaid initial direct costs with items of similar maturities on a classified balance sheet, *e.g.*, with other prepaid items associated with long-term contracts.

Income Statement

Sales-Type & Direct Financing Leases

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

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Operating Lease

A lessor should present rental income from an operating lease net of the amortization of rent receivables, deferred rent, or prepaid initial direct costs. A lessor should continue to measure the underlying asset subject to an operating lease in accordance with other GAAP. Depreciation of the underlying asset should be presented gross and should not offset rental income.

Cash Flow Statement

A lessor is required to classify cash receipts from all lease payments—regardless of lease classification—as operating activities. ASU 2019-01 clarifies that lessors that are depository and lending institutions within the scope of ASC 942, *Financial Services—Depository and Lending*, will present all principal payments received under leases within investing activities.

Disclosures

Required disclosures will increase dramatically under ASC 842 for both lessors and lessees. Companies must provide financial statement users with quantitative and qualitative information adequate to assess the amount, timing, and uncertainty of cash flows arising from leases. These new disclosures, bolded below, may require new processes and internal controls. These disclosures are subject to audit and for public entities will be in scope for management's report on internal controls.

Companies must consider the level of detail necessary to satisfy the disclosure objective and how much emphasis to place on each requirement. Aggregation should be at a level so useful information is not obscured by including a large amount of insignificant detail or by aggregating items that have different characteristics. For companies with extensive significant leasing activities, more comprehensive disclosures will be expected.

While ASC 842 requires only certain lessor disclosures to be made in all interim financial statements, Regulation S-X requires SEC registrants to provide both the applicable lessor and lessee annual and interim disclosures in each interim period included in the entity's quarterly reports on Form 10-Q in the year of adoption of a new accounting standard.

Lessee

A lessee shall disclose information about all the following:

Qualitative Disclosures

- Nature of leases, as well as any subleases, including:

  - A general description of leases
  - The basis and terms and conditions on which variable lease payments are determined
  - The existence and terms and conditions of options to extend or terminate the lease. A lessee should provide narrative disclosure about the options that are recognized as part of its ROU assets and lease liabilities and those that are not
  - The existence and terms and conditions of RVGs provided by the lessee
  - The restrictions or covenants imposed by leases, *e.g.*, those relating to dividends or incurring additional financial obligations
  - **Information about leases that have not yet commenced but that create significant rights and obligations for the lessee, including the nature of any involvement with the construction or design of the underlying asset**
- **Significant judgments, including:**
  - **The determination of whether a contract contains a lease**
  - **The allocation of the consideration in a contract between lease and nonlease components**
  - **The determination of the discount rate for the lease**
- Lease transactions between related parties
- **Accounting policy election for short-term leases exemption.** If the short-term lease expense for the period does not reasonably reflect the lessee's short-term lease commitments, a lessee shall disclose that fact and the amount of its short-term lease commitments
- **Accounting policy election of the practical expedient on not separating lease components from nonlease components**. Also, which class or classes of underlying assets the practical expedient was applied to

Quantitative Disclosures

- The amounts recognized in the financial statements relating to leases. For each period presented in the financial statements, a lessee shall disclose the following amounts relating to a lessee's total lease cost, which includes both amounts recognized in profit or loss during the period and any amounts capitalized as part of the cost of another asset, and the cash flows arising from lease transactions:
  - Finance lease cost, segregated between the ROU amortization and interest on the lease liabilities
  - Operating lease cost
  - Short-term lease cost, excluding expenses relating to leases with a lease term of one month or less
  - Variable lease cost
  - Sublease income, disclosed on a gross basis, separate from the finance or operating lease expense

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  - Net gain or loss recognized from sale and leaseback transactions
  - Amounts segregated between those for finance and operating leases for the following items:
    - **Cash paid for amounts included in the measurement of lease liabilities, segregated between operating and financing cash flows**
    - **Supplemental noncash information on lease liabilities arising from obtaining ROU assets**
    - **Weighted-average remaining lease term**
    - **Weighted-average discount rate**
- Maturity analysis of breaking out finance and operating lease liabilities separately, 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. A lessee shall disclose a reconciliation of the undiscounted cash flows to the finance and operating lease liabilities recognized in the statement of financial position.

Lessor

A lessor shall disclose qualitative and quantitative information about all the following:

- Nature of leases
  - A general description of those leases
  - The basis and terms and conditions on which variable lease payments are determined
  - The existence and terms and conditions of options to extend or terminate the lease
  - The existence and terms and conditions of options for a lessee to purchase the underlying asset
- **Significant judgments**
  - **The determination of whether a contract contains a lease**
  - **The allocation of the consideration in a contract between lease and nonlease components, unless the practical expedient was applied to all eligible leases**
  - **The determination of the amount the lessor expects to derive from the underlying asset following the end of the lease term**
- **Lessors that elect the lease/nonlease component separation practical expedient must disclose:**
  - **Its accounting policy election and the class or classes of underlying assets for which it has elected to apply the practical expedient**
  - **The nature of:**
    - **The lease components and nonlease components combined as a result of applying the practical expedient**
    - **The nonlease components, if any, that are accounted for separately from the combined component because they do not qualify for the practical expedient**

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- Lease transactions between related parties
- Lease income recognized in each annual and interim reporting period, in a tabular format, including:
    - For sales-type leases and direct financing leases, profit or loss recognized at the commencement date (can be gross or net basis), and the interest income either in aggregate or separated by components of the net investment in the lease
    - For operating leases, lease income relating to lease payments
    - Lease income relating to variable lease payments not included in the measurement of the lease receivable
- The components of its aggregate net investment in sales-type and direct financing leases, *i.e.*, the carrying amount of its lease receivables, its unguaranteed residual assets, and any deferred selling profit on direct financing leases
- Risk management information on the residual value of its leased assets, including:
    - Its risk management strategy for residual assets
    - The carrying amount of residual assets covered by RVGs (excluding guarantees considered to be lease payments for the lessor)
    - Any other means by which the lessor reduces its residual asset risk, *e.g.*, buyback agreements or variable lease payments for use in excess of specified limits

In addition to the items noted above, further disclosures are required for lessors depending on the type of lease:

- Sales-type and direct financing leases
    - Explain significant changes in the balance of its unguaranteed residual assets and deferred selling profit on direct financing leases
    - Maturity analysis of its lease receivables, showing the undiscounted cash flows to be received on an annual basis for a minimum of each of the first five years and a total of the amounts for the remaining years. A lessor shall disclose a reconciliation of the undiscounted cash flows to the lease receivables recognized in the statement of financial position (or disclosed separately in the notes)
- Operating leases
    - Maturity analysis of lease payments, showing the undiscounted cash flows to be received on an annual basis for a minimum of each of the first five years and a total of the amounts for the remaining years. A lessor shall present that maturity analysis separately from the maturity analysis required for sales-type leases and direct financing leases
    - Disclosures required by Topic 360 on PP&E separately for underlying assets under operating leases from owned assets. FASB concluded leased assets often are subject to different risks than owned assets. The lessor should disaggregate by significant class of underlying asset subject to lease because the risk related to one class of underlying asset may be very different from another, *e.g.*, a building versus an airplane

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Disclosure Summary	
Lessees	Lessors
Nature of leases	Nature of leases
Information about leases that have not yet commenced	Significant assumption and judgments used
Related-party lease transactions	Related-party lease transactions
Accounting policy election for short-term leases	Tabular disclosure of lease-related income
Financing and operating lease costs	Components of the net investment in a lease
Short-term and variable lease costs	Information about the risk management of residual assets
Sublease income	Maturity analysis of **operating** lease payments and lease receivable
Gain or loss from sale and leaseback	Information required by ASC 360, separating underlying assets under operating leases from owned assets
Maturity analysis for lease obligations	
Weighted-average remaining lease term	
Weighted-average discount rate	

Transition

As originally issued, companies were required to use a modified retrospective approach, which requires application of the new guidance for leases that exist or are entered into after the beginning of the earliest comparative period presented, *i.e.*, January 1, 2017, for calendar year-end public business entities. Companies beginning the implementation process cited unanticipated costs and complexities with the transition method required. ASU 2018-11 creates an additional optional transition method whereby a cumulative effect adjustment is made to the opening balance of retained earnings in the period of adoption. This additional transition method would change **when** an entity would be required to initially apply the transition requirements, but it would not change **how** those requirements apply. This would allow an entity's prior periods presented in its financial statements to be the same as under current guidance, including disclosures.

Adjust Comparative Periods	Do Not Adjust Comparative Periods
Apply the leases standard to each lease that existed at the beginning of the earliest comparative period presented in the financial	Apply the guidance to each lease that had commenced as of the beginning of the reporting period in which the entity first applies the leases

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statements, as well as leases that commenced after that date. Under this method, prior comparative periods presented are adjusted. For leases that commenced prior to the beginning of the earliest comparative period presented, a cumulative effect adjustment (if necessary) is recognized at that date. The period from the beginning of the earliest comparative period up until immediately before the effective date is referred to as the "look-back period." For example, if an entity adopts ASC 842 as of January 1, 2022, and presents 2021 comparative financial statements, it would: ▪ Apply the ASC 842 transition guidance to leases existing as of January 1, 2021, *e.g.*, record lease liabilities and ROU assets ▪ Recognize and measure leases commencing during the look-back period in accordance with the ASC 842 transition guidance ▪ Account for lease reassessment and lease modification circumstances during the look-back period in accordance with the guidance in ASC 840 if lease classification did not change or ASC 842 if lease classification did change ▪ Provide the disclosures required by ASC 842 for all periods presented	standard with a cumulative effect adjustment (if necessary) as of that date. Prior comparative periods would not be adjusted under this method. An entity that applies this method must provide the required disclosures under ASC 840 for all periods to which ASC 840 is applied, *i.e.*, the prior period(s). For example, if an entity adopts ASC 842 as of January 1, 2022, it would: ▪ Apply the ASC 842 transition guidance to leases existing as of January 1, 2022, *e.g.*, record lease liabilities and ROU assets ▪ Apply ASC 842 guidance related to lease reassessment, lease modifications, lease impairment, etc., for relevant circumstances occurring during 2022 ▪ Recognize and measure leases commencing during 2022 in accordance with ASC 842 ▪ Provide the disclosures required by ASC 842 for the period of adoption, i.e., the current year, and provide the disclosures required by ASC 840 for all periods that continue to be presented in accordance with ASC 840, *i.e.*, the prior year

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Transition Timing – Private Entities, December 31 Year-Ends		
	FY 2021	FY 2022
ASU 2016-02, As issued	**ASC 842** Cumulative catch-up at beginning of first year presented (1/1/19)	**ASC 842**
ASU 2018-11, Optional Transition Relief	**ASC 840**	**ASC 842** Cumulative catch-up at beginning of first year presented

Practical Expedients

Companies are allowed to apply the lease guidance at a portfolio level and elect a package of transition relief. If elected, an entity would not need to reassess the following at adoption:

- Whether any expired or existing contracts are or contain leases
- The lease classification for any expired or existing leases
- Initial direct costs for any existing leases

An entity that elects the transition relief must adopt all three provisions for all leases. The provisions cannot be applied on a lease-by-lease basis.

This relief package should not be applied to grandfather incorrect assessments determined under ASC 840. You should ensure that an analysis of contracts for embedded leases has been performed under ASC 840 before using the practical expedient to carry over the conclusions upon adoption of ASC 842.

Erroneous classifications under prior GAAP cannot be carried forward under the new rules.

Hindsight

An entity can use hindsight in evaluating lessee options to extend or terminate a lease—or purchase the underlying asset—in determining the lease term and assessing impairment of its ROU asset. If elected, a company essentially will continue to account for leases that commence before the effective date in accordance with ASC 840, unless the lease is modified. Hindsight applies to facts and circumstances up to the application date. Events that occur after the application date—but before issuance of the financial statements—should not affect the determination of the lease term or the assessment of impairment.

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Hindsight should be cautiously considered. It requires assessment of facts and circumstances for all leases as of the date of adoption of ASC 842. An entity also must reassess each lease's term based on the guidance for establishing a new lease's term under ASC 842. Note that reassessment of the lease term could affect the classification of the lease (if the package of practical expedients is not elected) and measurement of the lease. Since this is required for all leases, and requires consideration of market-, asset-, and entity-based factors as of the effective date, it could result in a significant undertaking for entities with large lease portfolios.

Land Easements

Land easements—also referred to as rights of way—represent the right to use, access, or cross another entity's land for a specified purpose. These easements take many forms—they may be perpetual or term-based, provide for exclusive or nonexclusive (shared) use of the land, and may be prepaid or paid over a defined term. Because a land easement conveys a right to use land, FASB's intention was that all those arrangements need to be evaluated to determine if they meet ASC 842's lease definition. Energy and telecom companies lobbied for relief.

FASB responded with ASU 2018-01, which provides an optional practical expedient. If elected, an entity would not apply ASC 842 to existing or expired land easements that are not currently accounted for under ASC 840. An entity would continue to apply its current accounting policy for those land easements. Only new or modified land easements would be assessed under ASC 842 to determine whether it is or contains a lease. This election must be applied to all an entity's land easements and not on a contract-by-contract basis. Because this election applies to existing and expired land easements, it can be elected independently of the other practical expedients above.

A company that currently applies ASC 840 for land easements would not be able to elect this practical expedient. Instead, current accounting would be maintained until adoption of ASC 842. If the arrangements were considered operating leases under ASC 840, those land easements generally would go on the balance sheet at adoption. At that point, the company could elect the package of practical expedients noted above, which permits an entity to grandfather its prior conclusions.

Impairment & Exit Cost Considerations at Transition

At the effective date, a lessee's ROU asset is subject to impairment guidance in ASC 360, *Property, Plant, and Equipment*. ASC 360 requires analysis of impairment indicators at each reporting date and is performed at the asset or asset-group level. If any indicators of impairment are present, a recoverability test is performed. Recoverability is determined by comparing the carrying amount of the asset group to the estimated future undiscounted cash flows expected from the company's use and eventual disposition

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of the asset group over the remaining life of the primary asset. If the ROU asset or group of assets fails the recoverability test, ASC 360 requires a fair value test. An impairment loss would be recognized based on the amount by which the carrying value of the asset group exceeds its fair value.

Once an ROU asset is impaired, lease expense is no longer recognized on a straight-line basis as the amortization of the ROU asset is “de-linked” from the lease liability. Prior to impairment, the amortization of the ROU asset is determined as the difference between the straight-line lease expense and the effective interest calculated on the lease liability. However, once the ROU asset is impaired, the lessee will continue to amortize the lease liability using the same effective interest method as before the impairment charge, whereas the ROU asset will be amortized on a straight-line basis. This causes the lease expense to be variable after impairment of the ROU asset.

Prior unrecognized liabilities/impairments may need to be recognized at adoption. Previously, companies applied ASC 420, *Exit and Disposal Costs*, to lease arrangements. If certain criteria were met, ASC 420 required a company to recognize a liability for the fair value of the remaining above-market lease payments. Under ASC 420, an entity would record the liability regardless of whether the lessee has the intent to sublease the asset. Under ASC 842, an entity must determine whether the leased asset is abandoned in accordance with ASC 360. Under ASC 842, an ROU asset is not considered to be abandoned if an entity has ceased use of the underlying asset but is currently subleasing (or plans to sublease) the asset. Therefore, any lease liabilities previously recognized under ASC 420 should be eliminated at transition by offsetting the pre-existing liability against the newly recognized right to use asset. If an entity ceases use of a leased asset before adopting ASC 842 and does not have the intent and ability to sublease the asset, the entity should not recognize an ROU asset upon adopting ASC 842 and should write off any related liability at transition.

BTS Transition

Another consideration during transition is the accounting for BTS leases, including derecognition of BTS-related assets and liabilities. Under ASC 840, in a BTS arrangement under the old leases standard, the lessee was often required to account for the construction project as if it was the owner of the project. Frequently, the lessee recorded an asset for all construction costs and a liability for the construction costs that were paid by the lessor. In many cases, the lessee was not able to derecognize the project’s assets and liabilities after construction was complete due to the prescriptive sale-leaseback rules.

Upon adoption of ASC 842, if construction is completed by the effective date, then lessees will derecognize any assets and liabilities that continued to be recognized solely as a result of the previous BTS accounting. The asset is derecognized regardless of whether the lessee would have been the accounting owner under the new standard. However, when construction is still in progress as of the effective date, the transaction must be reassessed under the control-based BTS model in ASC 842. If the

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lessee is determined not to be the accounting owner under ASC 842, the lessee will derecognize any assets and liabilities that resulted from previous BTS accounting.

BTS Transition			
	Guidance	**Lessee is not accounting owner**	**Lessee is accounting owner**
Construction completed before effective date	ASC 840	Apply lessee transition guidance	Derecognize asset and liability, recognize difference in equity, apply lessee transition guidance
Construction in progress at effective date	ASC 842	Derecognize asset and liability, recognize difference in equity, apply lessee transition guidance	Continue to account for BTS under ASC 842

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Identifying Minimum Rental Payments

In transitioning to ASC 842, the lease obligation for an operating lease is measured by using the remaining minimum rental payments. However, under ASC 840, there is diversity in practice related to how an entity quantifies minimum rental payments for the disclosures related to future operating lease

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commitments, specifically on the treatment of executory costs and lease payments that depend on an index or rate.

Operating Lease Payments with Variable Index

Some companies use an updated rate each time the disclosure is prepared while others use the rate at lease inception. If an entity changes from its historical approach of using the inception rate to an updated rate, and the historical approach represents a material accounting policy, preferability is required and an entity must retrospectively apply the change in accordance with ASC 250. If an entity historically updated the rate for disclosure purposes, the entity may change to the inception rate without having to perform a preferability assessment, based on FASB feedback. If, based on materiality, the historical rate disclosure is not considered an elected accounting policy, an entity could change the approach without establishing preferability and is not required to reflect the changes in prior period. The approach taken should be properly documented and reviewed with your auditor.

Executory Costs for Operating Leases

Under ASC 840, companies could either include or exclude executory costs from the disclosure of minimum rental payments for operating leases. FASB has indicated that a lessee should use its ASC 840 disclosure approach to determine the lease payment when establishing its lease liability under ASC 842. An entity may change its historical approach:

- If the inclusion (exclusion) of executory costs does not have a material effect on the financial statements, a lessee may change its treatment without assessing preferability.
- If an entity's historical approach has a material effect on its financial statements, it generally will represent the election of an accounting policy and must be applied retrospectively to all periods presented under ASC 840.

Executory Costs	
ASC 840	ASC 842
Maintenance = Executory costs Diversity in practice on inclusion of executory costs in minimum rental payments	Maintenance = Nonlease component Continue to apply election policy under ASC 840 when calculating the lease liability in transition
An entity may elect to combine lease and nonlease components in transition	

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Conclusion

ASC 842 adoption will be complex and likely will require significant hours to correctly implement. **FORVIS** can help educate your team, provide implementation tools, and assist with analysis and documentation. If you would like assistance in complying with ASC 842, contact a professional at FORVIS. We have prepared a library of **FORsights**™ on this issue. Visit our website to learn more.

Contributor

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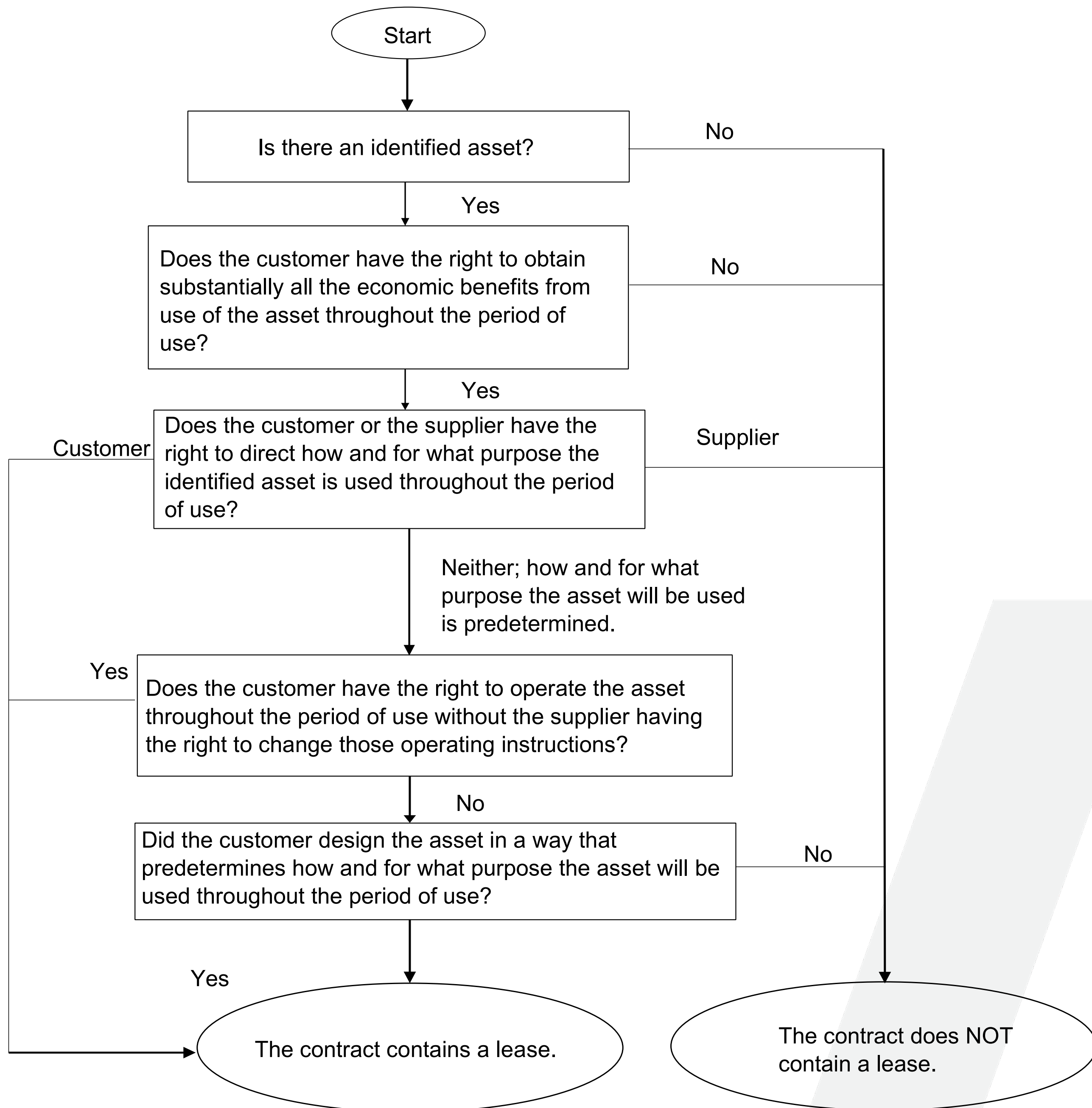
Appendix – Identifying a Lease



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