TOPIC 842, LEASES

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INTRODUCTION

In early February 2016, the Financial Accounting Standards Board ("FASB" or "the Board") issued its highly-anticipated leasing standard in FASB Accounting Standards Update (ASU) 2016-02[1] ("Topic 842" or "the new standard") for both lessees and lessors. Under its core principle, a lessee will recognize right-of-use (ROU) assets and related lease liabilities on the balance sheet for all leases except for short-term leases for which the recognition exemption is elected. The most significant change will be on the balance sheet for lessees. The pattern of expense recognition in the income statement will depend on a lease's classification and will be consistent with current U.S. GAAP.

Under prior U.S. GAAP, the key determination was whether a lease was an operating lease or capital lease as that drove whether a lease was recognized on the balance sheet. There were no major differences in accounting between an operating lease and an executory contract, and, accordingly, entities may not have historically put significant focus on the prior lease definition. Under the new standard however, the key determination will be whether a contract is or contains a lease as that will drive whether a contract is recognized on the balance sheet. Accordingly, entities may need to devote significant time on this aspect of the guidance to ensure that they comply with the new requirements.

The following table summarizes lessee accounting for finance and operating leases:

FINANCIAL STATEMENT	FINANCE LEASE	OPERATING LEASE
Balance Sheet	Recognize ROU asset and lease liability at the commencement date of the lease. The lease liability, initially and subsequently, is measured at the present value of the remaining lease payments. The ROU asset initially is measured at the amount of the lease liability recognized, plus initial direct costs and prepaid lease payments, less lease incentives received. The ROU asset is subsequently amortized generally on a straight-line basis.	Recognize ROU asset and lease liability at the commencement date of the lease. The initial and subsequent measurement of the lease liability, and the initial measurement of the ROU asset, are the same as for finance leases. The ROU asset is subsequently amortized in such a way that the lease cost is recognized generally on a straight-line basis over the lease term in the income statement.
Income Statement	Recognize interest on the lease liability separately from amortization of the ROU asset.	Recognize a single lease cost, calculated so that the cost of the lease is allocated over the lease term, generally on a straight-line basis.
Cash Flows	Classify repayments of the principal portion of the lease liability within financing activities and payments of interest on the lease liability and variable lease payments within operating activities.	Classify all cash payments for leases within operating activities.

[1] Leases (Topic 842)
[2] Revenue from Contracts with Customers (Topic 606)

Lessor accounting remains largely consistent with previous U.S. GAAP, but has been updated for consistency with the new lessee accounting model and with the new revenue standard, ASU 2014-09.[2]

For calendar-year public business entities the new standard takes effect in 2019, and interim periods within that year; for all other calendar-year entities it takes effect in 2020, and interim periods in 2021.

This publication summarizes the new leasing guidance, including practical examples to assist practitioners. It also includes our observations on key concepts, as well as insights into how certain aspects of the new standard compare with prior U.S. GAAP.

BACKGROUND

The FASB leases project began as one of several joint projects with the International Accounting Standards Board (IASB) aimed at converging U.S. GAAP and International Financial Reporting Standards (IFRS). The objective of updating the leases guidance was to increase transparency and comparability among organizations by recognizing lease assets and lease liabilities on the balance sheet and disclosing key information about leasing arrangements. The new guidance is intended to address stakeholder concerns that previous leases guidance did not result in a faithful representation of leasing transactions, specifically that the rights and obligations associated with operating leases were not recognized on the balance sheet.

Observation: Although the Board acknowledged in paragraph 110 in the Basis for Conclusions that the conceptual basis for excluding leases of intangible assets, inventory and assets under construction from the scope of the new standard is unclear, it nonetheless decided to continue to limit the scope of the new standard to property, plant or equipment only. As a result, those other arrangements will continue to be accounted for under Topic 350, Topic 330 and Topic 360, respectively. In addition, leases to explore for or use minerals, oil, natural gas and other similar resources, including leases of mineral rights, will continue to be accounted for under Topics 930 and 932, while leases of biological assets, including timber, will continue to be accounted for under Topic 905.

After several years of deliberations and two exposure drafts, the FASB and IASB reached different conclusions regarding the treatment of leases, and each of the Boards issued separate guidance early in 2016. Refer to **Appendix C** for a brief summary of the differences between Topic 842 and IFRS 16, Leases.

SCOPE

The scope of the new standard is generally consistent with prior guidance, and limits the application of the standard to leases of property, plant or equipment. The Master Glossary defines a lease as "a contract, or part of a contract, that conveys the right to control the use of identified property, plant, or equipment (an identified asset) for a period of time in exchange for consideration".
For a contract to be or include a lease, there must be an identified asset and the contract must grant to the customer both (a) the right to obtain substantially all of the economic benefits from the asset's use (the economic criterion), and (b) the right to direct the use of the identified asset throughout the period of use (the power criterion).

Identified Asset + Economic Criterion + Power Criterion = Lease

IDENTIFIED ASSET

In order to have an identified asset, a contract must either explicitly or implicitly specify the asset. Similar to prior requirements, an asset is not considered specified if the supplier has the right to substitute similar assets during the term of the contract and therefore maintain control. However, under the new standard substitution rights are considered substantive as described in ASC 842-10-15-10 only if the lessor (a) has the practical ability to substitute alternative assets throughout the period of use and (b) would benefit economically from the substitution. If a supplier's substitution rights are substantive, then the contract does not specify an identified asset, and thus does not contain a lease. A supplier's right to substitute the asset only on or after a particular date or event, for repairs and maintenance or based on the availability of a technical upgrade, are not considered substantive. In addition, the standard states that if the asset is located at the customer's premises, the costs associated with substituting the asset are generally higher than when located at the supplier's premises, and therefore are more likely to exceed the related benefits, and thus the substitution right would not be substantive. If the customer cannot determine whether a substitution right is substantive, the customer must presume that the substitution right is not substantive (that is, there is an identified asset, and the entity must evaluate the economic and power criteria to determine whether there is a lease).

Observation: The requirement that a right of substitution must provide economic benefits to the supplier in order to be considered substantive is new, and may require significant judgment. Because of this guidance, more contracts may be deemed to include a lease because they include an identified asset than under prior guidance. This determination becomes more important under the new guidance due to the balance sheet implications for the lessee.

RIGHT TO CONTROL USE (ECONOMIC AND POWER CRITERIA)

As previously explained, in addition to relating to an identified asset, a contract must convey to the customer the right to control the use of the asset, which is met when the customer has both (a) the right to obtain substantially all the economic benefits from the use of the asset (the economic criterion), and (b) the right to direct the use of the asset (the power criterion) throughout the period of use.

A customer can obtain economic benefits from use of an asset directly or indirectly in many ways, such as by using, holding, or subleasing the asset. The economic benefits from use of an asset include its primary output and by-products (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.

A customer has the right to direct the use of the asset if (1) it can direct, including how and for what purpose the asset is used throughout the period of use, or (2) when all the relevant decisions are predetermined, if the customer either designed the asset in a way that predetermined its use or the customer has the right to operate (or direct others in operating) the asset throughout the period of use. The relevant decision-making rights to consider include, for example, the right to change the type of output produced by the asset, the right to change when or where the output is produced, the right to change whether the output is produced and how much output is produced, if any. These rights are examples only, and are neither determinative nor prescriptive. For example, a requirement to use an asset in a specified location does not necessarily imply that the lessee does not direct the use of the asset.

Example 1: Customer enters into a contract with Manufacturer for the use of a copy machine for three years. Under the contract, the copier is explicitly specified by serial number, but Manufacturer has the right to replace the copier at any time during the agreement, including in lieu of repairing it. While the contract specifies a location for the copier, Customer has the right to move the copier to any of its facilities upon three days written notice to Manufacturer.

The contract contains a lease. There is an identified asset, and Customer has the right to control the use of the asset throughout the three-year period of the contract.

Although Manufacturer has the right to replace the copy machine at any time, such substitution would not generate an economic benefit for Manufacturer. As noted in ASC 842-10-15-12, if the asset is located at the customer's premises, then the costs associated with substitution are likely to exceed the benefits associated with substituting the asset. Specifically, in this example the supplier would incur costs to substitute the copy machine, such as transporting and installing another copy machine and removing and transporting back the original copy machine. It is not likely that events or circumstances would arise at contract inception from which the supplier would generate more income by substituting the copy machine than the costs it would incur.

Customer also has the right to obtain substantially all of the economic benefits from the use of the copier because it has exclusive use of the copier, and Customer has the right to direct the use of the copier, including when to use it and for how long, as well as the right to move it to another location, throughout the three-year period.

Both the economic and control criteria are evaluated within the defined scope of the customer's right to use the asset. Terms that limit the use of the asset a certain way (for example specifying a maximum amount of usage of the asset) or that protect the supplier's interest in the asset (such as requiring the customer to follow industry-standard operating procedures, or requiring notification of changes in how or where the asset will be used) do not, in isolation, prevent the customer from having the right to direct the use of the identified asset. For example, if a customer enters into a contract for the use of a corporate jet for a two-year period, restrictions within the contract limiting the number of hours the jet can be flown and/or which territories the aircraft can fly over will not prevent the customer from directing the use of the aircraft if, within that defined scope of the contract, the customer for example has exclusive use of the corporate jet throughout the two years (i.e., the economic criterion is met) and the customer decides where and when the aircraft will travel and what passengers and cargo it will transport throughout the two years (i.e., the power criterion is met).

LAND EASEMENTS

Land easements (also commonly referred to as rights of way) represent the right to use, access, or cross another entity's land for a specified purpose. Easements are used in a variety of industries, but are especially common in the energy, utilities, transportation and telecom industries. For example, an electric utility will typically obtain a series of contiguous easements so that it can construct and maintain its electric transmission system on land owned by third parties. A land easement may be perpetual or term based, provide for exclusive or nonexclusive use of the land, and may be prepaid or paid over a defined term. Diversity in practice has historically existed in U.S. GAAP in the accounting for land easements. Entities have typically accounted for their land easements by applying Topic 350, Intangibles–Goodwill and Other, Topic 360, Property, Plant, and Equipment, or Topic 840, Leases.

In January 2018, the FASB issued ASU 2018-01[3] which clarified that land easements should first be evaluated under the new standard to determine whether they are or contain a lease.

However, considering the diversity in accounting today in how entities applied U.S. GAAP to land easements, the FASB provided transition relief for existing land easements, as further discussed below in the **"Transition"** section. Once an entity adopts Topic 842, it must apply that Topic prospectively to all new or modified land easements that meet the definition of a lease in Topic 842.

[3] Leases (Topic 842): Land Easement Practical Expedient for Transition to Topic 842

Example 2: Telco enters into an agreement with Logistics Company. Under the agreement, Telco requires Logistics Company to build or otherwise obtain a warehouse in a specified geographic location. While Logistics Company has latitude in selecting the facility, it must be located in the specified area, and once selected cannot be relocated, even within the specified area, absent extraordinary circumstances (for example, destruction by fire). For the five-year term of the agreement, Logistics Company will process all returned handsets directed by Telco to this warehouse pursuant to repair instructions provided by Telco. If Telco does not direct handsets to the warehouse, then the warehouse does not operate. Logistics Company is not allowed to service any customers other than
Telco in the warehouse under the agreement. Logistics Company is required to operate and maintain the warehouse on a daily basis in accordance with industry- approved operating procedures.

Even though in form this arrangement appears to be a service contract, the agreement contains a lease of the warehouse. Telco has the right to use the warehouse for five years. The arrangement includes an identified asset because the facility is implicitly specified once the location is selected. Once selected, Logistics Company does not have the right to substitute the specified warehouse. Telco has the right to control the use of the warehouse throughout the five-year term of the contract because it has the right to obtain substantially all of the economic benefits from the use of the warehouse (Telco has exclusive use of the warehouse), and it has the right to direct the use of the warehouse. Telco makes the relevant decisions about how and for what purpose the warehouse is used throughout the five-year period because it has the right to determine whether, when and how much activity will occur at the warehouse. Because Logistics Company is precluded from using the warehouse for any other customer or purpose, Telco's decision making about the timing and quantity of handsets processed in effect determines when and whether the warehouse will be utilized.

SHORT-TERM LEASES

The new standard provides lessees with a practical expedient related to short-term leases. Lessees can elect an accounting policy under which the recognition provisions of the standard are not applied to leases with lease terms of 12 months or less and that do not include an option to purchase the underlying asset that is reasonably certain to be exercised. This election must be made by asset class. If elected, leases that qualify for the exemption are not recognized on the balance sheet and lease payments related to these short term leases are recognized on a straight-line basis over the lease term, consistent with current accounting standards.

This recognition exemption however does not mean that short-term leases are scoped out of the new requirements. To qualify as short-term leases, lessees will need to assess the lease term like any other leases (e.g., determine whether it is reasonably certain the lessee will exercise a renewal option). Short-term leases will be subject to the reassessment requirements of the new standard and other requirements in the new standard, including disclosures.

Accordingly, lessees will need to have appropriate processes and controls under the new standard, even for short-term leases.

Example 3: Builder is engaged to construct a 60 story building, and leases a crane from Supplier Co. for the six months during which the frame will be erected.

The lease agreement specifies a crane to be used, and although it does not allow the crane to be relocated without Supplier Co.'s approval, it otherwise allows Builder to direct the use of the crane. The lease does not include any renewal options, although in practice Builder could re-lease the crane at then current market rates at the end of the lease term.

The agreement includes a lease. However, because the duration of the contract is only six months, it qualifies for the practical expedient. If the lessee elects the short-term lease exemption for this asset class, Builder can account for the lease on a straight-line basis through income, without recognizing an ROU asset and a related lease liability on the balance sheet.

Example 4: Assume the same facts as in Example 3, with the exception that the contract does not specify a fixed duration. Instead, the crane is subject to a daily rental rate, with weekly rent payments, and can be retained indefinitely.

The agreement still contains a lease. In order to determine whether the lease qualifies for the practical expedient for short term leases, Builder must analyze the lease term, as further discussed below in the "Lease Term" section. In this scenario, given that Builder determines the most likely duration based on need to be six months, coupled with the physical difficulties of replacing the equipment during that period with another crane with this functionality and the limited number of available cranes of this magnitude in the market, Builder determines that the term is six months. Therefore, Builder can elect to apply the practical expedient for short-term leases, consistent with the FASB's intent (see paragraph 379 in the Basis for Conclusions).

Example 5: Calendar Co. manufactures and sells calendars. In order to sell its calendars directly, it enters into an agreement to lease a storefront in a mall for the months of November and December each year for five years. The agreement specifies the storefront, and the mall owner cannot substitute another storefront.

The agreement contains a lease. In order to determine whether the term is more than twelve months, Calendar Co. considers that "period of use" is defined in ASC 842-10-20 as "[t]he total period of time that an asset is used to fulfill a contract with a customer (including the sum of any nonconsecutive periods of time)." Because the periods of use are not consecutive, Calendar Co. must consider the aggregate term in order to determine whether it can apply the practical expedient for short term leases. The total aggregate term of the lease is ten months (two months per year for five years), and therefore Calendar Co. can elect to apply the practical expedient for short-term leases.

Observation: Topic 842 does not provide a scope exception for small value leases, similar to the exception provided in IFRS 16, the leasing standard issued by the IASB. Nonetheless, the FASB does note in paragraph 122 in the Basis for Conclusions that entities may adopt reasonable capitalization thresholds below which lease assets and lease liabilities are not recognized, consistent with other applications of accounting policies, such as capitalization of property, plant and equipment. We believe that any application of a lease capitalization threshold should result in materially the same result when considering all leases, not solely the impact from applying the policy to a single lease, and must consider the impact of not recognizing both the right-of-use asset and the lease liability. Careful consideration should be given to the resulting non-recognition of lease liabilities which may result in the use of lower capitalization thresholds for leases as compared to property, plant, and equipment.

UNIT OF ACCOUNT

Because the definition of a lease includes an identified asset, the unit of account is typically the individual asset. Therefore, if a contract includes the lease of multiple assets, it should be separated into multiple lease components if the lessee can benefit from the right to use each asset on its own or in conjunction with other readily available resources, and the right of use is neither highly dependent on nor highly interrelated with the other rights to use assets in the contract. The new standard also contains guidance requiring separate accounting for the land and building components, unless the effect of separating the land component would be insignificant.

In addition, two or more leasing contracts must be combined when they are entered into at or near the same time with the same counterparty or related parties, if (1) they were negotiated as a package with the same commercial purpose, (2) the amount of consideration to be paid in one contract depends on the price or performance of the other one, and (3) the rights to use the underlying assets conveyed in the contracts are a single lease component based on the separation guidance described above.

In addition, both lessees and lessors must separate lease components from non-lease components. For purposes of this analysis, administrative tasks to initiate a lease and reimbursement of the lessor's costs (such as property taxes and insurance) are not considered components, and any consideration for those items therefore should be allocated to the components of the contract.

The consideration in a contract must be allocated among the lease and non-lease components of the contract. See **"Lease Payments"** section for further information about what payments are included in lease payments, as defined in Topic 842.

Example 6: Clean Air Co. provides air purification systems, primarily to hospitals and other healthcare facilities, under leasing arrangements. Each system consists of multiple air filters installed throughout the lessee facility, in an amount and at locations determined based on the size and design of the facility.

Because of airflow throughout the lessee facility, any individual air filter is ineffective on its own. Achieving air purification requires the full complement of air filters provided in the arrangement. Therefore, the use of each air filter is highly dependent upon the use of the other air filters, and the arrangement is deemed to contain only one lease component.

Example 7: Lighting Co. provides energy-efficient light fixtures, primarily in industrial settings, under leasing arrangements. Payments under the leasing arrangements are based on calculated cost savings to the lessee. Each arrangement consists of multiple light fixtures installed throughout the lessee facility, in an amount and at locations determined based on the size and design of the facility.

The primary purpose of the light fixtures is to provide a lower cost alternative to traditional lighting solutions. Each light fixture provides a similar estimated cost saving, and would provide the same level of cost savings regardless of whether the fixture was installed on its own, or as part of a larger installation. Therefore, the lessee can benefit from the right to use each light fixture on its own, and the use of each light fixture is neither highly dependent upon nor highly interrelated with the use of the other light fixtures. As such, the arrangement is deemed to contain multiple lease components, one for each light fixture.

Observation: The guidance in ASC 842-10-15-28 on determining whether one or more lease components should be accounted for separately is similar to the guidance in ASC 606-10-25-19 through 25-21 on determining whether a good or service promised in a revenue contract is distinct, and therefore represents a separate performance obligation. By the same token, the guidance in ASC 842-10-25-19 on when to combine contracts is almost identical to the guidance in ASC 606-10-25-9 on combining revenue contracts. This linkage is intentional, as the new lease standard incorporates concepts from the new revenue recognition guidance, in particular the concept of control.

Observation: While Topic 840 also requires separation of lease and non-lease elements, given the similarities between current operating lease treatment and accounting for service contracts, this distinction often was not critical to the accounting. However, given the balance sheet implications of the new guidance for lessees, this distinction will become more important. For example, if a company leases one floor of a multi-story building as its office, and the lease payments include the cost of common area maintenance, the portion of the lease payments related to the maintenance will need to be bifurcated and accounted for separately unless the entity elects the practical expedient and accounts for it in conjunction with the lease (see later for discussion).

Lessees must allocate the consideration to the separate lease and non-lease components on a relative standalone price basis. If observable standalone prices are not readily available, lessees must estimate standalone prices maximizing the use of observable information to the extent possible. The residual approach may be acceptable if the standalone price for a component is highly variable or uncertain.

However, the new standard does allow lessees a practical expedient under which entities can elect not to separate non- lease components under the contract, but instead account for them as part of the associated lease component. That results in a larger ROU asset and lease liability, and it may result in a change in lease classification, so companies will need to consider whether they will avail themselves of the practical expedient. The election is by asset class.

Lessors must allocate the consideration in the contract using the revenue guidance in ASC 606-10-32-28 through 32-41.

In addition to amounts identified as lease payments, lessors should also include variable payments (other than those based on an index or rate) that relate specifically to (a) the lessor's efforts to transfer one or more goods or services that are not leases or (b) an outcome from transferring one or more goods or services that are not leases in the total arrangement consideration for purposes of allocating consideration to lease and non-lease components.

Example 8: Lessee leases a car for its salesperson from Dealership for three years. Under the lease, Lessee has the right to drive the car for up to 15,000 miles per calendar year and to bring the car into the maintenance department of Dealership once per quarter for regularly scheduled maintenance as defined in the lease agreement. In addition to fixed lease payments of $415 per month, Lessee is required to maintain full coverage insurance on the car to protect the lessor's asset and to pay for any maintenance services required beyond regularly scheduled maintenance defined in the lease agreement. At the end of the lease term, Lessee is also required to make additional lease payments on a per mile basis for any mileage greater than 45,000 miles.

In this example, the lease contains two components, a car lease component and a maintenance component. If Lessee has elected the practical expedient in ASC 842-10-15-37, Lessee would not separate the two components, but would instead account for the combined contract as a single lease component. Lessee must elect the practical expedient by class of underlying asset, in this case, automobile leases.

If Lessee has not elected the practical expedient for this asset class, Lessee would allocate the total consideration in the contract between the car lease and the maintenance components on a relative standalone price basis. Although Lessee is required to maintain insurance coverage, that requirement does not represent a separate component in the contract, but represents a lessor cost of owning the asset. In addition, because Lessee must contract directly with an insurance agency of its choice, those payments are not part of the consideration in the contract with the dealership, but rather are variable payments. By the same token, any additional maintenance services or charges for excess mileage would also be considered variable consideration and not included in the computation of total consideration in the contract. Thus the only amounts to be included in the consideration in the contract are the fixed monthly payments, which total $14,940 over the lease term.

In order to allocate the total consideration in the contract between the car lease and the maintenance services, Lessee should identify observable standalone prices for the maintenance services and for the vehicle lease. Lessee determines that it could enter into a maintenance agreement with an unrelated service center for $30 per month, and Dealership commonly leases the same car on a standalone basis for $400 per month. Therefore, the consideration in the contract is allocated to the lease and non-lease components as follows:

	Standalone Price	Relative Standalone Price
Car lease	$14,400	$13,898
Maintenance	1$,080	$1,042
	$15,480	$14,940

Lessee will also use this same allocation when accounting for, and allocating, the variable payments, unless Lessee is required to update the allocation subsequently.

In August 2018, the FASB released an exposure draft[4] which clarifies that a lessor should exclude from variable payments any lessor costs paid directly by a lessee to a third party when the amount of those costs is not readily determinable by the lessor. An example of such costs are insurance for a leased asset negotiated and paid directly by the lessee, but with the lessor as the named insured. While these costs would be considered variable payments by the lessee, the lessor would exclude such payments from its recognition of variable payments, as well as the related expense.

In July 2018, the FASB issued ASU 2018-11[5] , which provides lessors with a similar practical expedient as lessees. Under ASU 2018-11, a lessor may, as an accounting policy election, choose to not separate nonlease components from lease components and, instead, to account for each separate lease component and the nonlease components associated with that lease component as a single lease component if the nonlease component(s) otherwise would be accounted for under Topic 606 and (1) the timing and pattern of transfer for the lease component and nonlease component(s) associated with that lease component are the same and (2) the lease component, if accounted for separately, would be classified as an operating lease. This election must be made by asset class. For arrangements that qualify for this practical expedient, a lessor will account for the combined component as a single performance obligation in accordance with Topic 606 when the nonlease component(s) associated with the lease component is the predominant component of the combined component. Otherwise, the lessor will account for the combined component as an operating lease in accordance with Topic 842.

When a contract includes a lease component and multiple nonlease components, the fact that some nonlease components do not meet the conditions for combining (e.g., a nonlease component that transfers at a point-in-time) does not preclude the lessor from qualifying for the practical expedient. However, in those situations the lessor must combine all nonlease components that qualify with the associated lease component, and account for those as a single component. The nonlease components that do not qualify should be accounted for separately. Accordingly, the lessor is required to separate and allocate the consideration in the contract between the combined component on one hand and the nonlease components that do not qualify on the other hand.

PORTFOLIO APPROACH

The new lease standard allows for a portfolio approach. Specifically, paragraph 120 in the Basis for Conclusions indicates that the standard permits both a lessee and a lessor to apply the leases guidance at a portfolio level for leases with similar characteristics as long as the use of the portfolio approach would not differ materially from the application of the new standard to the individual leases in the portfolio.
ASC 842-20-55-18 through 55-20 provide an example in which the portfolio approach is utilized in determining the discount rate for the lease.

[4] Proposed Accounting Standards Update-Leases (Topic 842): Narrow-Scope Improvements for Lessors
[5] Leases (Topic 842): Targeted Improvements

Example 9: REIT Co. owns a multi-tenant commercial building, and enters into a lease with Tenant Inc. for one floor in the building for a term of five years. The lease is a modified gross lease, in which Tenant Inc. will pay a fixed monthly rent payment of $10,000. In addition, during years two through five of the lease, Tenant Inc. will pay its pro rata share of the increase of common area maintenance costs above the base year cost.

Provision of common area maintenance is considered a nonlease, service element of the arrangement, and there are no other nonlease components. REIT Co. considers whether it can elect the practical expedient to not separate the nonlease maintenance component from the lease. Because the maintenance service would be in the scope of ASC 606 if accounted for separately, REIT Co. considers whether the timing and pattern of transfer of the maintenance service and the lease are the same, and concludes that they are. In making this determination, REIT Co considers the following:

- The benefit of the lease transfers to Tenant Inc. evenly over time (i.e., straight-line) because the lease would be an operating lease if accounted for separately.
- The maintenance services are also transferred to Tenant Inc. over time using a time-based measure of progress. Specifically, the maintenance services are considered a stand-ready obligation to provide common area maintenance throughout the five-year term of the lease and represents a series.

Therefore, REIT Co. concludes that the practical expedient is available for this lease agreement, and it elects to use the practical expedient to account for the lease and nonlease components together as a single component for this asset class. REIT Co. then considers whether the lease component or the nonlease maintenance component is predominant, and concludes that the lease component is predominant. Therefore, it accounts for the single component as an operating lease under ASC 842.

LEASE CLASSIFICATION

The new lease standard carried forward lease classifications that are generally consistent with previous U.S. GAAP. For lessees, leases are classified as either an operating lease or a finance lease, while for lessors, leases are classified as sales-type, direct financing or operating. The one exception is that, for lessors, the new standard no longer allows leveraged lease treatment for leases that are entered into or modified after the effective date of the new standard. As a result, new or modified leases that previously met the definition of a leveraged lease will be accounted for as one of the other three types of leases. Existing leveraged leases are grandfathered into the new standard, and should continue to be accounted for by the lessor under Topic 840 until they expire or are modified.

Observation: We believe many entities (including real estate entities and cable companies) will welcome this lessor practical expedient as it generally will enable them to account for their transactions under the new lease or revenue standards in a manner similar to how they have accounted for them in the past.

The following considerations are important in understanding (and evaluating whether a lessor qualifies for) the practical expedient:

- The practical expedient applies only to nonlease components that otherwise would be accounted for under Topic 606. It does not apply, for example, to a contract that includes a lease component and a loan component accounted for under Topic 310 on receivables.
- Because of the condition that the lease component be classified as an operating lease if separated, this means that the timing and pattern of transfer of the nonlease components also must be straight-line (i.e., over time, time-based) to qualify for the practical expedient.
- Determining whether the lease component would be classified as an operating lease if accounted for separately generally should not require a detailed quantitative analysis and may often be determined using a reasonable qualitative assessment.
- A lessor should be able to reasonably determine which component is predominant (i.e., a lessor does not have to perform a detailed quantitative analysis or theoretical allocation). We believe entities may use a >50% threshold in determining which component is predominant for this lessor practical expedient, even though this may not necessarily align with how the concept of predominance is described under Topic 606.

Lease classification should be determined upon, and recognition of leases begun on, lease commencement, which is defined as the date when the lessee obtains the right to use the asset. Any changes to the assumptions between lease commencement and the start of payments under the lease should be accounted for as a reassessment by lessees, as further described in the **"Reassessment"** section.

Leases must be classified as finance leases by a lessee and sales-type leases by a lessor if any one of the following five criteria are met:

- The lease transfers ownership of the underlying asset to the lessee by the end of the lease term.
- The lease grants the lessee an option to purchase the underlying asset that the lessee is reasonably certain to exercise.
- The lease term is for the major part of the remaining economic life of the underlying asset. However, this criterion is not used if the lease commences at or near the end of the asset's economic life.
- The present value of the sum of the lease payments and any residual value guaranteed by the lessee that is not already reflected in the lease payments equals or exceeds substantially all of the fair value of the underlying asset.
- The underlying asset is of such a specialized nature that it is expected to have no alternative use to the lessor at the end of the lease term.

Observation: Under Topic 840, a leverage lease is one that meets the criteria to be classified as a direct financing lease, but also includes a long-term creditor that provides financing in an amount sufficient to provide the lessor with significant leverage in the arrangement. In addition, the lessor's net investment in the lease must decline during the early years and rise during the later years of the lease, typically due to tax-related cash flows. Given the requirement in Topic 840 for leveraged leases to first meet the criteria for direct financing leases, we believe it is likely that many new or modified leases that would have historically been accounted for as leveraged leases will be accounted for as a sales-type or direct financing lease under the new standard.

Example 10: Burgers R Us enters into a ground and building lease to be used for a new restaurant. The lease provides for payments of $16,000 per month if Burgers R Us begins operations in the location on or before November 1, 2012. Monthly lease payments increase by $500 for every month the grand opening is delayed beyond November 1, 2012. The lease term ends ten years after the first payment, which is due when the restaurant opens for business. The lease is entered into on May 1, 2012, at which time both lessee and lessor begin the work to obtain the relevant permits required to operate a Burgers R Us restaurant in that location.

The relevant permits are obtained, and the lessor grants access to Burgers R Us to the site on August 1, 2012. At that time, Burgers R Us begins leasehold improvement construction and other efforts required to conform the building to its brand requirements. The restaurant opens for business on December 1, 2012, at which time payments under the lease begin.

The lease commencement date is August 1, 2012. Although payments have not begun, Burgers R Us has the right to control access to and use of the building, as evidenced by starting construction on leasehold improvements. Lease classification should be determined, and lease recognition should begin, as of that date. Because Burgers R Us does not know at lease commencement when lease payments will begin or the amount of lease payments, the total payments and term must be estimated. The lease liability and ROU asset should be remeasured when the contingencies are resolved to reflect any difference between the estimate at lease commencement and the final amounts. See **"Reassessment"** section for further information on performing the remeasurement.

If the lease agreement includes the right to use multiple assets with different useful lives, and they are not separated into separate lease components as previously discussed, then the economic life of the predominant asset should be used when determining whether the lease term is for the major part of the remaining economic life of the underlying asset.

The first four criteria are consistent with the criteria in prior guidance, albeit without the bright line thresholds. If the lease transfers ownership of the underlying asset prior to the end of the lease term, or includes a purchase option that the lessee is reasonably certain to exercise, then the lease should be accounted for as a finance lease/sales-type lease. In determining whether the lessee is reasonably certain to exercise a purchase option, both lessee and lessor should consider the purchase price inherent in the option, as well as other economic factors related to the asset and the company's economic environment, as further discussed under **"Lease Term".**

Under the new standard, the FASB removed the bright line thresholds from the third and fourth criteria, while retaining the intent and substance of the prior guidance. However, ASC 842-10-55-2 indicates that one reasonable approach to determining whether either of these criterion have been met would be to conclude that 75% or more of the remaining economic life represents a major part, while 90% or more of the fair value of the underlying asset amounts to substantially all.

In addition, a company might conclude that a commencement date that falls within the last 25% of the useful life of the underlying asset results in a commencement date at or near the end of the asset's economic life.

Observation: Paragraph 73 in the Basis for Conclusions indicates that the guidance in ASC 842-10- 55-2 was provided in order to assist companies as they establish internal accounting policies and controls in order to ensure that the leasing guidance is operational in a scalable manner. Thus, we believe that a strict adherence to the bright lines of prior leasing guidance is no longer required. Entities should consider how best to articulate accounting policies in order to achieve consistent classification for similar leases, while adhering to the economic structure of the arrangement and the principle of the new standard. While companies could adopt a policy that establishes ranges, similar to the approach taken when determining whether a contingent liability is probable under Topic 450-20, companies should also consider how those terms are applied in other areas of U.S. GAAP, and ensure consistent application (for example, "substantially all" is used in many other areas of U.S. GAAP and is understood to generally be at or around 90%). While adhering to the bright lines provided in ASC 842-10-55-2 would not require much documentation (other than documenting the use of the thresholds as permitted in the implementation guidance), deviating from those bright lines would require an entity to document its considerations in arriving at the thresholds used for lease classification purposes.

The new standard added a fifth criterion in determining whether a lease is a finance lease or sales-type lease, specifically whether the underlying asset is of such a specialized nature that it is expected to have no alternative use to the lessor at the end of the lease term. Most lessors would be expected to structure such a lease to ensure that they are able to recover their investment in the underlying asset through required lease payments, thus resulting in finance/ sales-type lease treatment because the present value of future lease payments represents substantially all of the fair value of the underlying asset. However, to the extent that is not the case, an inability of the lessor to repurpose the asset without undue cost at the end of the lease term will result in finance/ sales-type lease treatment.

Example 11: Widget Co. enters into a lease agreement with Bob's Custom Manufacturing. Under this agreement Bob's will construct a piece of equipment to be used in Widget's production process. The requirements for the asset will be provided by Widget, and are subject to a U.S. patented design. Because of the existence of the patent, Bob's would be precluded from reusing the equipment at the end of the lease through redirecting it through a sale or subsequent lease. In addition, it would likely be cost prohibitive to modify the equipment in such a way that it no longer complies with the patented design requirements. Therefore, the fifth lease criterion applies, and Widget would account for the lease as a finance lease, while Bob's would account for the lease as a sales-type lease.

If none of the five criteria are met, a lessee will account for the lease as an operating lease. However, a lessor must still consider whether the present value of the future lease payments plus the value of any residual value guaranteed by the lessee or an unrelated third party equals or exceeds substantially all of the fair value of the underlying asset. If that is the case, and it is probable that the lessor will collect the lease payments plus any amount due under the residual value guarantee, then the lessor will account for the lease as a direct financing lease. Unless both criteria are met, the lessor will account for the lease as an operating lease.

Note that a lessor is required to use a different rate implicit in the lease in testing whether the lease is a sales-type lease or direct-financing lease when the fair value of the underlying asset is different from its carrying value (which impacts initial direct costs included in the determination of the rate implicit in the lease). See **Example 17** for an illustration of this requirement.

LEASE TERM

The lease term must include the noncancellable period for which the lessee has the right to use the underlying asset plus any period covered by an option to extend the lease if the lessee is reasonably certain to exercise the option or if the exercise of the option is controlled by the lessor. In addition, if the lease contains an early termination provision, the period covered by the termination option should be included unless the lessee is reasonably certain not to exercise the termination option.

The concept of "reasonably certain" is a relatively high threshold, and is intended to be interpreted consistently with the "reasonably assured" concept in Topic 840. In determining whether it is reasonably certain that an option will be exercised, a company should consider all economic factors relevant to that assessment, including contractual terms and conditions, significant leasehold improvements that are expected to have significant economic value after the initial lease term, costs related to exiting the lease including negotiating a new lease and relocation costs, costs associated with returning the leased asset to its contractually specified condition and/or location, and the importance of the underlying asset to the company's operations.

Observation: In paragraphs 193 through 195 in the Basis for Conclusions, the Board explained that the concept "reasonably certain" is consistent with the term "reasonably assured" in prior guidance, and is intended to take into consideration all relevant economic factors, including contractual, asset, entity and market- based factors. Similar to the application of "reasonably assured" under Topic 840, "reasonably certain" is a very high threshold. The Board rejected an approach that would include renewal periods and purchase options based solely on management's intent. Therefore, while a company's historical practice of exercising renewal or purchase options may indicate the existence of significant economic factors, past practice in and of itself should not impact the evaluation.

Example 12: Retailer leases a building from Owner. The lease includes an initial term of 15 years, plus five optional renewal terms of five years each. Prior to opening the store to the public, Retailer must complete the construction of significant leasehold improvements in order to align the building with Retailer's brand image. The leasehold improvements are expected to cost $500,000. The building is expected to have a remaining economic life of 30 years at lease inception; however, Retailer concludes that the leasehold improvements have an economic life of only 20 years as it is Retailer's experience that after 20 years the building will require a major remodel in order to refresh the brand and remain competitive in the market. At the end of the lease term (or renewal term if exercised), any leasehold improvements transfer to Owner. While the building is in a desirable location, Retailer concludes that it could obtain a similar building within the trade area at a similar cost at any time during the remaining economic life of the building.

The lease term should include the initial term plus one renewal term. At the end of the initial term, Retailer will continue to own leasehold improvements with a remaining economic life of five years and an undepreciated carrying value of $125,000 which would transfer to Owner if a renewal option is not exercised. Thus, Retailer concludes that it is reasonably certain to exercise the first renewal option because it will have leasehold improvements that are expected to have significant economic value when the renewal option becomes exercisable.

Conversely, Retailer concludes that it is not reasonably certain at lease commencement that it will exercise the second, third, fourth and fifth renewal terms. At the end of the first renewal period, Retailer will no longer have leasehold improvements with a significant economic value. Instead, Retailer believes that it would be required to incur significant costs to remodel the building in order to remain competitive in the market if it were to exercise the second renewal term. In addition, at lease commencement the lease payments for the renewal periods are considered at market, and a similar building could be found at a reasonable cost.

This definition of lease term applies equally to lessors and lessees. While it may be difficult for a lessor to determine whether a lessee is reasonably certain to exercise a renewal option or purchase option if the determination is based on lessee-specific factors, a lessor must nonetheless assess the likelihood, and must consider all known information.

LEASE PAYMENTS

Lease payments include the following:

- Fixed payments, including in substance fixed payments, less incentives paid or payable
- Variable lease payments based on an index or a rate
- Exercise price of purchase option if reasonably certain
- Penalty payments if reflected in lease term
- Fees paid by lessee to owners of special-purpose entity
- Amounts probable of being owed under a residual value guarantee

Example 13: Consider the same facts as Example 12, with the exception that the building is located in a highly desirable location in mid-town Manhattan close to Times Square. Retailer believes that a presence in this market is essential to its national growth strategy, and there are no similar structures in this area that would be acceptable at a reasonable cost. The building has a remaining useful life of 30 years.

In this scenario, the lease term includes the initial term plus three renewal terms. Although Retailer would no longer own leasehold improvements with significant economic value at the end of the first renewal term, because of the importance of the location to Retailer's strategy, and the lack of alternative options, Retailer determines that it would not be able to identify and obtain a lease on a similar building in this area without significant cost. Therefore, it is reasonably certain that Retailer will exercise the first three renewal terms, which will result in use of the building through the end of its remaining economic life. Because the building is not expected to have a useful life beyond 30 years, it is not reasonably certain that Retailer would exercise any renewal options beyond that period.

In addition to any fixed payments during the term of the lease, including in-substance fixed payments, lease payments include any variable lease payments that depend on an index or rate, measured using the index or rate in place at lease commencement, as well as the exercise price of a purchase option that the lessee is reasonably certain to exercise, penalties related to a termination provision if it is reasonably certain that the lessee will exercise the termination option, any fees paid to the owners of a special-purpose entity for structuring the transaction, and for a lessee, amounts probable of being owed to the lessor under a residual value guarantee. Any lease incentives paid or payable by the lessor to the lessee reduce lease payments. Variable lease payments include any payments that vary because of changes in facts or circumstances occurring after the commencement date, other than the passage of time. Examples of variable lease payments include payments measured as a percentage of sales, payments based on units produced, payments that increase based on changes in the value of an index such as the Consumer Price Index, and payments that are triggered upon occurrence of an event. Variable payments not included in the consideration in the contract are generally recognized in profit or loss when the changes in facts and circumstances on which the variable payments are based is resolved.

Observation: While fixed payments, purchase options and termination penalties are typically specified in the lease agreement, it may require judgment to determine whether variable payments are in substance fixed, and at what amount. Likewise, estimating the amount expected to be owed under a residual value guarantee will also require judgment.

In addition, ASC 842-10-55-37 clarifies that costs to dismantle and remove an underlying asset at the end of the lease term which are imposed by the lease agreement and which cannot be avoided generally would be considered lease payments.

Conversely, obligations imposed by a lease resulting from a modification of the underlying asset (for example, a requirement to remove any leasehold improvements at the end of the lease term) would generally be considered an asset retirement obligation and accounted for in accordance with ASC 410-20.

Observation: Because variable payments are generally not included in lease payments (other than those based on index or rate), they would not be included in the lease receivable to be recognized by a lessor in a sales-type lease. While this treatment is consistent with Topic 840, it is considerably different than the treatment of variable payments in revenue arrangements accounted for in accordance with ASC 606, which includes the estimated amount of variable consideration that is not probable of reversal in the transaction price. Therefore, the timing of recognition and measurement could be different for sales of assets versus for sales-type leases of similar assets when both transactions include variable consideration.

Example 14: Susie's Stitch-n-Sew enters into a five- year lease agreement with a mall operator that includes three five-year renewal options. Rent payments are $5,000 per month plus one percent of sales during the initial term, with base rent increasing by 10% in each renewal period. There are no nonlease components.
Susie's incurs costs of $100,000 installing leasehold improvements to customize the space to its brand requirements. These leasehold improvements have a useful life of eight years. The lease requires Susie to remove the leasehold improvements at the end of the lease term. Because the leasehold improvements have a useful life that is longer than the initial lease term, Susie's is reasonably certain to exercise the first renewal option.

The payments under the lease include both fixed and variable lease payments. The portion based on sales is variable and not based on an index or rate, and is therefore not included in lease payments. In addition, because the removal requirement is related to modifications made to the space by Susie's, it would be considered an asset retirement obligation, and also not included in lease payments. Therefore, the total lease payments consist solely of the base rent for the initial lease term of $60,000 per year plus $66,000 per year in the first renewal period, for a total of $630,000.

INITIAL DIRECT COSTS

Initial direct costs are defined in the Master Glossary, as incremental costs that would not have been incurred if the lease had not been executed, such as commissions and payments made to an existing tenant to incentivize that tenant to terminate its lease. Costs to negotiate or arrange the lease that would have been incurred regardless of whether the lease was obtained are not considered initial direct costs. Examples of such costs are fixed employee salaries, general overheads, costs incurred by the lessor to solicit potential lessees including advertising, costs to service existing leases, and costs related to activities that occur before a lease is obtained such as costs to negotiate the lease, obtain legal or tax advice, or evaluate a potential lessee's financial condition.

Example 15: Assume the same facts as in Example 14, with the exception that rent payments for all periods are seven percent of sales, with no base rent. However, the lease specifies that annual sales for the initial lease term should be assumed to be at least $1,000,000, while annual sales for the first renewal period should be assumed to be at least $1,100,000.

While the payments under the lease appear variable in nature, the existence of a minimum sales threshold results in payments that are in substance fixed. Therefore, in this example lease payments equal $70,000 per year for the initial period and $77,000 per year for the first renewal period, for a total of $735,000.

Observation: The definition of initial direct costs in the new standard is substantially narrower than the definition in prior leasing guidance, and aligns with the definition of incremental costs of obtaining a contract under the new revenue recognition guidance (see ASC 340-40-25-1 through 25-3). This will likely represent a significant change in practice, as many companies with active leasing programs currently capitalize external legal and other consulting fees and may capitalize costs associated with an internal leasing department or internal legal counsel as initial direct costs of their leases. Under the new standard, these costs will be expensed as incurred.

LESSEE ACCOUNTING

INITIAL MEASUREMENT

At the commencement date, the lessee recognizes a ROU asset and a lease liability for any leases for which the short- term lease exception has not been elected (see section entitled **"Short-term Leases"**). The lease liability is calculated as the present value of the lease payments not yet paid, discounted using the discount rate for the lease at lease commencement. The lease payments used in this calculation are the same lease payments, over the same lease term, as used in determining the lease classification.

Observation: The definition of initial direct costs in the new standard is substantially narrower than the definition in prior leasing guidance, and aligns with the definition of incremental costs of obtaining a contract under the new revenue recognition guidance (see ASC 340-40-25-1 through 25-3). This will likely represent a significant change in practice, as many companies with active leasing programs currently capitalize external legal and other consulting fees and may capitalize costs associated with an internal leasing department or internal legal counsel as initial direct costs of their leases. Under the new standard, these costs will be expensed as incurred.

The discount rate should be the rate implicit in the lease if that rate is readily determinable. The rate implicit in the lease is the rate that causes the aggregate present value of the lease payments and the residual value of the underlying asset to equal the sum of the fair value of the underlying asset and any deferred initial direct costs of the lessor, minus any related investment tax credit expected to be retained and realized by the lessor. If not readily determinable, the lessee should use its incremental borrowing rate, which is defined as the rate that the lessee would have incurred to borrow on a collateralized basis over a term similar to the lease term an amount equal to the lease payments in a similar economic environment.
The new standard includes an optional practical expedient whereby non-public entities may use a risk-free rate, determined using a period comparable to that of the lease term, as an accounting policy applied to all leases.

The value of the ROU asset to be recognized equals the amount of the lease liability, plus any lease payments made to the lessor at or before lease commencement and any initial direct costs of the lessee, less any lease incentives received from the lessor.

SUBSEQUENT MEASUREMENT

After initial measurement, the lessee must recognize the costs associated with the lease each period. For finance leases, the lessee amortizes the ROU asset over the term of the lease on a straight-line basis or another basis if it more closely represents the benefits obtained under the lease. The lease liability

Observation: The concept of using the rate implicit in the lease when it is readily determinable is similar to prior leasing guidance. As such, we believe that "readily determinable" implies information that is known without undue effort. In practice, we expect that it will be rare that the lessee will know the rate implicit in the lease, consistent with current U.S. GAAP.

However, the requirement to use a rate that reflects a collateralized basis for a company's incremental borrowing rate is a change, and may create challenges for lessees. In general, we believe that a company's weighted- average corporate borrowing rate will not be reflective of the incremental borrowing rate due to differences in underlying security, term and amount. Companies should consider how best to determine the incremental borrowing rate for a specific lease, which might include obtaining hypothetical mortgage rates for a borrowing of an amount equal to the lease payments over a similar term as the lease term. If such a rate is not available in the market, for example because the lease term is longer than standard mortgage loans, companies should also use relevant market data to adjust available rates to comply with the new standard. In addition, we believe that an entity must use an effective interest rate, which would take into consideration any points or other lender fees that might cause the stated rate to vary unrelated to the economic risk of the borrowing. Finally, companies should consider the controls in place to determine the incremental borrowing rate.

is measured each period at the present value of the lease payments not yet paid, discounted using the discount rate established at lease commencement (or at the most recent modification not accounted for as a separate contract, or the most recent remeasurement resulting from a reassessment of the lease term or purchase option). The lessee also recognizes interest on the lease liability calculated using the discount rate established at lease commencement. Any variable lease payments not included in the measurement of the ROU asset and lease liability are recognized in earnings in the period in which they become payable.

Example 16: Lessee leases a piece of equipment under a ten-year lease. The lease payments are $50,000 per year, and payments are due at the beginning of the year. Lessee pays a commission of $15,000 to its broker upon executing the lease. Lessee is unable to determine the rate implicit in the lease, but its incremental borrowing rate is 5.87%. Lessee expects to benefit from use of the equipment evenly throughout the lease term.

In order to determine the value of the lease liability, Lessee considers the remaining lease payments and the discount rate. Because the lease payments are paid in advance, the remaining payments total $450,000. The lessee then discounts the payments over the term using its incremental borrowing rate of 5.87% because the rate implicit in the lease is not readily available. The present value of the remaining lease payments is $342,017.

The value of the ROU asset to be recorded is the value of the lease liability of $342,017, plus lease payments made on or before lease commencement and initial direct costs, less any lease incentives received. In this scenario, Lessee does not receive any lease incentives, but the commission paid to the broker qualifies as an initial direct cost, and the first lease payment was made at lease commencement. Thus the initial value of the ROU asset is $407,017.

Lessee records the following entry to recognize lease commencement:

Right-of-use asset	$407,017	
Lease liability		$342,017
Cash (lease payment for year 1)		$50,000
Cash (initial direct costs)		$15,000

If Lessee concluded that the lease was a financing lease, the entry to recognize lease expense for the first year under the lease would be:

Interest expense	$20,076(1)	
Lease liability		$20,076
Amortization expense	$40,702(2)	
Right-of-use asset		$40,702

(1) Calculated as 5.87% x $342,017

(2) Calculated as $407,017 ÷ 10 years

If Lessee concluded that the lease was an operating lease, the entry to recognize lease expense for the first year under the lease would be:

Rent expense	$51,500(1)	
Lease liability		$20,076
Right-of-use asset		$31,424(2)

(1) Calculated as ($500,000 + $15,000) ÷ 10 years

(2) Calculated as $51,500 – $20,076

Regardless of lease classification, at the beginning of the second year, Lessee would record the second lease payment as follows:

Lease liability	$50,000	
Cash (lease payment for year 2)		$50,000

For an operating lease, the lessee recognizes a single lease cost, calculated so that the remaining cost of the lease is recognized over the remaining lease term on a straight-line basis, unless another systematic and rational basis is more representative of the pattern of benefit under the lease. The lease liability is measured each period similar to finance leases.

The difference between the single lease cost and the change in the carrying value of the lease liability is applied to the ROU asset to determine the subsequent carrying value of the ROU asset. Variable lease payments related to operating leases are also recognized in earnings in the period in which they become payable.

LESSOR ACCOUNTING

The accounting for the lease by the lessor varies depending on the lease classification, and remains substantially unchanged from prior guidance. For an operating lease, the underlying asset continues to be recognized and depreciated over its remaining useful life, while initial direct costs are deferred.
After the commencement date, lease payments are recognized in income over the lease term on a straight-line basis unless another systematic and rational basis better reflects the pattern of benefit to be derived from use of the underlying asset, while variable lease payments are recognized in the period in which the changes in facts and circumstances on which the variable lease payments are based occur. Initial direct costs are amortized as an expense over the lease term on the same basis as lease payments are recognized.

For a sales-type lease, the lessor derecognizes the underlying asset and recognizes the net investment in the lease, as well as selling profit or loss. The net investment in the lease is calculated as the present value of lease payments not yet received and any residual value guarantee, discounted at the rate implicit in the lease, plus the present value of any unguaranteed residual asset. The selling profit or loss is calculated as the fair value of the underlying asset (or the sum of the lease receivable and any prepaid lease payments if less), minus the carrying amount of the underlying asset net of any unguaranteed residual asset. Any deferred initial direct costs should also be included in selling profit or loss unless the fair value of the asset equals its carrying amount, in which case initial direct costs are included in the net investment in the lease.

Observation: During the deliberations of the new standard, the FASB considered requiring a symmetrical approach for operating leases, which would have resulted in the lessor recognizing a lease receivable, consistent with the lease liability recognized by the lessee. However, the Board ultimately concluded in paragraph 88 in the Basis for Conclusions that continuing to recognize the underlying asset and separately recognizing rental income provides more useful information to financial statement users and better reflects the business model of many lessors. An asymmetrical approach also reduces the complexity that would be inherent in applying a derecognition model to leases of portions of larger assets, such as one floor of a building.

Subsequent to lease commencement, the lessor increases the carrying amount of the net investment in the lease to reflect interest income using the effective interest method, and reduces the carrying amount as payments are received. In addition, any variable lease payments will be recognized in income in the period in which the changes in facts and circumstances on which the variable lease payments are based occur. At the end of the lease term, any remaining net investment in the lease (which would represent the unguaranteed residual value of the underlying asset) is reclassified to the appropriate category of asset, typically property, plant and equipment.

Under the new standard, collectibility is not a criterion to be assessed when determining whether a lessor should classify a lease as a sale-type lease or not. If one of the five criteria in ASC 842-10-25-2 is met, then the lease must be classified as a sales-type lease. If the lessor determines that it is not probable that the lease payments will be collected, then the arrangement is accounted for under the deposit method.
The underlying asset is not derecognized, and any payments received are recorded as a deposit liability. This treatment continues until the lessor concludes that the remaining payments are probable of collection, at which time the lessor derecognizes the asset and recognizes the net investment in the lease, along with any selling profit.

Direct financing leases are accounted for in a similar manner to sales-type leases, with one important difference. While any selling loss is recognized at lease commencement, any selling profit and initial direct costs are deferred and included in the net investment in the lease. Subsequent accounting is also consistent with sales-type leases, except for the accretion of the deferred selling profit which does not exist for sales-type leases.

Unlike a sales-type lease, collectibility is a criterion that must be met in order to classify a lease as a direct financing lease. Therefore, if collectibility is not assured despite meeting the other criteria to be classified as a direct financing lease, the lessor must account for the lease as an operating lease.

SUBLEASES

A lessee that enters into a sublease agreement should first consider whether it is relieved of the primary obligation under the original lease or not. If the lessee is relieved of the primary obligation under the original lease, then the sublease transaction is considered a termination of the original lease, and the ROU asset and lease liability are written off and gain or loss recognized for any difference. Any termination penalty paid that was not already included in the lease payments used to determine the ROU asset and lease liability would be included in the determination of profit or loss on termination of the lease. If the lessee remains secondarily liable, any guarantee obligation should be accounted for in accordance with ASC 405-20-40-2.

Observation: The treatment of sales-type leases when collectibility is not probable is consistent with the guidance in ASC 606 related to contracts with customers for which collectibility is not assured.However, it represents a change from prior guidance, which resulted in operating lease treatment when collectibility was not probable.

Example 17: Assume the same facts as in Example 16. Also assume the following. At lease commencement, the equipment has a fair value of $425,000 and a carrying value of $395,400. The asset has a remaining useful life of 12 years, and Lessor expects the residual value of the equipment at the end of the lease term to be $20,000. Lessor incurs $5,000 of initial direct costs. The rate implicit in the lease for purposes of determining whether the lease is a sales-type lease is 4.58% (it assumes no initial direct costs are deferred because the fair value of the asset is different from its carrying amount – see ASC 842-10-25-4). Using that rate, the present value of the remaining unpaid lease payments is $362,214.

Because the present value of the lease payments (including the lease payment of $50,000 received at lease commencement) using the 4.58% rate represents substantially all of the fair value of the equipment, Lessor accounts for the lease as a sales-type lease.

[Note: if the carrying value of the underlying asset equaled its fair value, the rate implicit in the lease would have included deferred initial direct costs. Accordingly, the rate used for lease classification would have been 4.29%].

Lessor records the following entries at lease commencement:

Derecognize the underlying asset (see ASC 842-30-45-4 for guidance on presentation – here we assume the entity uses leases as an alternative means of realizing value from the goods it otherwise sells):

Cost of goods sold	$395,400	
Equipment		$395,400

Recognize the net investment in the lease and selling profit (see ASC 842-30-45-4 for guidance on presentation):

Net investment in the lease	$375,000	
Cash (lease payment for year 1)	$50,000	
Revenue from sales-type lease		$425,000

Expense initial direct costs:

Initial direct costs	$5,000	
Cash		$5,000

At the end of the first year, Lessor records the following entry to recognize interest on the net investment in the lease:

Net investment in the lease	$17,157[1]	
Interest income		$17,157

(1) Calculated as $375,000 x 4.58%

At the beginning of the second year, Lessor records the following entry:

Cash (lease payment for year 2)	$50,000	
Net investment in the lease		$50,000

If the lessee remains primarily liable under the original lease, then the lessee should account for the sublease in a manner similar to that of a lessor.

If the sublease is classified as an operating lease, the lessee continues to account for the original lease as it did prior to the sublease. Any sublease income is recognized on a straight- line basis in earnings, unless another systematic and rational method is more representative of the benefits to be obtained by the sublessee. If the sublease is classified as a sales-type or direct financing lease, the lessee should derecognize the ROU asset associated with the original lease (whether it was an operating or finance lease ROU asset), recognize a net investment in the sublease, and continue to account for the original lease liability as it did prior to the sublease.

The sublessor must use the rate implicit in the sublease in order to determine the sublease classification, unless it is not readily available, in which case the discount rate established for the original lease may be used. The sublessee should look to the original underlying asset in order to determine classification.

REASSESSMENT

A lessee should reassess the lease term or a lessee option to purchase the underlying asset only if one of the following events occur:

- There is a significant event or significant change in circumstances that is within the control of the lessee that directly affects whether the lessee is reasonably certain to exercise a renewal or termination option.
- There is an event written into the contract that obliges the lessee to exercise or not exercise a renewal or termination option.
- The lessee elects to exercise an option even though it had previously determined that it was not reasonably certain to do so.
- The lessee elects not to exercise an option even though it had previously determined that it was reasonably certain to do so.

Example 18: Corporation Inc. enters into a lease for a private jet. The term of the lease is 10 years, which is also the expected remaining useful life of the jet, and the lease requires monthly payments of $100,000. The fair value of the private jet is $10,250,000. Because Corporation Inc. does not know the rate implicit in the lease, it uses its incremental borrowing rate of 4.68% to calculate the present value of the lease payments to be $9,568,620. The lease transfers ownership in the jet to Corporation Inc. at the end of the lease term. Corporation Inc. did not incur any initial direct costs, nor did it receive any lease incentives from the lessor.

The present value of the future lease payments represents substantially all of the fair value of the private jet, the lease term is for the entire remaining useful life of the asset, and the lease transfers ownership at the end of the lease term; therefore, Corporation Inc. accounts for the lease as a finance lease. At lease inception, Corporation Inc. records the following entry:

ROU asset	$9,568,620
Lease liability	$9,568,620

After using the jet for three years, Corporation Inc. acquires another company which owns a private plane. As a result, Corporation Inc. enters into a sublease for the first jet. Corporation Inc. is still the primary obligor under the original lease. At the commencement date of the sublease, the ROU asset has a balance of $6,698,034[(1)], while the lease liability has a balance of $7,151,012[(2)].

(1)Calculated as $9,568,620 ÷ 10 years x 7 years remaining on the lease
(2)Calculated as the present value of the remaining lease payments of $8,400,000, discounted at the original rate of 4.68%

The sublease is coterminous with the original lease, and provides the sublessee with the right to purchase the jet at the end of the sublease for a purchase price of $100. Because the market for private jets has appreciated, Corporation Inc. is able to obtain monthly payments of $110,000 under the sublease. The sublessee has an A debt rating, and therefore Corporation Inc. concludes that collectibility of the lease payments is probable.

Because Corporation Inc. could not determine the rate implicit in the sublease, it uses its incremental borrowing rate at the time of the original lease commencement to calculate the present value of the sublease payments plus the $100 purchase price to be $7,866,185. Based on market rates for comparable jets, Corporation Inc. believes that the present value of the sublease payments represents substantially all of the fair value of the underlying jet. In addition, the sublease includes a purchase option that the sublessee is reasonably certain to exercise because it represents a substantial discount to the expected residual value of the jet at the end of the sublease term. Therefore, Corporation Inc. accounts for the sublease as a sales-type lease.

At the commencement of the sublease, Corporation Inc. records the following entries:

Derecognize the original ROU asset:

Net gain/loss on sublease	$6,698,034
ROU asset	$6,698,034

Recognize the net investment in the sublease and the selling profit:

Net investment in sublease	$7,866,185
Net gain/loss on sublease	$7,866,185

At the end of the first month after commencement of the sublease, Corporation Inc. records the following entries related to the original lease and the sublease:

Recognize interest expense on and payment of the original lease:

Interest expense	$27,889[(1)]
Lease liability	$72,111
Cash	$100,000

(1) Calculated as $7,151,012 x (4.68%/12)

Recognize sublease payment and interest on net investment in sublease:

Cash	$110,000
Net investment in sublease	$79,322
Interest income	$30,678[(2)]

(2) Calculated as $7,866,185 x (4.68%/12)

Examples of significant events or changes in circumstances that are within the lessee's control include but are not limited to constructing leasehold improvements that are expected to have significant value when the option becomes exercisable, making significant modifications or customizations to the underlying asset, making a business decision that is directly relevant to the ability to exercise an option such as extending the lease of a complementary asset, and subleasing the underlying asset for a period beyond the exercise date of the option. Changes in market factors, such as market rates to lease comparable assets, do not in isolation trigger reassessment.

A lessee should remeasure the lease payments if any of the following events occur:

- A contingency upon which some or all of the variable payments during the remaining lease term is resolved, so that the payments become fixed (*).
- The lease is modified, and the modification is not accounted for as a separate contract (**).
- There is a change in the lease term, as described in the two preceding paragraphs (**).
- There is a change in the assessment of whether the lessee is reasonably certain to exercise a purchase option, as described (**).
- There is a change in the amount expected to be paid under a residual value guarantee (*).

(*) In those situations, remeasure the lease payments and the consideration in the contract and update the allocation of the consideration in the contract to the lease and nonlease components. Remeasurement is required whenever relevant facts and circumstances occur (i.e., it is not based on triggering events).

(**) In addition to the steps in (*), also update the discount rate and reassess lease classification.

If the lessee remeasures its lease payments, any variable payments that depend on a rate or index should be remeasured using the rate or index at the remeasurement date.

A lessor should only reassess the lease term, a lessee option to purchase the underlying asset or lease payments if the lease is modified and that modification is accounted for as a separate contract, as further discussed below. If a lessee exercises a previously unplanned renewal, termination or purchase option, the lessor should account for that exercise as a modification of the lease.

MODIFICATIONS

LESSEE ACCOUNTING

Modifications are accounted for as a separate contract if the modification grants the lessee an additional right of use not included in the original lease and the increase in the lease payments is commensurate with the standalone price of the additional right of use.

If either of the criteria above are not met, then the lessee will reallocate the remaining consideration to the lease and any nonlease components; the lessee will also remeasure the lease liability using the discount rate determined at the effective date of the modification and will reassess the classification of the lease as of the effective date of the modification based on the modified terms and other circumstances as of that date (for example, using the fair value and remaining economic life of the underlying asset at the modification date). If the modification results in an additional right of use, extends or reduces the term of the existing lease other than through the exercise of a contractual option, or changes the consideration in the contract, any difference resulting from remeasuring the lease liability is recognized as an adjustment to the corresponding ROU asset. If the modification fully or partially terminates the existing lease, then the lessee will decrease the carrying amount of the ROU asset on a basis proportionate to the full or partial termination. Any difference between the reduction in the lease liability and the proportionate reduction in the ROU asset is recognized as a gain or loss at the effective date of the modification.

Example 19: Assume the same facts as in Example 12 related to determining the lease term. At lease inception, Retailer concludes that the lease term consists of the initial 15-year lease term and one five-year renewal period due to the existence of significant leasehold improvements with a 20-year life. After 13 years, Retailer adopts a new brand strategy which requires a complete reconstruction of the store front, plus various aspects of the internal structure and design. The reimaging costs $300,000, and the new leasehold improvements are expected to have a useful life of 10 years.

Because the construction of the reimaged leasehold improvements is within Retailer's control, and they are expected to have significant value at the end of the first renewal period, Retailer must reassess the lease term. Retailer concludes that it is now reasonably certain to exercise both the first and second renewal periods.

Because there are no nonlease components, the change in the lease term results in a remeasurement of the lease payments only. Retailer must remeasure the lease liability using the remaining lease payments from the last two years of the initial term plus lease payments for the first and second renewal periods, discounted at Retailer's incremental borrowing rate at the time of reassessment. The difference between the remeasured lease liability and its carrying amount immediately before the remeasurement is recorded as an adjustment to the related ROU asset to reflect the cost of the additional rights. Retailer also should reassess lease classification to determine the accounting subsequent to the remeasurement date.

Example 20: Company T leases one floor of an office building totaling 10,000 square feet, which it uses to house its headquarters. There are no nonlease components. The lease commences on January 1, 2013, has a term of 10 years, and a price of $70/ square foot. Company T determines that the lease should be classified as an operating lease. During 2015, Company T experienced significant growth, and on January 1, 2016, modified the lease to include 6,000 square feet on a second floor of the office building. The modification allowed for the lease of the 6,000 square feet at $80/square foot, the then current market price, and made the lease of the additional space coterminous with the lease for the original space.

In this example, the modification results in a new lease because the terms of the existing lease are not changed, and the new space is leased at the then current market price. As such, the lease of additional space should be accounted for as a new lease, with an additional right- of-use asset and related liability recognized.

Observation: Example 18 in the new standard, which is provided in ASC 842-10-55-177 through 55-185, provides two different methodologies for determining the proportionate reduction in the ROU asset and thus the gain or loss when a modification partially terminates an existing lease. We believe either methodology is acceptable. However, companies should select one methodology and apply it consistently to all lease modifications.

LESSOR ACCOUNTING

If a lessor modifies an operating lease in such a way that the modification is not accounted for as a separate lease, the lessor should account for the modification as a termination of the existing lease and the creation of a new lease. If the modified lease is also classified as operating, then any prepaid or accrued lease payments related to the original lease are accounted for as part of the lease payments for the modified lease. If the modified lease is classified as a direct financing or sales-type lease, then any accrued rent asset or deferred rent liability should be included in the calculation of selling profit or loss.

If a lessor modifies a sales-type lease or a direct financing lease without resulting in a separate lease, the resultant accounting depends on the classification of the modified lease, as follows:

- If the modified lease is classified as a direct financing lease, the lessor simply adjusts the discount rate so that the initial net investment in the modified lease equals the carrying amount of the net investment in the original lease immediately before the effective date of the modification.

- If the modified lease is classified as a sales-type lease, the accounting depends on the classification of the original lease. If the original lease was also classified as a sales-type lease, then the lessor applies the same approach outlined above by adjusting the discount rate. However, if the original lease was classified as a direct-financing lease, then the net investment in the original lease immediately before the effective date of the modification is assumed to be the carrying amount of the underlying asset. The carrying value is derecognized, and represents the cost of goods sold portion of selling profit or loss.

Example 21: Consider the same facts as in Example 20, with the exception that the lease was modified to reprice the entire space (existing floor plus new 6,000 square feet) at $75/square foot, and the term of the lease was extended for an additional five years.

In this fact pattern, the new lease agreement changes the terms of the original lease such that a modification has occurred. Accordingly, Company T first remeasures the consideration in the contract to reflect the change in payments and extension of the term. Company T then reallocates the lease payments in the modified lease agreement to the two components (i.e. the two floors) on a relative standalone price basis. Because the current market rental rate of $80 per square foot is the same for both floors, the consideration can be allocated based on relative square footage. The first floor represents 62.5% of the total space leased, and thus 62.5% of the total remaining future lease payments of $14,400,000 will be allocated to that lease component, while the remaining 37.5% will be allocated to the second floor component. Company T then remeasures the lease liability of the original lease to reflect the revised lease payments, using the discount rate determined at the modification date. The increase in the lease liability is recognized as an adjustment to the ROU asset of the original lease. Company T then reassesses the lease classification of the original lease, and in this example concludes that operating lease classification is still appropriate. Company T also recognizes a lease liability and ROU asset related to the second floor, which represents a second lease component at its commencement date.

- If the modified lease is classified as an operating lease, the carrying amount of the underlying asset equals the net investment in the original lease immediately before the effective date of the modification.

IMPAIRMENT

LESSEE ACCOUNTING

ROU assets must be monitored for impairment, similar to other long-term nonfinancial assets. Impairments of both operating lease ROU assets and finance lease ROU assets are accounted for in accordance with ASC 360-10-35 on impairment or disposal of long-lived assets. The new standard indicates that a sublease arrangement in which the sublease revenue is less than the original lease cost is an indicator that the carrying amount of the ROU asset associated with the original lease may not be recoverable and thus must be assessed for impairment.

If an ROU asset related to an operating lease is impaired, the carrying value of the ROU asset post impairment should be amortized on a straight-line basis through the earlier of the end of the useful life of the ROU asset or the end of the lease term. Post impairment, a lessee must calculate the amortization of the ROU asset and interest expense on the lease liability separately, although the sum of the two continues to be presented as a single lease cost, as further discussed in the **"Lessee Presentation"** section.

Because of the balance sheet presentation of ROU assets and lease liabilities, operating leases are no longer subject to assessment under the guidance on exit and other disposal costs in ASC 420-10. If a lease will be abandoned prior to the end of its lease term, the ROU asset should be assessed for impairment.

Observation: In many cases, assets under operating leases have historically benefited asset groups without adding carrying cost that must be recoverable in order to avoid impairment. However, under the new standard, all leases are reflected on the balance sheet, and thus the related ROU assets will be included in the carrying value of the relevant asset groups for impairment testing purposes.

Topic 842 and Topic 360 do not specify whether the related lease liability should be included in an asset group for impairment testing purposes. Because the FASB indicates (as further discussed in subsequent sections) that lease liabilities associated with finance leases should be considered financial liabilities, we believe it is generally inappropriate to include the carrying value of a lease liability related to a finance lease in the asset group as an offset to the carrying value of the ROU asset and to include the lease payments in the undiscounted cash flows. Conversely, as lease liabilities associated with operating leases are considered operating liabilities, we believe it is generally acceptable to include the carrying value of such lease liabilities in the asset group, similar to the treatment of other operating liabilities. If the lease liability is included in the asset group, the lease payments (net of the portion representing accretion of the lease liability) should also be included when estimating the undiscounted cash flows of the asset group.

LESSOR ACCOUNTING

For lessors, the guidance in ASC 310-10-35-16 through 35-30[6] on assessing whether a loan is impaired and measuring any resulting impairment is applicable to the net investment in the lease related to sales-type and direct financing leases.
When determining the loss allowance under this guidance, a lessor should consider the cash flows the lessor would expect to receive or derive from the lease receivable and unguaranteed residual asset during and following the end of the remaining lease term, such as by selling or releasing the asset, as collateral.

Because lessors do not derecognize the underlying asset associated with an operating lease, there is no net investment in the lease to be assessed for impairment. Instead, the underlying asset should continue to be assessed for impairment using the guidance in ASC 360-10-35. As indicated in ASC 842-30-25-13, any difference between the amount collected and the amount of rental income recognized on a straight-line basis should be recognized as a current-period adjustment to lease income if it is no longer probable that the lessor will collect those amounts.[7]

SALE AND LEASEBACK TRANSACTIONS

When an entity transfers an asset to a third party and subsequently leases the asset back, the entity must first follow the guidance in ASC 606-10-25-1 through 25-8 on identifying a contract and in ASC 606-10-25-30 on determining whether a performance obligation is satisfied at a point in time to evaluate whether it should account for the original transfer as a sale or not. One of the key criteria in determining whether the contract represents a sale is whether the buyer obtains control of the asset or not. As such, if the leaseback would be

[6] In June 2016, the FASB issued ASU 2016-13, Measurements of Credit Losses on Financial Instruments, which replaces the guidance in ASC 301-10 with a current expected credit losses model contained in new Topic 326. The guidance in ASU 2016-13 is effective for SEC filers in fiscal years ending after December 31, 2019 and in fiscal years ending after December 31, 2020 for all other entities.

classified as a finance lease by the seller-lessee or a sales-type lease by the buyer-lessor, then the buyer does not obtain control. In addition, if the leaseback agreement provides the seller-lessee with an option to repurchase the asset, the buyer is also deemed not to obtain control unless the exercise price of the option is the fair value of the asset at the time the option is exercised, and there are alternative assets, substantially the same as the transferred asset, readily available in the marketplace.

If the transfer of the asset is deemed a sale, then the seller- lessee derecognizes the underlying asset at the point in time the buyer-lessor obtains control, recognizes the transaction price for the sale in accordance with ASC 606-10-32-2 through 32-27, and accounts for the leaseback as an operating lease in accordance with the new standard.

If the sale and leaseback transactions are not at fair value, then the entity must adjust the sales price of the asset appropriately. Any increase in the sales price will be reflected as a prepayment of rent, while any decrease in the sales price will be reflected as additional financing provided by the buyer- lessor to the seller-lessee. Evaluating whether the transaction is priced at fair value is assessed based on the difference between the sales price of the asset and the fair value of the asset or the present value of the lease payments and the present value of market rentals, whichever is more readily determinable.

If the transfer of the asset does not meet the criteria for sales accounting, the seller-lessee will not derecognize the asset and will recognize any consideration received as a financial liability, and the buyer-lessor will not recognize the asset but will account for any consideration paid as a receivable.

LESSEE CONTROL BEFORE LEASE COMMENCEMENT

If a lessee controls an underlying asset prior to lease commencement date, then the leasing arrangement should be accounted for as a sale and leaseback transaction. This may be the case when the lessee is involved with the construction and/or design of the underlying asset, such as a build-to-suit real estate project. The new standard provides several criteria (which are not all-inclusive) to consider when determining whether the lessee controls the asset during construction:

- The lessee has the right to obtain the partially constructed underlying asset at any point during the construction period.
- 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 (1) both the land and the property improvements that are under construction or (2) the non-real-estate asset that is under construction.
- The lessee controls the land that property improvements will be constructed upon and does not enter into a lease of the land before the beginning of construction that, together with renewal options, permits the lessor or another unrelated third party to lease the land for substantially all of the economic life of the property improvements.
- The lessee is leasing the land upon which the property improvements will be built, the term of which, together with renewal options, is for substantially all of the economic life of the property improvements, and does not enter into a sublease of the land that allows the lessor or another unrelated third party to sublease the land for substantially all of the economic life of the property improvements before beginning construction.

Observation: Topic 840 included very specific requirements for a sale and leaseback transaction involving real estate to be classified as a sale, as well as separate guidance related to sale and leaseback transactions involving other types of assets. The new standard establishes a requirement for both scenarios to follow the revenue guidance in ASC 606. As a result, in some cases, entities may find it easier to achieve sales accounting.

However, the new standard retains a provision that a purchase option at other than fair value precludes transfer of control of an asset, and therefore precludes sales accounting. In addition, even if the purchase option is at fair value, if a replacement asset is not readily available, sales accounting is still precluded. Paragraph 352(c) in the Basis for Conclusions clarifies that real estate assets would generally not meet this criterion, as real estate is unique such that no other real estate asset is "substantially the same".

[7] August 2018, the FASB issued a proposed Accounting Standards Update, Codification Improvements to Topic 326, Financial Instruments-Credit Losses, which would clarify that receivables arising from operating leases are not within the scope of Subtopic 326-20. Instead, impairment of receivables from operating leases would be accounted for in accordance with paragraphs 842-30-25-12 through 25-13, as noted.

Observation: The requirements in the new standard for the buyer-lessor to account for a failed sale as a receivable rather than an acquired asset may be a change in practice for some entities. In addition, this guidance will require the buyer-lessor to assess whether the transfer qualifies as a sale for the seller-lessee, which may require incremental effort and coordination with the seller-lessee.

If the lessee is deemed to control the underlying asset during construction, and is thus the accounting owner, then the lessee must recognize the costs associated with constructing or designing the asset in accordance with ASC 360. Similar to financed construction costs for other owned assets, any costs paid by the lessor should be accounted for as financing liabilities by the lessee. Upon transfer of control of the underlying asset to the lessor, the lessee must follow the guidance on accounting for sale and leaseback transactions discussed.

OTHER ISSUES

Business Combinations – Similar to prior guidance, a previous lease classification should be retained in a business combination unless the lease is modified at the time of the business combination or after. If the target company is a lessee, the lease liability should be measured at the present value of the remaining lease payments, as if the acquired lease was originated at the business combination date. The ROU asset is recorded at the same amount as the lease liability, adjusted for any favorable or unfavorable terms. This is true for operating and financing leases. An acquired lessor should continue to recognize an unfavorable lease liability or favorable lease intangible asset related to operating leases. Otherwise, a net investment in the lease should be recorded for acquired sales-type or direct financing leases.

Sales of Equipment with Guaranteed Minimum Resale Amounts – In certain cases, a manufacturer may sell equipment utilizing a sales incentive that contractually guarantees that the purchaser will receive a minimum resale amount when it disposes of the equipment. If an assessment of the arrangement under the guidance in ASC 606-10-25-30 and ASC 606-10-55-66 through 55-78 on the satisfaction of performance obligations and repurchase agreements results in a lease, then the program should be accounted for under the new standard. ASC 842-30-55-1 through 55-15 of the new standard provide more specific guidance on accounting for similar programs.

Leases Denominated in a Foreign Currency – As further discussed in paragraphs 245 through 247 in the Basis for Conclusions, a lessee's lease liability and a lessor's net investment in the lease are both considered monetary items, and therefore must be remeasured using exchange rates at the end of each reporting period if denominated in a foreign currency pursuant to the guidance in ASC 830. As a result, any foreign currency gains and losses related to this remeasurement are recognized currently in net income. However, a lessee's ROU asset is considered a nonmonetary asset which would not be remeasured for changes in foreign currency exchange differences.

Fair Value Option – Although lease liabilities are otherwise considered financial liabilities, they are not eligible for the fair value option provided by ASC 825-10-15-5, consistent with prior guidance.

Lease Receivables Held for Sale – The sale of lease receivables by a lessor should be accounted for pursuant to ASC 860 on transfers and servicing. Consistent with previous guidance, if a lessor sells substantially all of the lease receivable associated with a sales-type or direct financing lease, the carrying amount of the unguaranteed residual asset at the date of sale ceases to be accreted to its estimated value over the remaining lease term.

Leases Between Related Parties –The new standard requires leases between related parties to be classified solely on the basis of the legally enforceable terms and conditions of the lease, rather than based on the economic substance of the arrangement. In addition, the sales price in a sale and leaseback transaction between related parties is not adjusted to reflect off-market rates, but instead should be disclosed.

LESSEE PRESENTATION

A lessee is required to present ROU assets resulting from finance leases separately from ROU assets resulting from operating leases and separately from other assets, either on the face of the balance sheet or in the footnotes. The same presentation is required for lease liabilities. In addition, ROU assets and related lease liabilities are subject to current and long-term presentation requirements in a classified balance sheet. If the lessee chooses to report ROU assets and liabilities within a line item on the balance sheet rather than in a separate caption, the lessee is prohibited from reporting finance lease ROU assets or finance lease liabilities in the same caption as operating lease ROU assets and operating lease liabilities.

On the income statement, a lessee should present the interest expense on the lease liability and amortization of the ROU asset in a manner consistent with how the lessee reports other interest expense and depreciation or amortization expense. For operating leases, the lessee must present the lease expense within income from continuing operations, consistent with the presentation of other operating expenses.

The cash flow classification of payments related to finance leases should be consistent with the classification of payments associated with other financial liabilities. Payments of principal should be presented as financing activities, while payments of interest would typically result in operating cash flow presentation.

Payments related to operating leases, leases to which the lessee has applied the practical expedient for short term leases, and any variable lease payments for either operating or finance leases should all be classified as operating cash outflows.

Observation: As discussed in paragraph 264 in the Basis for Conclusions, the Board concluded that presenting the assets and liabilities arising from finance leases and operating leases in the same line item in the balance sheet would be misleading because of the difference in the underlying economics of each lease type. Specifically, the Board indicated that finance lease liabilities are the equivalent of debt, while operating lease liabilities are not debt-like but are operating in nature. As a result, it is inappropriate to report operating lease ROU assets within a balance sheet caption that includes owned assets, and operating lease liabilities within a caption that includes debt of the reporting entity.

One of the primary concerns raised by financial statement preparers during the deliberation process was the impact that balance sheet recognition for all leases would have on various ratios, including debt covenants. Presentation of operating lease liabilities separate from debt on the balance sheet may partially alleviate some of those concerns.

LESSOR PRESENTATION

A lessor is required to present lease assets resulting from sales- type and direct financing leases separately from other assets in the balance sheet. Lease assets are subject to current and long-term presentation requirements in a classified balance sheet. Lessors must classify all cash receipts from leases as operating activities in the statement of cash flows.

Income arising from leases should be presented separately in the income statement or in the footnotes. If presented in the footnotes, a lessor must also disclose which line items include lease income. The disclosure of lease income recognized in each annual and interim reporting period is required to be made in a tabular format.

A lessor is required to present any profit or loss on leases recognized at the commencement date based on the lessor's business model; that is, presented on a gross basis (revenue and costs of goods sold) if the lessor uses leases as an alternative means of realizing value from goods that it would otherwise sell, or presented on a net basis (a single item) if the lessor uses leasing as a means of providing finance.

Observation: Because lessees will recognize all leases on the balance sheet, the distinction between operating leases and finance leases will be most relevant to the income statement and statement of cash flows. As such, companies may want to consider how their lease negotiation strategies may be impacted. For example, EBITDA is impacted differently by operating and financing leases. In addition, while lease classification does not impact overall cash flows, it does impact the amounts reported in the reconciliation of cash flows from operating activities under the indirect method.

In addition, lessees are required to disclose the following information:

- Finance lease costs, segregated by interest on the lease liabilities and amortization of the ROU assets
- Operating lease costs
- Variable lease costs

Observation: A lessor that uses leasing as an alternative means of realizing value from goods that it would otherwise sell must report revenues and cost of goods sold on a gross basis in the income statement so that income and expenses from sold and leased items are presented consistently. While this is obviously the situation when a manufacturer both sells and leases the products that it makes, we believe it is also applicable to resellers who both sell and lease assets acquired from other companies. For example, a retail store may offer leasing arrangements for appliances that it also sells. In this scenario, we believe the retail store would report revenues and cost of goods sold associated with its leasing arrangements on a gross basis.

- Short-term lease cost, excluding expenses relating to leases with a lease term of less than one month
- Sublease income, disclosed on a gross basis separate from finance lease and operating lease expense
- Net gain or loss from sale and leaseback transactions
- Separately for finance and operating leases, the following information:
    - Cash paid, 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
- Information about leases that have not yet commenced but that create significant rights and obligations
- The fact that the lessee has elected the practical expedients related to short-term leases and separating lease and nonlease components, if applicable, and related information.

DISCLOSURES

The objective of the disclosure requirements is to enable users of the financial statements to assess the amount, timing, and uncertainty of cash flows arising from leases. The following information is required to be disclosed:

DISCLOSURE REQUIREMENT:	LESSEE	LESSOR
Qualitative and quantitative information about the significant judgments made in accounting for leases.	✓	✓
Information about the nature of leases including[1]: • General description	✓	✓
• Basis and terms and conditions related to variable lease payments	✓	✓
• Terms and conditions of any options to extend or terminate the lease, including narrative disclosure about those that are included in the measurement of ROU assets and lease liabilities and those that are not	✓	
• Terms and conditions of any purchase options		✓
• Terms and conditions of any residual value guarantees	✓	
• Restrictions or covenants imposed by leases, such as relating to dividends or incurring additional financial obligations.	✓	

Information about significant assumptions, including:	LESSEE	LESSOR
• The determination of whether a contract contains a lease	✓	✓
• Allocation of consideration between lease and nonlease components	✓	✓
• Determination of the amount of any residual value		✓
• Determination of the discount rate for the lease.	✓	
A maturity analysis of finance lease liabilities/sales-type and direct financing lease receivables separately from operating lease liabilities/operating lease payments on an undiscounted basis for each of the first five years and in total for the periods thereafter, including a reconciliation of the undiscounted amount to the amount recognized in the balance sheet.	✓	✓
Lease transactions between related parties.	✓	✓

(1) Lessees must disclose this information related to subleases if applicable.

In addition to the disclosures in the table above, lessors must also disclose the following in a tabular format:

- Profit or loss recognized at commencement for sales-type and direct financing leases, plus interest income either in aggregate or separated by the components of the net investment in the lease
- Lease income relating to operating lease payments
- Lease income relating to variable lease payments not included in the measurement of the lease receivable.

The following disclosures are also required for lessors:

- The components of net investments in sales-type and direct financing leases, including carrying amount of lease receivables, unguaranteed residual assets and any deferred selling profit on direct financing leases
- Information about how the entity manages risk associated with residual value of leased assets, including its risk management strategy, the carrying amount of residual assets covered by guarantees, and any other means by which the lessor reduces its residual asset risk
- Significant changes in the balance of its unguaranteed residual assets and deferred selling profit on direct financing leases.

Both lessees and lessors must disclose the fact that they have elected to use one or more of the practical expedients in ASC 842-10-65-1.

The level of detail and how much emphasis to place on each of the various requirements is a matter of judgment, and the reporting entity must aggregate or disaggregate disclosures to ensure that useful information is neither obscured by presenting a large amount of insignificant detail nor by aggregating items that have different characteristics. More extensive disclosures are appropriate for entities for which leasing is a significant portion of their business.

TRANSITION

OVERVIEW

The new standard is effective for public business entities for fiscal years beginning after December 15, 2018 (which is 2019 for calendar year companies), and for interim periods within those fiscal years. For all other companies, the new standard is effective for fiscal years beginning after December 15, 2019, and interim periods beginning the following year. Early adoption is permitted for both public and nonpublic entities. The new standard provides for a modified retrospective approach which requires recognition at the beginning of the earliest comparative period presented of leases that exist at that date (for example at January 1, 2017 for a calendar

Observation: Many of the disclosure requirements under the new standard are incremental to the prior requirements, and will likely require significant effort and judgment to prepare, especially the information about significant assumptions required from both lessees and lessors and information about risk management related to residual assets required from lessors.

public business entity that adopts Topic 842 on January 1, 2019), as well as adjusting equity at the beginning of the earliest comparative period presented as if the new standard had always been applied (the modified retrospective approach). However, in July 2018, the FASB issued ASU 2018-11, which provides an additional (and optional) transition method (the effective date approach). Under the additional transition method, an entity initially applies the new leases guidance at the adoption date (rather than at the beginning of the earliest period presented). Therefore, a calendar year-end entity with an initial adoption date of January 1, 2019 which elects the additional transition method would apply Topic 840 in the comparative periods and recognize the effects of applying Topic 842 as a cumulative adjustment to retained earnings as of January 1, 2019. If an entity elects the new transition method, it is required to provide the Topic 840 disclosures for all prior periods presented that remain under the legacy leases guidance.

The date at which an entity will initially apply the new lease standard ("date of initial application") depends on the transition method elected.

- Modified retrospective approach – The date of initial application is the later of the beginning of the earliest period presented and the commencement date for the lease. Consider for example a public business entity with a calendar year-end. The required adoption date is January 1, 2019 (assuming the entity does not early adopt). The beginning of the earliest period presented is January 1, 2017. For a lease that commenced before January 1, 2017, the date of initial application is January 1, 2017. For a lease that commenced after January 1, 2017, the date of initial application for that lease would be its commencement date (for example, June 30, 2017).

- Effective date approach – The date of initial application is the beginning of the period in which an entity adopts the new lease standard. Consider for example a public business entity with a calendar year-end. The required adoption date, and its date of initial application, is January 1, 2019 (assuming the entity does not early adopt).

A summary of the new standard's transition provisions follows.

PRACTICAL EXPEDIENTS

The new standard provides multiple practical expedients in order to simplify adoption, including the following:

- An entity need not reassess whether any expired or existing contracts are or contain leases.

- An entity need not reassess the lease classification for any expired or existing leases. Instead, any leases previously classified as operating leases will continue to be classified as operating leases, while any leases previously classified as capital leases will be classified as finance leases.

- An entity need not reassess initial direct costs for any leases.

The three practical expedients must be elected as a package and must be applied by an entity to all of its leases (those for which the entity is a lessee or a lessor).

In addition to the package of practical expedients, the new lease standard also provides the following two other expedients.

- An entity may use hindsight in determining the lease term, including consideration of renewal, termination and purchase options, and in assessing impairment of ROU assets. This expedient also must be elected at the entity level and may be elected separately or in conjunction with either or both the package of practical expedients and the land easements practical expedient.

- An entity may elect a practical expedient not to assess whether existing or expired land easements that were not previously accounted for as leases under ASC 840 are or contain a lease. This expedient also must be elected at the entity level and may be elected separately or in conjunction with either or both the package of practical expedients and the hindsight practical expedient.

LEASES - LESSEE

For leases classified as operating leases under Topics 840 and 842, the lessee should measure the lease liability as the present value of the remaining rental payments as applied under Topic 840 and any amounts probable of being owed under a residual value guarantee, using the discount rate in effect at the date of initial application. The ROU asset is measured as the value of the lease liability, adjusted for any prepaid or accrued rent payments, any unamortized lease incentives or tenant improvement allowances, any unamortized initial direct costs, and the carrying amount of any liability recognized in accordance with Topic 420 on exit or disposal cost obligations for the lease. direct costs previously deferred but which do not meet the definition of initial direct costs under the new standard are to be written off as an adjustment to equity or earnings depending on the transition method elected. In addition, the ROU asset related to any leases previously classified as operating leases but which are classified as a finance lease under the new standard would be calculated as a proportion of the original lease liability, adjusted only for any prepaid or accrued lease payments and any liability recognized in accordance with Topic 420. The proportion of the liability to record is the commencement date liability, multiplied by the remaining lease term at transition and divided by the total lease term.

Observation: Entities are reminded that the practical expedient not to reassess whether a contract is, or contains, a lease (which is included in the package of practical expedients above) does not grandfather errors. Accordingly, entities that wish to take advantage of the package of practical expedients should ensure that they have a complete population of leases identified and appropriately classified in accordance with Topic 840 at the date of initial application.

For leases previously classified as capital leases under Topic 840 and 842, the lessee should recognize an ROU asset and a lease liability at the carrying amount of the lease asset, including any unamortized initial direct costs, and capital lease obligation at the date of initial application. If the lessee does not elect the practical expedients package, any initial direct costs that no longer meet the definition of initial direct costs as defined by Topic 842 should be written off as an adjustment to equity (or earnings for leases entered into after the initial date initial application).

Observation: Although the practical expedient allows use of hindsight in determining the lease term and assessing impairment, it does not allow the use of hindsight in determining lease payments. Specifically, the FASB staff has indicated that when a lease includes variable payments based on a rate or index, entities should use the rate or index that was in place at lease commencement for purposes of valuing the lease liability and ROU asset in transition, not the rate or index that is in place at the date of transition.

However, it is our understanding that the SEC staff has indicated that using the rate in place at the date of initial application is acceptable if the entity has historically used an updated rate for determining the amount of future lease payments disclosed in their five-year maturities footnote under ASC 840.

Therefore, if an entity has historically used inception date payments in their ASC 840 disclosures, then they must use inception date values for measuring the ROU asset and lease liability upon adoption of ASC 842. However, if they have historically used current payments in their ASC 840 disclosures, then they can elect whether to use inception date values or values as of the date of initial application for measuring the ROU asset and lease liability upon adoption of ASC 842. We believe that this choice is an accounting policy election that should be consistently applied to all leases.

In addition, for any leases previously classified as finance leases which are classified as operating leases under the new standard, the lessee must derecognize the carrying amount of any capital lease asset and capital lease obligation, with any difference accounted for as prepaid or accrued rent. The lessee will recognize an ROU asset and lease liability as the present value of remaining lease payments, with the ROU asset adjusted for any prepaid or accrued rent, any unamortized initial direct costs, and any unamortized lease incentives. The applicable discount rate depends on the transition method selected and, for the modified retrospective transition method, whether the lease commenced before or after the beginning of the earliest period presented.

LEASES - LESSOR

A lessor should continue to recognize the underlying asset related to any leases classified as an operating lease under Topics 840 and 842, along with any related lease assets or liabilities. If the lessor does not elect the practical expedients package, then any initial direct costs no longer meeting the definition of initial direct costs must be written off as an adjustment to equity (or earnings for leases entered into after the date of initial application). In addition, for any leases previously classified as operating leases but classified as sales-type or direct financing leases under the new standard, the objective is to account for the lease as if it had always been accounted for as a sales-type or direct financing lease under the new standard. Accordingly, a lessor must derecognize the underlying asset and recognize the initial net investment in the lease at the date of initial application, with the difference between the two recorded as an adjustment to equity or earnings depending on the transition method elected.

Observation: In determining the discount rate in effect at the date of initial application, a question has arisen whether that rate should reflect the original term of the lease, or the remaining term as of the date of initial application. Because the guidance is not clear on this point, the FASB staff indicated, and the SEC staff subsequently confirmed in a speech, that either method is acceptable, as long as it is consistently applied for all leases. We believe the same option is applicable to private companies as well.

For leases classified as sales-type or direct financing under Topics 840 and 842, the lessor should continue to recognize a net investment in the lease at the carrying amount of the net investment at the date of initial application. If the lessor does not elect the practical expedients package, for any leases previously classified as direct financing or sales-type but now classified as operating leases, the objective is to account for the lease as if it had always been accounted for as an operating lease under the new standard. Accordingly, the lessor must recognize the underlying asset at what the carrying amount would have been had the lease been classified as an operating lease under Topic 840 guidance and derecognize the carrying amount of the net investment in the lease, with any difference recorded as an adjustment to equity (or earnings for leases entered into after the date of initial application).

SALE AND LEASEBACK TRANSACTIONS

An entity will not reassess any sale and leaseback transactions previously accounted for as a sale. If prior transactions were accounted for as a sale and a capital leaseback, the seller- lessee should continue to recognize any deferred gain on a straight-line basis over the remaining lease term for leases of land only, in proportion to the amortization of the ROU asset if the underlying asset is not land only and the leaseback is a finance lease, or in proportion to the recognition of the lease cost if the underlying asset is not land only and the leaseback is an operating lease. If the previous transactions were accounted for as a sale and an operating leaseback, the seller- lessee should recognize any deferred gain or loss not resulting from off-market terms as a cumulative-effect adjustment

Observation: Entities should be aware of the accounting differences that will exist between existing leases versus new leases once the entity adopts Topic 842 because of the transition provisions. For example, lessees will recognize existing operating leases on the balance sheet using the minimum lease payments as applied under Topic 840, rather than using the lease payments as defined under Topic 842 (even though there are differences between the two concepts). However, after the effective date, if those existing leases are modified and not accounted for as a separate contract, or the lessee is required to remeasure the lease payments, then the lessee should use the remaining lease payments as defined under Topic 842 in accounting for those leases starting at the date of modification or remeasurement and should no longer user minimum lease payments.

We understand that there is diversity in practice on whether lessees include executory payments in the minimum rental payments, including in the five-year maturities tabular disclosure required by Topic 840. The SEC staff has indicated that it expects registrants to recognize existing operating leases in transition using the definition of minimum rental payments that it has historically used in applying Topic 840. We believe the same approach is required for nonpublic companies.

at the date of initial application, recognize any deferred loss resulting from off-market terms as an adjustment of the leaseback ROU asset, and recognize any deferred gain resulting from off-market terms as a financial liability.

However, if a previous transaction was accounted for as a failed sale and remains a failed sale at the effective date, the entity will reassess whether a sale would have occurred.
If a sale is deemed to have occurred, the lease should be accounted for under the applicable transition provisions discussed.

OTHER TRANSITION PROVISIONS

In addition to the discussed transition provisions, the new standard includes other transition provisions, including build- to-suit lease arrangements and amounts previously recognized in respect of business combinations.

TAX IMPLICATIONS

Federal income tax law governing the income tax treatment of transactions covered by the new standard remains unchanged as of the writing of this publication. Therefore, taxpayers must continue to assess existing tax law to determine the federal income tax treatment of leases within the scope of Topic 842.

TAX LAW CONTEXTUAL OVERVIEW

A leasing arrangement generally provides a financing party (the lessor) with the right to claim tax benefits from the ownership of an asset intended to be used by another party (the lessee) so that the tax benefits can be "shared" with the lessee through lower rent or lease payments. The basic tax benefit is tax deferral – i.e., accelerated tax deductions in early years to reduce income from the leasing arrangement and from other sources in exchange for more taxable income in later years when tax depreciation deductions from the leased asset are less than in early years. Additional tax benefits might include investment tax credits.

The U.S. federal income treatment or classification of these arrangements range from a "true lease" which means the lessor is considered the tax owner of the leased property (the lessee does not own an asset for tax purposes), a conditional sale (the lessor is a conditional seller and the lessee is a conditional buyer), a lending transaction (the lessor is a creditor and the lessee is a debtor and the owner of a mortgaged asset), or other type of participation. Therefore, depending on the terms of the arrangement, the classification of a lease arrangement for federal income tax purposes could differ from the classification for financial reporting purposes.

The primary focus of the U.S. federal tax classification analysis is whether the lessor retains sufficient risks and rewards from ownership, including consideration of whether the lessor has made a substantial equity investment and retains a meaningful interest in the residual value of the asset (i.e., whether the lessor has upside and downside residual risk in the leased property).

While U.S. federal tax law does not contain a comprehensive articulation of "true leases," certain principles or bright lines have been developed through IRS administrative guidance and case law that define a "true lease" including:

- Minimum unconditional "at risk" investment (i.e., equity investment and remaining useful life beyond lease terms).
- No bargain purchase options (i.e., less than fair market value when option is exercised) or put option to lessee.
- No economic compulsion to purchase the asset at the end of the term or at a fixed purchase option.
- No investment by lessee beyond certain improvements or additions.
- No lessee loans or guarantees.
- Profit (beyond tax benefits) and positive cash flow requirements.
- No limited use property.
- Commercially feasible that another party can use the asset after lease expiration, considering remaining useful life and residual value.
- Other considerations and facts and circumstances.

An arrangement which qualifies as a "true lease" for federal income tax purposes for accrual method taxpayers is accounted for on the lessor's and lessee's tax returns as follows:

	Lessor	Lessee
Rent	Taxable income as earned *	Deducted as accrued
Fees Received	Taxable income when collected	N/A
Residual – sale/purchase	Taxable income when collected	Establishes depreciable basis
Residual – re-leases	Taxable income accrued	Deducted as as earned
Depreciation	Annual deduction on MACRS**	N/A
Fees paid – up front	Capitalize and deduct straight line***	N/A
Feeds paid – over life	Deducted as paid	N/A
Interest expense	Deductible using interest method	N/A

Source: Equipment Leasing and Finance Association

*Advance rents taxable when collected; arrears rents accrued into proper period under either section 451 or section 467 in the case of rents pertaining to a section 467 rental agreement

** Modified Accelerated Cost Recovery System as defined in IRS Code section 168 and related regulations

*** Capitalized fees are deducted ratably over the lease term

For an accrual method taxpayer, an arrangement which fails the requirements to be considered a "true lease" would be accounted for on the lessor's and lessee's tax returns as follows (i.e., conditional sale or financing):

	Lessor	Lessee
Rent	Allocated between interest income and return of principal	Allocated between interest expense and payment of principal
Depreciation	N/A – lessor is not owner for tax purpose	Annual depreciation deductions under MACRS**
Interest Expense	Deductible using the interest method	N/A

FINANCIAL AND TAX REPORTING IMPLICATIONS

The biggest impact of the new standard is the requirement that all leases be recognized on the balance sheet of the lessees' financial statements (except for those for which the short term lease exemption has been elected). For example, if a leasing arrangement qualifies as a "true lease" for tax purposes, under the new standard, the lessee will now have to recognize a ROU asset and a corresponding lease liability even when the underlying arrangement qualifies as an operating lease under Topic 842. This will result in the recognition of new deferred tax assets or liabilities because the lessee would neither have a tax basis in the right-of-use asset, nor a lease liability for federal income tax purposes.

Specifically, a lessee would recognize a deferred tax liability (measured at the applicable tax rate) for the ROU asset since future recovery of the book basis (i.e., generating cash inflows from the use of the leased asset) will not have a corresponding depreciable tax basis, thereby resulting in more taxable income to the lessee. The lessee would also recognize a deferred tax asset (measured at the applicable tax rate) for the lease liability because the future settlement of the lease liability (i.e., paying down the carrying value or principal) will result in a tax deduction through deductible rents.

The ROU asset is initially measured by reference to the present value of the lease liability. However, certain initial costs might be capitalized in the ROU asset if they qualify as initial direct costs as defined under Topic 842. Subsequent measurements of the liability and related asset will invariably cause the carrying values to diverge and thus the respective deferred taxes would not entirely offset (i.e., the deferred tax liability for a ROU asset would not be entirely offset by the deferred tax asset for the lease liability).

A deferred tax asset would be assessed, together with all other deferred tax assets within a jurisdiction or a taxpaying entity, for recoverability or the need for a valuation allowance. However, the deferred tax liability for the ROU asset would generally be considered a source of income to support realization of the deferred tax asset.

The magnitude of the deferred taxes recognized initially would depend on several factors including the lessee's accounting policy election related to nonlease components (e.g., maintenance service) and initial direct costs. The new standard permits an accounting election to include non- lease components in the measurement of the lease liability. The deferred income taxes initially recognized would be higher when lessees elect to include nonlease components in the measurement of the lease asset and liability. For example, a lessee elects an accounting policy to include in the measurement of the lease liability and ROU asset the relative standalone value of a three-year maintenance contract included with the leasing of a certain class of machinery or equipment. For tax purposes, the standalone value of nonlease components, such as the three-year maintenance contract, would not be capitalized into the cost basis of leased property. Prepayment of nonlease components could be capitalized as a separate asset and amortized over time (e.g., a three-year maintenance contract that is prepaid at inception). However, nonlease components could also be deducted as incurred depending on the terms of the agreement and the taxpayer's method of accounting for such items.

Also, under the new standard, the definition of initial direct costs is significantly narrowed to only include incremental costs of a lease that would not have been incurred if the lease had not been obtained. Consequently, certain initial costs now would be expensed for accounting purposes but still required to be capitalized for income tax purposes, thereby creating additional temporary differences and deferred income taxes. However, federal tax law allows for an immediate deduction of de minimis costs incurred to acquire an asset (i.e., up to $5,000 of the entire cost for taxpayers with applicable financial statements). This tax deduction allowance might be suitable for small value leases (e.g., certain office equipment and computers).

While the balance sheet change is very significant, the income statement change is less pronounced. This is because the FASB decided to retain the income recognition pattern of a typical operating lease which is going to continue to be a single cost recognized on a straight-line pattern over the lease term.
However, lease expense (i.e., single lease cost) is unlikely to be the same for tax purposes given the initial and subsequent measurements of the lease liability and the ROU asset. In fact, an operating lease expense includes an accretion of the lease liability and amortization of the asset (albeit, as a balancing amount), whereas for income tax purposes the deductible expense would be limited to the actual lease payments (i.e., the cash payment which reduces the balance of the lease liability). The tax deduction for advance rents, stepped rents, and rent bonuses will be determined based on the terms of the agreement and the taxpayer's current accounting methods. Therefore, the book-to-tax expense difference would be accounted for as a temporary difference under Topic 740 to be reconciled with the movement in the deferred tax balances related to the lease liability and asset.

For finance leases, the income statement recognition of total lease cost remains the same as under prior guidance. That is, there would be an interest expense and depreciation expense – and lessees would recognize deferred income taxes for temporary differences arising from different book and tax depreciation schedules.

Deferred income tax accounting for sale and leaseback transactions by the seller-lessee could also see some changes. The new standard requires the application of the principles in the new revenue recognition accounting standard, Topic 606, to determine whether the seller-lessee would qualify for sale accounting.
If the transaction fails the revenue recognition requirements under Topic 606, the consideration paid by the buyer-lessor for the asset is accounted for as a financing transaction by both the seller-lessee and the buyer-lessor. Some sale and leaseback transactions that meet the current tax law requirements for sales to seller-lessees and purchases to buyer-lessors might

fail the requirements in Topic 606 for sales accounting, creating more temporary differences for lessees and lessors. Consequently, a seller-lessee would recognize current taxable income but will have a deferred tax asset representing the future inclusion of book income but not taxable income (the seller-lessee would have a liability for accounting purposes). Conversely, certain sale and leaseback arrangements involving real estate which cannot be accounted for as sales under prior guidance would likely achieve sales accounting treatment under Topic 606, further impacting deferred income taxes.

SUMMARY OF SELECTED INCOME TAX CONSIDERATIONS

Reporting entities implementing the new standard will also need to consider and track the classification of their leases for tax purposes - i.e., the domestic federal and/or foreign income tax classification of all leases. Proper classification of leases for income tax purposes is required to ensure accurate application of Topic 740 and to avoid recognition of uncertain tax benefits related to leases.

There might also be current tax implication such as re- determination of state & local income taxes due to changes in apportionment factors used to allocate income to states and local jurisdictions. Additionally, a reevaluation of the tax classification of existing leases might necessitate applying for accounting method changes for federal tax purposes.

[8] This method change is made on a cut-off basis and applies to transactions entered into on or after the beginning of the year of change.

Currently, Rev. Proc. 2016-29 provides an automatic change procedure for taxpayers to change the classification of sale, lease, or financing transactions.[8] In summary, lessees and lessors should consider the following list of potential tax implications, which is not all-inclusive:

- **Accounting for Income Taxes:**
    - Recognition of new deferred tax assets and liabilities for previously unrecorded lease-related assets and liabilities
    - New or revised book-to-tax differences included in the provision for income taxes.
- **Federal income tax:**
    - No change to current tax framework for recording leased property
    - When tax classification follows book classification of leases (as operating , sales-type, or direct financing), the federal tax classification should be evaluated under federal tax principles to ensure tax classifications are sustainable
    - New or revised book-to-tax Schedule M adjustments.
- **State and local:**
    - Changes to classification of leased property for apportionment purposes
    - Evaluation of whether the new accounting for leases creates or changes sales tax obligation related to leased assets
    - Evaluation of whether leased property is included in the tax base subject to property taxes.

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APPENDIX A – FREQUENTLY ASKED QUESTIONS – SEC REGISTRANTS

Q1: Can an SEC registrant early adopt ASU 2016-02?
A1: Yes. Early adoption is permitted for all entities.

Q2: Is a private entity that meets the definition of a public business entity solely because its financial statements are included in a public business entity's filing with the SEC required to adopt ASC 842 using the effective dates of a public business entity?
A2: No. The SEC staff announced that it will not object if an entity that qualifies as a public business entity solely because its' financial statements or financial information is included in another entity's filing with the SEC using the effective dates applicable to nonpublic entities.

Q3: Are any disclosures required prior to adoption of the new standard?

A3: Yes. SEC registrants will need to make disclosures under Staff Accounting Bulletin (SAB) No. 74 (codified in SAB Topic 11-M) in their next annual and interim filings. SAB 74 addresses disclosure of the impact that recently issued accounting standards will have on the financial statements of the registrant when adopted in a future period. Companies will understandably need time to assess the standard's effects on their financial statements. Accordingly, the initial SAB 74 disclosures about the standard's effect may be general in nature. These disclosures will be expected to evolve over time as companies begin to better understand how the standard will impact their financial statements. As encouraged by SAB 74, registrants should also consider making disclosure of the potential impact of other significant matters that may result from the adoption of the new standard (e.g. technical violations of debt covenants or planned changes in business practices).

Q4: Do SEC registrants have to recast the 5-year Summary of Selected Financial Data in accordance with the new lease standard?

A4: No. **At the March 21, 2016 SEC Regulations Committee Joint Meeting with SEC Staff**, the SEC staff indicated that the selected financial data table should follow the transition provisions of the ASU, which requires the new standard to be applied as of the date of initial application. For example, if a registrant adopts the new standard using the modified retrospective approach for its year ending December 31, 2019, then the beginning of the earliest comparative period presented in the financial statements included in its 2019 Form 10-K would be January 1, 2017. Therefore, the registrant would only apply the new standard to 2019, 2018 and 2017 in the selected financial data table. The selected financial data for 2016 and 2015 will be prepared using the prior lease accounting guidance. Likewise, if a registrant adopts the new standard using the effective date approach for its year ending December 31, 2019 (that is, beginning on January 1, 2019), we expect that, while not formally communicated by the SEC yet, the registrant would apply the new standard to 2019 only in the selected financial data table. The selected financial data for 2015 through 2018 will be prepared using the prior lease accounting guidance. Consistent with Instruction 2 to S-K Item 301, the registrant must provide disclosure, or cross-reference to a discussion thereof, regarding the lack of comparability of data presented in the selected financial data table if material.

Q5: Does the issuance of a registration statement after the effective date change the date of initial application?

A5: No. If a registrant files a registration statement during 2019, it is not required to change its date of initial application. For example, a calendar year-end public entity adopts the new standard on January 1, 2019 using the modified retrospective approach. The beginning of the earliest comparative period presented is January 1, 2017. In May 2019, the registrant files its first quarter 2019 Form 10-Q, which reflects the adoption of the new standard. Shortly after, the registrant files a registration statement on Form S-3 that incorporates by reference the financial statements for the years ending December 31, 2018, 2017 and 2016, as well as the quarters ending March 31, 2019 and 2018. The reissuance of the financial statements on Form S-3 requires the financial statements for the years ended December 31, 2018 and 2017 to be restated under the new standard, but it does not change the date of initial application from January 1, 2017. Accordingly, the financial statements for the year ended December 31, 2016 need not reflect the application of ASC 842.

Q6: Are there any internal control implications related to adopting and implementing the new leases standard?

A6: Yes. Registrants should ensure they have the appropriate controls in place with respect to implementing new accounting standards, including the new leases standard. This is prior and in addition to any internal control changes related to leases after adoption.

APPENDIX B – ASC 840 TO ASC 842 KEY DIFFERENCE CONSIDERATIONS

Following is a summary of certain key differences between ASC 840 and 842 that companies may consider as they evaluate management's adoption of ASC 842.

TOPIC	ASC 842 CONSIDERATIONS	ASC 840 CONSIDERATIONS	CHALLENGES
Lease Definition	One of the key elements for an arrangement to be considered a lease or contain a lease is that the supplier does not have a substantive substitution right. That is, the supplier does not have the practical ability to substitute alternative assets during the lease term and would not economically benefit from the substitution. This is an explicit requirement under ASC 842.	While ASC 840 indicated that an arrangement depended on a specified property, plant or equipment if it was not 'economically feasible' to use an alternative asset, it did not provide for an explicit requirement like under ASC 842. Further, ASC 840 did not require that a supplier economically benefit from a substitution.	Determining whether an arrangement contains a lease is likely to be more important since virtually all leases will require recognition of an asset and liability. The requirement under ASC 842 that a substitution right be economically beneficial to a supplier is a higher threshold than under ASC 840. Therefore, there could be more arrangements subject to lease accounting under ASC 842.
Lessee Accounting: Classification as an Operating vs. Finance Lease	There are no bright lines in determining whether a lease should be classified as an operating or a finance lease. In addition, ASC 842 introduces an additional criterion regarding the specialized nature of the underlying asset for lease classification.	Under ASC 840, there were four specific criteria used to determine if a lease was an operating or capital lease, with explicit bright lines.	The lack of explicit bright lines may increase the level of judgment required when classifying a lease, particularly for certain highly structured transactions. Companies should set accounting policies to determine what constitutes 'major part' and 'substantially all' for lease classification purposes.
Lessee Accounting: Presentation within the Balance Sheet	Lessees will recognize a right-of- use asset and a lease liability for virtually all leases.	Under ASC 840, operating leases were not included in the balance sheet.	Including all leases on the balance sheet will be one of the biggest challenges for companies as they implement the standard.
Lessee Accounting: Expense Recognition and Impairment Considerations	Expense will be recognized on a straight-line basis for an operating lease. This is accomplished by increasing the amortization of the right-of-use asset as interest expense on the liability declines over the lease term. Recognition of expense for a finance lease will be similar to capital leases under ASC 840.	Under ASC 840, operating leases were off balance sheet, so lease expense recognition did not typically impact impairment testing.	Under ASC 842, the accounting for an operating lease will backload amortization of the right-of-use asset, potentially increasing the risk of an impairment. If the practical expedient is not elected, lessees must allocate the lease consideration to the separate lease and non-lease components on a relative standalone price basis.

TOPIC	ASC 842 CONSIDERATIONS	ASC 840 CONSIDERATIONS	CHALLENGES
Lease vs. Non-lease Components	A contract may contain lease and non-lease components. Under ASC 842, components include only those items or activities that transfer a good or service to the lessee. The right to use land is considered a separate lease component, unless the accounting effect of doing so would be immaterial. Under ASC 842, property taxes and certain insurance costs are not considered to be components of a contract, as they are not for a service provided by the lessor to the lessee and are therefore a part of lease payments. Lessees and lessors each have a practical expedient to not separate. For lessors, certain criteria must be met.	Under ASC 840, property taxes, insurance, and maintenance services are considered executory costs and part of the lease element. Under ASC 840, land is separately classified when the fair value of the land is 25% or more of the combined fair value of the land and building.	If observable standalone prices are not readily available, lessees must estimate standalone prices maximizing the use of observable information to the extent possible. The residual approach may be acceptable if the standalone price for a component is highly variable or uncertain. Similarly, if the practical expedient is not elected, lessors must allocate the consideration to the separate lease and non-lease components generally on a relative standalone selling price basis.
Initial Direct Costs	Under ASC 842, initial direct costs are defined as incremental costs of a lease that would not have been incurred if the lease had not been obtained.	Under ASC 840, incremental direct costs can include internal costs as well as external costs, even if the costs were incurred before the lease was obtained.	Under ASC 842, certain items that were previously capitalized will no longer be eligible for capitalization. Companies will need to be aware of such costs, if material, as they evaluate new leases.
Lease Reassessment	Under ASC 842, lessees are required to reassess the lease term or a purchase option if a triggering event occurs that is under the lessee's control. There also are other changes in circumstances which will require lessees to remeasure and reallocate the consideration in the contract, remeasure the lease liability and sometimes to reassess lease classification and update the discount rate.	ASC 840 does not require a reassessment of lease classification unless the lease is modified or an option is exercised.	Companies will need to keep in mind any potential triggering events, or changes in facts and circumstances that may require remeasurement of the lease liability.

TOPIC	ASC 842 CONSIDERATIONS	ASC 840 CONSIDERATIONS	CHALLENGES
Lease Modification	A lease modification is a change to the contractual terms and conditions of a lease that was not part of the original lease and that results in a change in scope or consideration. A modification that grants the lessee an additional right of use priced at market is a separate lease that is then classified at the lease modification date.	Lease modifications under ASC 840 can be very complex and difficult to differentiate from a termination of a lease contract.	Companies will need to keep in mind any changes in terms that may trigger the need to evaluate whether a lease modification has occurred.

APPENDIX C – COMPARISON TO IFRS STANDARD

The lease project began as a joint project with the IASB. The IASB released its final standard, IFRS 16 Leases, in January 2016. Although many aspects of the two standards are converged, there are significant differences, the most notable of which is the lessee accounting model. The lessor accounting models in Topic 842 and IFRS 16 are substantially converged, but important differences exist.

LESSORS

One key difference is the recognition of selling profit on direct financing leases. Topic 842 requires selling profit, if any, to be deferred at lease commencement and recognized as additional interest income over the lease term. Because IFRS 16 does not differentiate between sales-type and direct financing leases, any selling profit on leases accounted for under IFRS 16 that would be classified as direct financing leases in accordance with Topic 842 is recognized at lease commencement.

Another key difference is gain or loss recognition in sale and leaseback transactions. Topic 842 requires a seller-lessee to account for any gain or loss on the sale of the asset consistently with the guidance that would apply to any other sale of the underlying asset, while IFRS 16 requires a seller- lessee to recognize only the amount of any gain on sale that relates to the rights retained in the underlying asset at the end of the leaseback.

Other lessor differences include collectability and modifications of sales-type and direct financing leases.

Further, the private company accounting alternative to use a risk-free rate to discount the lease liability, applicable to both lessees and lessors under Topic 842, is not included in IFRS 16.

LESSEES

Although both standards require lessees to reflect assets and liabilities associated with leases on the balance sheet, IFRS 16 does not differentiate between finance and operating leases, but rather treats all leases of assets with values greater than $5,000 as finance leases. This means leases classified as operating leases under U.S. GAAP will be accounted for differently under IFRS, resulting in different recognition and presentation patterns in the income statement and cash flow statement.

There are other differences between Topic 842 and IFRS 16 that directly relate to the different decisions reached on the lessee accounting model. These include discount rate used upon modification, classification of subleases and presentation, disclosure, and transition.

Additionally, the events that trigger a lessee's reassessment of variable lease payments differ under Topic 842 and IFRS 16.

One key difference is that IFRS 16 requires remeasurement of the lease liability upon changes in an index or rate on which variable payments are based.