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# Lessor accounting under ASC 842

October 2022



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## 1. Introduction

### 1.1 Background information

In February 2016, the FASB issued ASU 2016-02, which was codified in ASC 842.

On its effective date, ASC 842 replaces the legacy U.S. GAAP for leases in ASC 840. For ease of use, definitions for acronyms and titles for ASUs, ASC topics and subtopics and other guidance referred to in this white paper are included in Appendix A.

As many entities started implementing ASC 842, numerous questions arose, many of which were submitted to the FASB for further consideration. Upon considering many of these questions, the FASB decided certain changes to ASC 842 were necessary. In addition, the FASB and the SEC staff provided limited effective date relief for ASC 842 and the SEC staff superseded almost all of its preexisting guidance on accounting for leases (which was included in the S99 sections of ASC 840). To incorporate its and the SEC staff's changes to ASC 842 and ASC 840, the FASB has issued the following 12 ASUs since the issuance of ASU 2016-02:

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

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

### 1.2 Most significant change under ASC 842

The most significant change resulting from ASC 842 is the requirement for lessees to recognize right-of-use (ROU) assets and lease liabilities for almost all leases. This change, along with other changes, is expected to have a significant impact on the financial statements of lessees.

In contrast, the impact of ASC 842 on lessors is not expected to be as significant. Paragraph BC 90 of the Basis for Conclusions of ASU 2016-02 discusses the FASB's conclusion that "... the lessor accounting model in previous GAAP did not need comprehensive improvements and, therefore, changing that model in a significant way would not produce benefits (and would perhaps reduce the usefulness of lessors' financial reporting) significant enough to justify the costs of doing so."

### 1.3 Contents of this white paper

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

- Determine whether the contract is within the scope of ASC 842.
- Determine whether the contract is or includes a lease that meets the definition of a lease in ASC 842.
- If the contract is or includes one or more leases, determine the unit(s) of account in the contract, which involves identifying the lease and nonlease components in the contract, as well as noncomponents (e.g., taxes, insurance), and determining whether the lease and nonlease components should be treated as separate units of account.
- Identify or determine the key inputs needed to classify and account for a lease under ASC 842.
- Determine the lease's classification under ASC 842.



- Apply the appropriate accounting model in ASC 842 to the lease (which depends on its classification).
- Present and disclose the lease in the financial statements in accordance with ASC 842.

In addition, this white paper discusses the effective date and transition requirements in ASC 842 and differences between how lessors account for leases under ASC 842 and IFRS 16.

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

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

## 2. Scope

### 2.1 General

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

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

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

### 2.2 What's in a label?

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

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

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

### 2.3 Embedded derivatives

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

### 2.4 Land easements

As discussed in ASC 842-10-65-1(gg), a land easement is a right of way that provides one entity with the right to use, access or cross another entity's land for a specified purpose. For example, an electric company may have a land easement to build and maintain electric towers or poles on land owned by others. Both parties to a land easement (e.g., the landowner and the electric company) must evaluate the

contract and (or) law under which the easement is granted to determine whether it meets the definition of a lease (see Section 3). If the land easement meets the definition of a lease, it is accounted for as such under ASC 842.

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

Given that land easements were not necessarily thought of as leases under legacy U.S. GAAP, the FASB provided a practical expedient with respect to addressing land easements in transitioning to ASC 842, which is discussed in Section 9.3.3.

## 2.5 Sales with repurchase agreements

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

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

### 2.5.1. Forwards and call options

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

### 2.5.2. Put options

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

### 3. Determine if the contract is or includes a lease

#### 3.1 Overall definition and decision points

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

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

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

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

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

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

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

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

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

Considerable guidance is provided in ASC 842 related to each of these decision points, including 10 examples (addressing application of these decision points to 16 different scenarios) provided in ASC 842-10-55-41 to 55-130. Each of these decision points is focused on in the next several sections. Example 3-1 to Example 3-4 and those other scenarios in ASC 842-10-55 that are specifically referenced in these sections, and the many others that are not, may assist in understanding how to apply the decision points to a live set of facts and circumstances. However, each specific set of facts and circumstances should be

independently analyzed given the likelihood of a live set of facts and circumstances differing from those in the examples and illustrative scenarios and the effects those differences could have on the analysis as to whether a lease exists.

### Spotlight on change: Definition of a lease

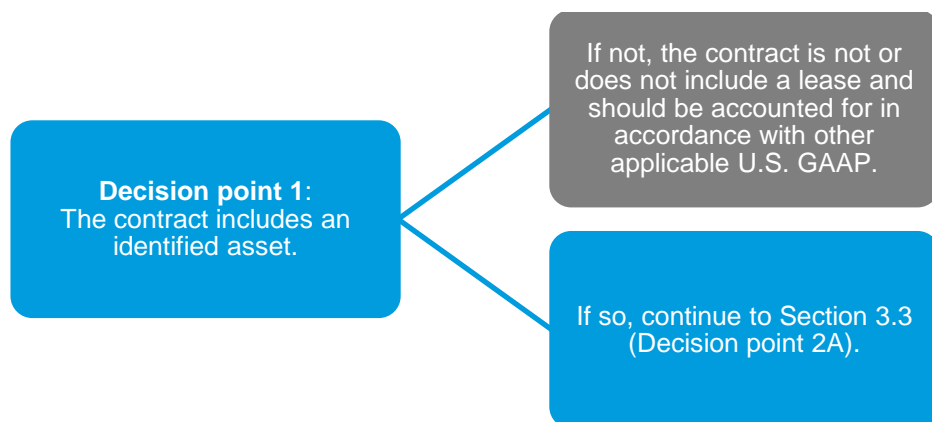
Under ASC 840, a lease may exist solely based on the contract conveying to the customer the right to obtain substantially all of the economic benefits related to the underlying asset. While this continues to be an important part of the definition of a lease under ASC 842, a contract must also convey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

As discussed in Section 9.3.1, if a lessee elects the package of transition practical expedients upon transition to ASC 842, it does not determine whether a preexisting contract at the date of initial application is or includes a lease. In other words, it retains the conclusion reached upon the application of ASC 840 with respect to whether a lease exists.

### 3.1.1 Period of use

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

## 3.2 Identified asset



### 3.2.1 Property, plant or equipment

An identified asset must be property, plant or equipment. If the contractual right to use involves an asset other than property, plant or equipment, the asset cannot be an identified asset, which means the contract is not (nor does it contain) a lease.

### 3.2.2 Explicit identification of the asset

In many cases, the asset subject to the right of use is explicitly identified in the contract. For example, a truck or other vehicle may be explicitly identified in a contract by its vehicle identification number, a

building may be explicitly identified in a contract by its specific location and address, and network equipment may be explicitly identified in a contract by its serial numbers.

### 3.2.3 Implicit identification of the asset

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

### 3.2.4 Supplier substitution rights

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

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

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

- *The supplier must have the practical ability to substitute the asset with an alternative asset throughout the period of use.* One point to consider in the evaluation of whether the supplier has the practical ability to substitute the asset with an alternative asset throughout the period of use is whether the asset subject to the right of use is a specialized asset (and, if it is, how the specialized nature affects the supplier's ability to substitute the asset). The supplier should consider whether it has readily available replacements for the asset subject to the right of use, and if not, what would be involved in creating or obtaining replacements. If it will take a significant amount of time or cost to obtain or create replacements for the asset subject to the right of use, any substitution rights for that asset may not be substantive. In addition, the supplier does not have the practical ability to substitute the asset with an alternative asset throughout the period of use if the contract allows the customer to refuse the substitution.
- *The supplier would have to benefit economically from exercising the substitution right (i.e., the economic benefits of exercising the substitution right outweigh the related costs).* In evaluating whether this is true, one point to consider is whether the asset subject to the right of use requires installation, and if it does, the complexity of that installation. Another point to consider is where the asset subject to the right of use is located. Examples of situations in which substitution rights for an asset subject to a right of use may not be substantive include those in which the asset requires complex installation, the asset is in a remote location that is difficult or costly for the supplier to reach or the asset is real estate and moving the customer to different real estate may be difficult or costly for the supplier.

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

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

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

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

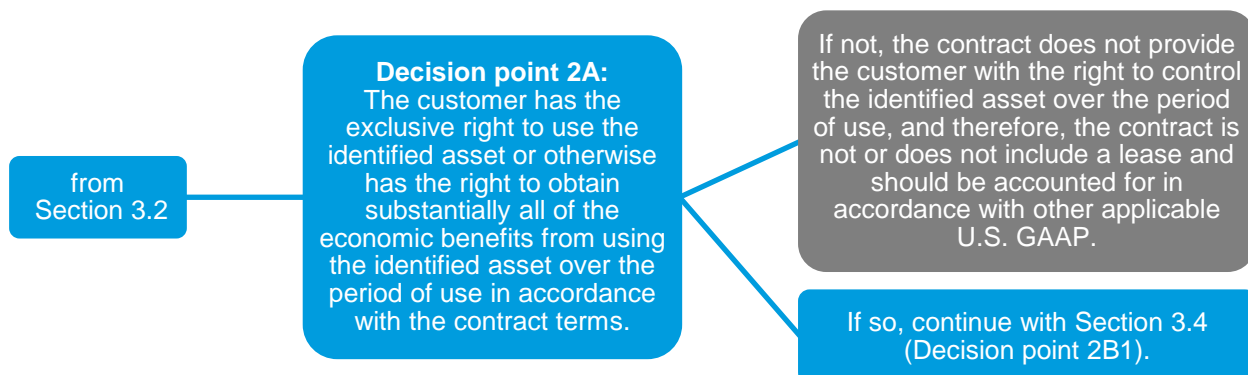
A capacity portion of an asset represents an identified asset if: (a) it is physically distinct (e.g., a specific floor in a building) or (b) it represents substantially all of the asset's capacity. In the context of one of the lease classification criteria (see Section 6.4), ASC 842 indicates that one reasonable approach to defining *substantially all* would be to use a threshold of 90% or more. We believe use of a 90% or more threshold generally is also appropriate for purposes of determining whether the capacity portion of an asset that a customer has the right to use represents substantially all of the asset's capacity.

For example, Case B of Example 3 in ASC 842-10-55-60 to 55-62 addresses a situation in which the right to use a portion of the capacity of a fiber-optic cable should not be considered an identified asset because the supplier may use any of the 15 fibers in the cable to provide the equivalent capacity of three fibers to the customer. The right to use 20% of a fiber-optic cable's capacity does not represent the right to use substantially all of the cable's capacity. As a result, an identified asset does not exist.

In comparison, consider a situation in which the customer has the right to use 90% of the capacity of a specific pipeline of the supplier. While 90% of the pipeline's capacity is not physically distinguishable from the other 10%, it still represents substantially all of the pipeline's capacity. As a result, an identified asset exists. Determining whether the contract providing the customer with the right to use this identified asset also results in the customer obtaining substantially all of the pipeline's economic benefits over the period of use is discussed in Section 3.3.3.



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



#### 3.3.1 Nature of the economic benefits

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

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

#### 3.3.2 Exclusive use of the identified asset

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



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

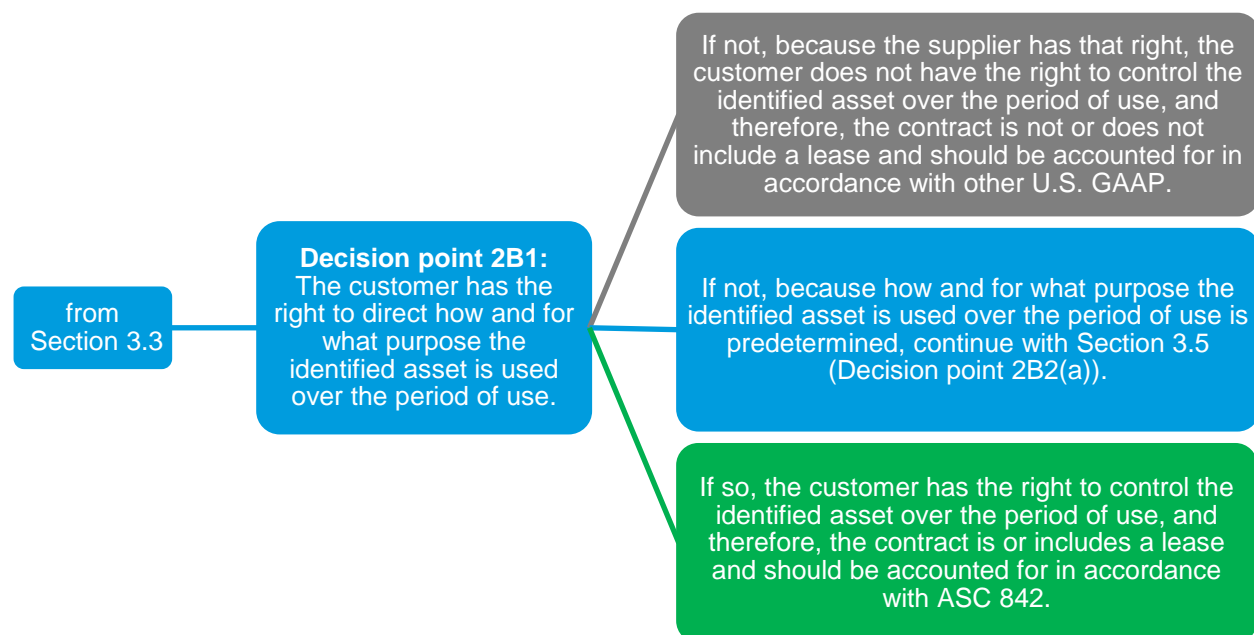
A customer that has the right to use substantially all of the capacity of an identified asset may have the right to obtain substantially all of the economic benefits from the asset's use. Whether that is the case will often depend on considering additional facts and circumstances present in a specific situation. In the context of lease classification criteria (see Section 6.4), ASC 842 indicates that one reasonable approach to defining *substantially all* would be to use a threshold of 90% or more. We believe use of a 90% or more threshold generally is appropriate for purposes of determining whether a customer having the right to use substantially all the capacity of an identified asset provides the customer with the right to obtain substantially all of the economic benefits from use of the identified asset.

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

### **3.3.4 Payments to supplier based on use of the identified asset**

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

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



#### 3.4.1 Decision-making rights

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

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

- The type of output produced by the identified asset (e.g., mix of products to be sold in a retail unit, use of a shipping container for storage or transport).
- When the output is produced (e.g., when a piece of machinery will be used to produce a widget, when a truck will be used to make a delivery).
- Where the output is produced (e.g., the destination of a truck, the location of equipment).
- Whether, and if so, how much of the output is produced (e.g., how much, if any, power will be produced by a power plant).

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

Examples of decision-making rights that do not provide the customer or supplier with the right to direct how and for what purpose the identified asset is used over the period of use include those limited to operating or maintaining the asset. The difference between decision-making rights that result in the

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

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

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

Customer enters into a contract with an information technology company (Supplier) for the use of an identified server for three years. Supplier delivers and installs the server at Customer's premises in accordance with Customer's instructions and provides repair and maintenance services for the server, as needed, throughout the period of use. Supplier substitutes the server only in the case of malfunction. Customer decides which data to store on the server and how to integrate the server within its operations. Customer can change its decisions in this regard throughout the period of use.

The contract contains a lease. Customer has the right to use the server for three years.

There is an identified asset. The server is explicitly specified in the contract. Supplier can substitute the server only if it is malfunctioning.

Customer has the right to control the use of the server throughout the three-year period of use because:

- a. Customer has the right to obtain substantially all of the economic benefits from use of the server over the three-year period of use. Customer has exclusive use of the server throughout the period of use.
- b. Customer has the right to direct the use of the server. Customer makes the relevant decisions about how and for what purpose the server is used because it has the right to decide which aspect of its operations the server is used to support and which data it stores on the server. Customer is the only party that can make decisions about the use of the server during the period of use.

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

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

Customer enters into a contract with a telecommunications company (Supplier) for network services for two years. The contract requires Supplier to supply network services that meet a specified quality

level. To provide the services, Supplier installs and configures servers at Customer's premises; Supplier determines the speed and quality of data transportation in the network using the servers. Supplier can reconfigure or replace the servers when needed to continuously provide the quality of network services defined in the contract. Customer does not operate the servers or make any significant decisions about their use.

The contract does not contain a lease. Instead, the contract is a service contract in which Supplier uses the equipment to meet the level of network services determined by Customer.

Customer does not control the use of the servers because Customer's only decision-making rights relate to deciding on the level of network services (the output of the servers) before the period of use—the level of network services cannot be changed during the period of use without modifying the contract. For example, even though Customer produces the data to be transported, that activity does not directly affect the configuration of the network services and, thus, it does not affect how and for what purpose the servers are used. Supplier is the only party that can make decisions about the use of the servers during the period of use. Supplier has the right to decide how data are transported using the servers, whether to reconfigure the servers, and whether to use the servers for another purpose. Accordingly, Supplier controls the use of the servers in providing network services to Customer. There is no need to assess whether the servers are identified assets because Customer does not have the right to control the use of the servers.

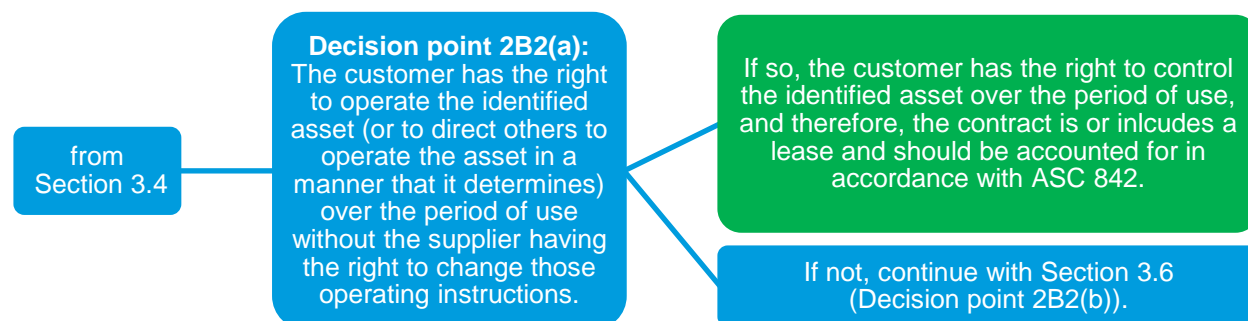
### **3.4.2 Protective rights of the supplier**

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

### **3.4.3 Predetermined decisions about the identified asset's use**

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

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



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

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

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

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

The contract does not contain a lease.

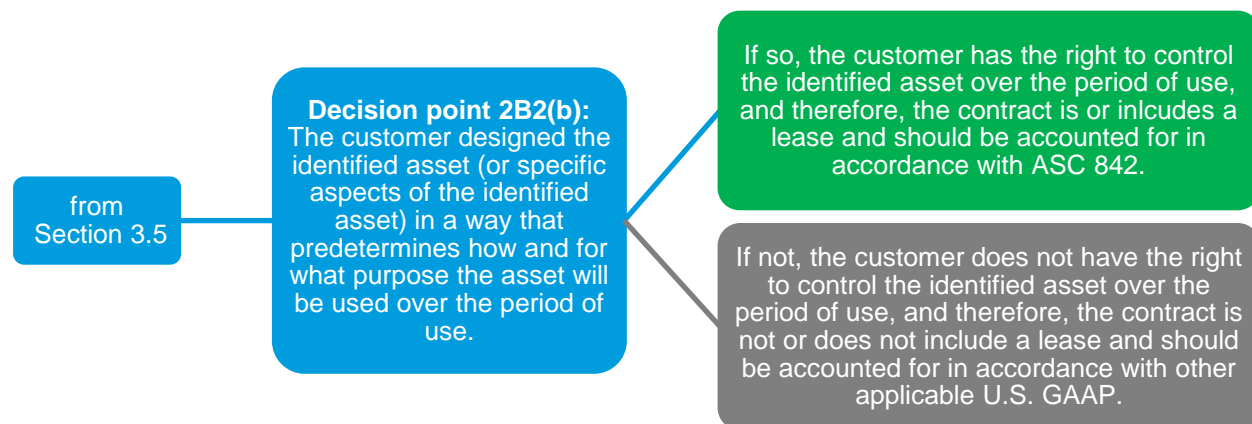
There is an identified asset because the power plant is explicitly specified in the contract, and Supplier does not have the right to substitute the specified plant.

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

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

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

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



Considering whether the customer designed the identified asset in a way that predetermines how and for what purpose the asset will be used over the period of use is relevant because controlling the key decision-making rights by designing the asset is substantively no different from otherwise controlling the

key decision-making rights. Example 3-4 addresses a situation in which the customer has the right to control the use of a solar farm over the period of use because it designed the solar farm and that design predetermined whether, when and how much electricity will be produced by the solar farm.

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

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

A utility company (Customer) enters into a contract with a power company (Supplier) to purchase all of the electricity produced by a new solar farm for 20 years. The solar farm is explicitly specified in the contract, and Supplier has no substitution rights. The solar farm is owned by Supplier, and the energy cannot be provided to Customer from another asset. Customer designed the solar farm before it was constructed—Customer hired experts in solar energy to assist in determining the location of the farm and the engineering of the equipment to be used. Supplier is responsible for building the solar farm to Customer's specifications and then operating and maintaining it. There are no decisions to be made about whether, when, or how much electricity will be produced because the design of the asset has predetermined these decisions. Supplier will receive tax credits relating to the construction and ownership of the solar farm, while Customer receives renewable energy credits that accrue from use of the solar farm.

The contract contains a lease. Customer has the right to use the solar farm for 20 years.

There is an identified asset because the solar farm is explicitly specified in the contract, and Supplier does not have the right to substitute the specified solar farm.

Customer has the right to control the use of the solar farm throughout the 20-year period of use because:

- a. Customer has the right to obtain substantially all of the economic benefits from use of the solar farm over the 20-year period of use. Customer has exclusive use of the solar farm; it takes all of the electricity produced by the farm over the 20-year period of use as well as the renewable energy credits that are a by-product from use of the solar farm. Although Supplier will be receiving economic benefits from the solar farm in the form of tax credits, those economic benefits relate to the ownership of the solar farm rather than the use of the solar farm and, thus, are not considered in this assessment.
- b. Customer has the right to direct the use of the solar farm. Neither Customer nor Supplier decides how and for what purpose the solar farm is used during the period of use because those decisions are predetermined by the design of the asset (that is, the design of the solar farm has, in effect, programmed into the asset any relevant decision-making rights about how and for what purpose the solar farm is used throughout the period of use). Customer does not operate the solar farm; Supplier makes the decisions about the operation of the solar farm. However, Customer's design of the solar farm has given it the right to direct the use of the farm (as described in paragraph 842-10-15-20(b)(2)). Because the design of the solar farm has predetermined how and for what purpose the asset will be used throughout the period of use, Customer's control over that design is substantively no different from Customer controlling those decisions.

### 3.7 Reassessment of whether a contract is or includes a lease

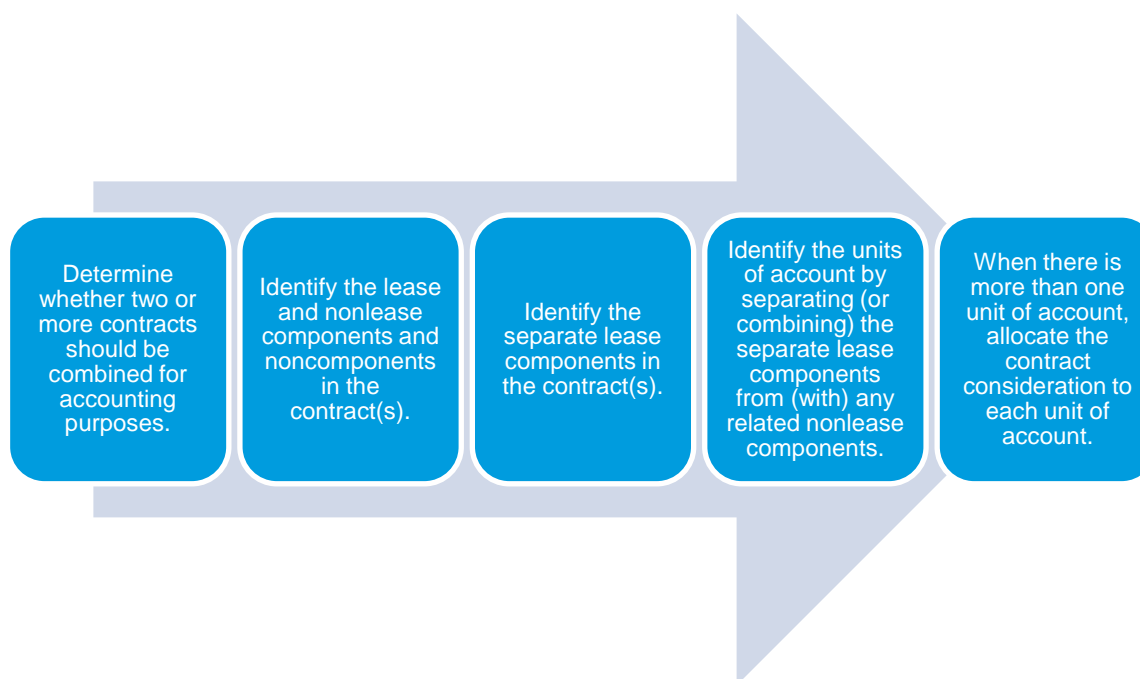
A lessor would only reassess whether a contract is or includes a lease if the contract's terms and conditions are modified.

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



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

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



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

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

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

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

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



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

A lease component is the right to use an underlying asset that meets the definition of a lease. A nonlease component transfers a good or service to the lessee that is separate from the right to use the underlying asset. For example, a nonlease component that often arises in a contract with a lease component is maintenance services related to the underlying asset, such as cleaning and providing scheduled and as-needed upkeep and repairs. For another example, a nonlease component that often arises in a contract to lease space in a building is common area maintenance, which involves the lessor providing cleaning services for the common areas, such as the building lobby and parking lot. In addition, utilities for leased office space are also considered a nonlease component. Lease components and nonlease components may be a unit of account, depending on the facts and circumstances. Warranties provided by the lessor with respect to the performance of the underlying asset or to effectively protect the lessee from obsolescence of the underlying asset are generally not considered nonlease components. However, if the lessor's commitment goes beyond the commitment that would be provided under a typical warranty for the underlying asset, the lessor may be providing an additional service to the lessee that should be treated as a nonlease component.

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

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

A noncomponent cannot be a unit of account. As such, no contract consideration is allocated to noncomponents.

### 4.2.1 Master lease agreements

A master lease agreement is an umbrella agreement under which multiple underlying assets (usually of the same type, such as vehicles or printers) may be leased by the lessee. The master lease agreement typically provides the primary terms of the leases that will fall under its umbrella. Then, when a specific underlying asset is leased under the master lease, other paperwork or schedules with relevant information related to that asset is executed. While neither would likely meet the definition of a lease on

its own, together the master lease and the other paperwork or schedules typically combine to include all of the necessary elements of a lease. Specific underlying assets are often leased at varying times over the term of the master lease agreement based on the lessee's needs.

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

When the lessee is *committed* to obtaining control of an additional underlying asset under the master lease agreement, the lessor must determine if the additional rights of use should be accounted for as separate lease components and, if so, how the contract consideration should be allocated to those separate components. The types of underlying assets subject to the right of use under a master lease agreement will often result in the right to use those assets meeting the criteria to be accounted for as separate lease components.

When the lessee is *permitted* to obtain control of an additional identified underlying asset under the master lease agreement, the lessor should account for obtaining an additional right of use as a modification (see Section 7.2.6).

### 4.3 Identify the separate lease components in the contract

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

#### 4.3.1 Rights to use land and other assets

If a contract contains rights to use land and other assets, a lessor is required to consider the right to use land as a separate lease component unless the effect of separately accounting for the land element is insignificant. Although the term "insignificant" is not defined in ASC 842, paragraph 842-10-15-29 suggests that the accounting effect of treating the land as a separate lease component would be insignificant if separate treatment would have no effect on lease classification and the amount recognized for the land lease component would be insignificant.

As explained further in paragraph BC147 of ASU 2016-02, the FASB concluded that the right to use land should be accounted for separately (unless the effects of doing so are insignificant) given that its indefinite economic life makes it substantially different from other assets.

Additionally, the lessor is required to consider how the land portion and the building element would be classified.

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

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

Under ASC 840, if a lease involves both land and buildings, the lessor's accounting depends on whether the lease meets the transfer-of-ownership criterion, the bargain purchase option criterion, or neither.

Under ASC 842, when a contract includes the right to use land and the right to use another asset (e.g., building, equipment), the right to use the land must be accounted for separately unless there is an insignificant difference between accounting for it separately vs. accounting for it together with the right

to use the other asset. In addition, lease payments are allocated to the right to use the land and the right to use the other asset based on their relative standalone prices.

Based on the different guidance in ASC 842 compared to ASC 840, we expect to see more situations in which the right to use land and the right to use another asset will be accounted for separately

#### 4.3.1.1 Inherent leases of land

We believe that when a contract provides the lessee with the right to use an entire building, the lessor should identify two potential lease components—the lessee’s right to use the building and the lessee’s right to use the underlying land on which the building sits. To determine whether each is in fact a lease component, the lessor should determine whether each meets the definition of a lease. Typically, when a lessee has the right to use an entire building, and that right of use meets the definition of a lease, the right to use the underlying land on which the building sits also meets the definition of a lease. In other words, when a lessee enters into a lease for an entire building, it is typically also inherently leasing the land on which the building sits. When there is a building lease component and a land lease component, the guidance in Section 4.3.1 is applied to determine whether they should be accounted for separately.

- If the lessee has the right to use substantially all of the building, and that right of use meets the definition of a lease, it is likely that the right to use the land on which the building sits also meets the definition of a lease. In other words, all other things being equal, the same conclusion should typically be reached on whether a land lease component exists regardless of whether the lessee has the right to use an entire building or substantially all of a building.
- If the lessee has the right to use less than substantially all of the building, the lessor should consider whether the part of the building being leased by the lessee has specific land associated with it. For example, if the lessee is leasing one complete wing of a building with three wings, and that right of use meets the definition of a lease, it is possible that the right to use the land on which the wing being leased by the lessee sits also meets the definition of a lease.
- We believe that if the lessee has the right to use less than substantially all of the building and there is not specific land associated with the part of the building being leased by the lessee, the lessee typically does not have the right to use a physically distinct part of the land (i.e., the land is not an identified asset) or the lessee would not have the right to control the land on which the building sits (e.g., the entity would not be able to obtain substantially all of the economic benefits related to that land).

#### 4.3.2 Separating lease components

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

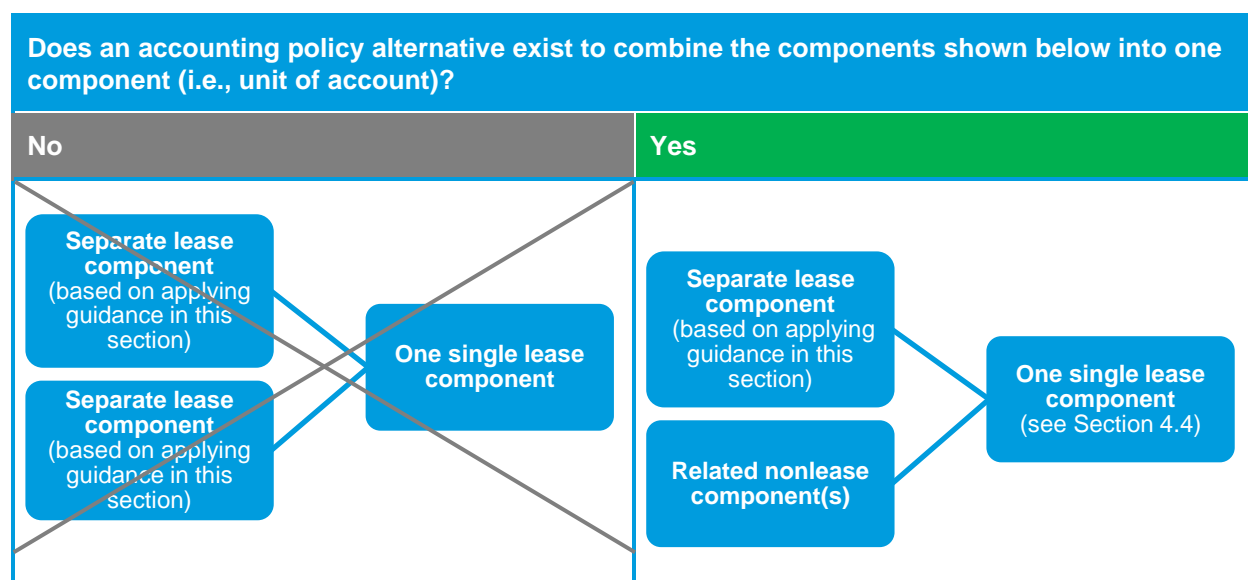
When one of the rights to use an asset in a contract that includes multiple rights to use assets is the right to use land, the guidance in Section 4.3.1 should be applied to determine whether the right to use the land should be accounted for separate from the rights to use the other assets included in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

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

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

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

Lessors are not permitted to combine lease components that should be separated. However, Section 4.4 discusses an accounting policy alternative provided in ASC 842 that allows a lessor to combine a lease component with the related nonlease components if certain criteria are met.



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

#### 4.4 Identify the units of account

When a contract includes both lease and nonlease components, the lessor may treat each separate lease component as a unit of account separate from the nonlease components. Alternatively, the lessor may elect to apply a practical expedient by class of underlying asset to account for each separate lease component together with the nonlease component(s) related to it as one combined unit of account, provided that the following criteria are met:

- The nonlease component would be within the scope of ASC 606 if accounted for separately
- The timing and pattern of transfer to the lessee of the lease component and the nonlease component(s) associated with that lease component are the same
- The lease component, if accounted for separately, would be classified as an operating lease

If the lessor elects this practical expedient, and the agreement includes nonlease components that meet the criteria above and other nonlease components that do not, the lessor combines those that meet the criteria with the lease component and separately accounts for any nonlease component that does not meet the criteria.

The lessor then determines whether the lease component or the nonlease component is the predominant component. The FASB declined to provide a separate definition or threshold to determine which component is predominant, but did note that the lessor should consider whether the lessee would be reasonably expected to ascribe more value to the nonlease component than to the lease component.

A lessor that elects this practical expedient would combine the lease component with associated nonlease components meeting the conditions above as a single unit of account. If the nonlease component is the predominant component, the combined component would be accounted for as a single performance obligation under ASC 606. If the lease component is predominant, the combined component is accounted for under ASC 842.

One common example of a nonlease component is common area maintenance (CAM) in a real estate lease. CAM arrangements generally require the lessor to provide maintenance services for the common areas such as the lobby or grounds. Such services may include snow removal, landscaping services, janitorial services, etc. Because CAM transfers a service to the lessee that is separate from the right to use the office space being leased, CAM qualifies as a nonlease component.

Other lease arrangements require lessees to reimburse or pay the lessor's property taxes or insurance. Such payments on the part of the lessee do not constitute activities that transfer goods or services to the lessee. Property taxes and insurance are accounted for as lessee costs if the lessee makes the payments directly to the third party. If the lessor pays the third party and gets reimbursed by the lessee, the lessor accounts for the property taxes or the insurance premiums as lessor costs.

Under certain leases, lessees are subject to sales taxes or other similar taxes (e.g., use taxes, value-added taxes, etc.). Lessors may elect a practical expedient to present all funds that they collect from lessees for sales and similar taxes net of the related tax expense. If elected, this practical expedient must be applied to all leases, and application of the expedient must be disclosed.

If the lessor elects to apply the practical expedient, the taxes are accounted for as lessee costs.

If the lessor does not elect to apply the practical expedient, or if the taxes are not within the scope of the practical expedient, the lessor's accounting depends on whether the tax is a lessee or a lessor cost. If the lessee pays the taxing authority directly, the tax is a lessee cost. In such instances, the lessor would account for the tax as if they had elected the practical expedient. The tax would be presented net of the lessee payment.

If the lessor remits the payment to the taxing authority and receives reimbursement from the lessee, the tax is a lessor cost.

## 4.5 Allocate the contract consideration to the units of account

### 4.5.1 Elements of contract consideration

Contract consideration includes all of the following:

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

+	Any other variable payments that would be included in the transaction price under ASC 606 and that relate specifically to either: <ul style="list-style-type: none"> <li>a. The lessor's efforts to transfer one or more goods or services that are not leases; or</li> <li>b. An outcome from transferring one or more goods or services that are not leases.</li> </ul>
=	Contract consideration

The process by which a lessor determines contract consideration is similar to the process performed by a lessee, with one additional step: a lessor makes an adjustment for variable payments that relate to either (a) the lessor's efforts to transfer one or more goods that are not leases or (b) an outcome from transferring one or more goods or services that are not leases. Variable payments that depend on an index or rate are included in the consideration of the contract. Variable payments that relate (entirely or partially) to a lease component and that do not depend on an index or rate are excluded from contract consideration, as are variable payments that (if included in contract consideration) would give rise to a more than remote possibility of a significant revenue reversal.

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

When a contract includes more than one unit of account, the lessor should allocate the contract consideration to the units of account using the guidance in ASC 606, unless the lessor has elected to apply the practical expedient discussed in Section 4.4. The guidance in ASC 606 is primarily based on relative standalone selling prices. However, in certain circumstances, that guidance will require that discounts or variable consideration be allocated to certain lease or nonlease components. Lessors will also allocate any capitalized costs to the separate components to which they relate.

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

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

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

Assume under Scenario A that Lessor separately accounts for the lease and nonlease components, and under Scenario B that Lessor elects (and meets the criteria to apply) the practical expedient to not separate each lease component from the nonlease components related to it. The following two tables list the units of account under each scenario, the standalone prices for each unit of account and the contract consideration allocated to each unit of account. The standalone prices were established by Lessor on the basis of observable standalone prices charged to other lessees of the same printers and the same maintenance services.



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

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

Under Scenario A, Lessor accounts for the lease of Printer X and the lease of Printer Y as separate lease components under ASC 842 with lease payments of \$155,520 and \$92,160, respectively. The payments allocated to the maintenance services for Printer X and Printer Y of \$23,040 and \$17,280, respectively, are accounted for in accordance with other applicable U.S. GAAP (ASC 606).

Under Scenario B, Lessor accounts for two combined units of account, which include the separate lease component and the related maintenance services, as lease components under ASC 842 with lease payments of \$181,440 and \$106,560, respectively. The expedient can be applied because the criteria discussed in Section 4.4 have been met:

- The nonlease component (maintenance services) would be within the scope of ASC 606 if accounted for separately
- The timing and pattern of transfer to the lessee of the lease component and the nonlease component(s) associated with that lease component are the same
- The lease component, if accounted for separately, would be classified as an operating lease

#### 4.5.3 Allocation of variable payments not included in contract consideration

ASC 842-10-15-40 provides guidance on allocation and recognition of variable payments that were not included in the contract consideration. The lessor allocates those payments on the same basis as the initial allocation of the contract consideration (or the most recent modification that was not accounted for as a separate contract). For example, if a contract consisted of two units of account—a lease component and a maintenance component—and the contract consideration was allocated by the lessor on a basis of 80% to the lease component and 20% to the maintenance component (based on the standalone prices), when a variable payment not included in the contract consideration is recognized by the lessor, 80% of that payment is attributed to the lease component and 20% is attributed to the maintenance component.

Any variable payments that are not included in the contract consideration that are allocated to the separate lease component are recognized by the lessor as revenue in the period in which the changes in facts and circumstances on which the variable payment is based occur. Variable payments allocated to the nonlease component are recognized in accordance with other GAAP.

#### **4.5.4 Remeasuring and reallocating contract consideration**

Contract consideration should be remeasured and reallocated to the contract's units of account only if there is a contract modification that is not accounted for as a separate contract (see Section 7.2.6.1). Current standalone prices should be used for each unit of account for reallocation purposes.



## 5. Key inputs to classifying and accounting for a lease

### 5.1 Commencement date

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

The commencement date is the date on which a number of important determinations and measurements are made related to the accounting for a lease (e.g., lease term, lease classification, lease payments).

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

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

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

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

#### Spotlight on change: Lease commencement vs. lease inception

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

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

Under ASC 842, a lease is classified, recognized and initially measured on the commencement date of the lease. While a lease is also recognized on the commencement date of the lease under ASC 840, the lease is classified and measured under ASC 840 as of the lease's inception date, which is the earlier of the date of the lease agreement or the commitment date. The inception date of a lease typically occurs before its commencement date. Using different dates for classification and initial measurement purposes means that the lessee could reach different classification conclusions and recognize different amounts under ASC 840 and ASC 842. For example, if one or more of the inputs

changes between the inception date of the lease and its commencement date, a lessor could reach a different classification conclusion under ASC 840 compared to ASC 842.

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

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

The commencement date for the lease is March 1, 20X6, because that is the date Lessor makes its land available to Lessee for its use, which includes the construction of a building that Lessee will own. The fact that there is a construction period causing Lessee not to commence operations or make lease payments until September 1, 20X6 does not affect the determination of the commencement date.

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

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

The commencement date for the lease is April 1, 20X7, because that is the date Lessor makes the office building available to Lessee to build leasehold improvements that Lessee will own. The fact that there is a three-month delay in Lessee moving into the office building to allow for the installation of these leasehold improvements does not affect the determination of the commencement date. The timing of lease payments also has no bearing on the commencement date.

## **5.2 Discount rate**

The discount rate used by a lessor is the rate implicit in the lease.

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

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

A lessor should reassess the discount rate only when the lease has been modified and the modification is not accounted for as a separate contract (see Section 7.2.6.1), or when an option is exercised that was originally determined to be not reasonably certain of exercise.

## 5.3 Lease term

### 5.3.1 General information

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

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

### 5.3.2 Termination and renewal options

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

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

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

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

If the termination option rests with both the lessee and lessor, the lessor considers whether exercising the termination option results in more than an insignificant penalty. If any penalty is not more than insignificant, then the lease is not enforceable. Conversely, if the penalty is more than insignificant, the period covered by the termination option is included in the lease term if the lessee is reasonably certain to not exercise the option.

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

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

Factor	Indicator that the lessee is reasonably certain to not exercise a termination option	Indicator that the lessee is reasonably certain to exercise a renewal option
Historical conclusions about the likelihood of the lessee exercising the option under ASC 840	When not exercising the option was historically deemed reasonably assured under ASC 840	When exercising the option was historically deemed reasonably assured under ASC 840
Option's exercise price (or penalty for not exercising the option) compared to the lease payments for the period covered by the option	When the exercise price (i.e., termination penalty) is substantive compared to the lease payments for the period covered by the option	When there is a penalty for not exercising the option and that penalty is substantive compared to the lease payments for the period covered by the option
Contractual rates for the period covered by the option compared to market rates for the same period	When contractual rates are favorable compared to market rates (e.g., contractual rates for the period covered by the termination option are less than the market rates for that period)	When contractual rates are favorable compared to market rates (e.g., contractual rates for the renewal period are less than the market rates for that period)
Costs to enter into a new lease for a replacement asset. (Note 1)	When exercising the option would result in the lessee incurring significant costs to enter into a new lease	When exercising the option would result in the lessee not incurring significant costs to enter into a new lease (e.g., costs to negotiate and execute the new lease) until after the end of the renewal period
Costs to return the asset or restore the underlying asset to its prior specified condition	When exercising the option would result in the lessee incurring significant costs of this nature	When exercising the option would result in the lessee not incurring significant costs of this nature until after the end of the renewal period
Degree of specific design and customization of the underlying asset	When the underlying asset required a significant degree of design and customization	When the underlying asset required a significant degree of design and customization
Importance of the underlying asset to the lessee's operations	When the underlying asset is critical to the lessee's operations	When the underlying asset is critical to the lessee's operations
When the underlying asset is a building or part of a building, the extent of leasehold improvements and their remaining economic life compared to the period covered by the option	When there are significant leasehold improvements with a remaining economic life that extends into or past the period covered by the option	When there are significant leasehold improvements with a remaining economic life that extends into or past the period covered by the option

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

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

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

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

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

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

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

### 5.3.3 Fiscal funding clauses

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

### 5.3.4 Calculation of the lease term

The lease term is calculated as follows:

Determination of the lease term (subject to two guardrails)	
	Noncancellable lease term (including any rent-free periods) (see Section 5.3.1)
+	Period(s) covered by any renewal or termination option(s) that rest solely with the lessor (see Section 5.3.2)
+	Period(s) covered by any renewal option(s) that rest solely with the lessee and that the lessee is reasonably certain to exercise (see Section 5.3.2)

+	Period(s) covered by any renewal option(s) that rest with both the lessee and lessor (see Section 5.3.2)
+	Period(s) covered by any termination option(s) that rest solely with the lessee and that the lessee is reasonably certain to not exercise (see Section 5.3.2)
+	Period(s) covered by any termination option(s) that rest with both the lessee and lessor when both: (a) any termination penalty is more than insignificant (see Section 5.3.2) and (b) the lessee is reasonably certain to not exercise the option (see Section 5.3.2)
=	Lease term (subject to two guardrails)

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

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

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

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

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

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

#### 5.3.5 Reassessment of the lease term

The lessor reassesses the lease term only upon a lease modification that is not treated as a separate contract. If the lessee exercises an option to extend or terminate a lease, or to purchase the underlying asset, and the lessor had not incorporated such an exercise in its initial determination of the lease term, the lessor should account for that exercise in a manner similar to a lease modification.

### 5.4 Purchase options

#### 5.4.1 General information

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



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

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

Factor	Indicator that the lessee is reasonably certain to exercise a purchase option
Historical conclusions about the likelihood of the lessee exercising the option under ASC 840	When exercising the option was historically deemed reasonably assured under ASC 840
Option's exercise price compared to the expected market value of the underlying asset on the option's exercise date	When the exercise price is specified and fixed and also less than the expected market value of the underlying asset on the option's exercise date
Costs to enter into a new lease (Note 1) compared to the option's exercise price	When exercising the option would eliminate the lessee incurring the costs to enter into a new lease and those costs are significant relative to the option's exercise price
Degree of specific design and customization of the underlying asset	When the underlying asset required a significant degree of design and customization
Importance of the underlying asset to the lessee's operations	When the underlying asset is critical to the lessee's operations
When the underlying asset is a building or part of a building, the extent of leasehold improvements and their expected remaining economic life at what would otherwise be the end of the lease term	When there are significant leasehold improvements with a remaining economic life that extends past what would otherwise be the end of the lease term by more than an insignificant period of time
When the underlying asset has been subleased, the end of the sublease's lease term compared to what would otherwise be the end of the head lease's lease term	When the sublease's lease term extends past what would otherwise be the end of the head lease's lease term

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

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

#### 5.4.2 Reassessment of purchase option exercise

A lessor only reassesses the likelihood of exercise of a lessee purchase option upon a lease modification that is not treated as a separate contract.



## 5.5 Lease payments

### 5.5.1 Classification vs. measurement

Lease payments are used for lease classification purposes (see Section 6.4) and, when applicable, for purposes of measuring the net investment in the lease recognized by lessors. While the nature of the lease payments used for these purposes is the same, the amount used for each purpose could differ.

### 5.5.2 Nature of payments included and excluded from lease payments

Lease payments for lessors include and exclude the following:

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

Nature of payment	Include in or exclude from lease payments?	Additional discussion in Section
Renewal fee	<p>Include when the lease term reflects the lessee exercising the renewal option (i.e., the lease term includes the period covered by the option) and the fee is fixed or variable based on an index or rate</p> <p>Exclude when the lease term reflects the lessee exercising the renewal option and the fee is variable based on other than an index or rate</p> <p>Exclude when the lease term does not reflect the lessee exercising the renewal option (i.e., the lease term does not include the period covered by the option) regardless of whether the renewal fee is variable or fixed</p>	5.3.2
Fees paid by the lessee to the owners of a special-purpose entity for structuring the transaction	Include (see ASC 842-10-30-5(e) and ASC 958-810-55-14)	
Residual value guarantees	<p>Include the amount of the guarantee probable of being owed</p> <p>Exclude the amount of the guarantee not probable of being owed</p>	5.5.6
Stated purchase price in a lessor put option	Include the stated purchase price for the underlying asset	5.5.7
Payments related to the lessee's guarantee of the lessor's debt	Generally, exclude. However, in limited circumstances, the lessee's guarantee of the lessor's debt is an in-substance residual value guarantee (see Section 5.5.6) and should be reflected in lease payments as such. For those limited circumstances to exist, the lessee's guarantee of the lessor's debt must be in place until the end of the lease term. In addition, the debt must be nonrecourse to the borrower (i.e., lessor) and (or) the underlying asset must be the only significant asset held by the lessor.	
Payments related to indemnification of the lessor	<p>Exclude when indemnification is for adverse tax consequences resulting from a change in tax laws</p> <p>Exclude when indemnification is for environmental contamination</p> <p>Inclusion or exclusion of other indemnifications depends on the facts and circumstances</p>	5.5.10

Nature of payment	Include in or exclude from lease payments?	Additional discussion in Section
Contract consideration allocated to unit(s) of account including only nonlease component(s)	Exclude	5.5.11
Contract consideration allocated to unit(s) of account that is (are) lease component(s)	Final determination of lease payments for a unit of account	5.5.11

### 5.5.3 Variable lease payments

Variable lease payments are included in lease payments if they are in-substance fixed payments (see Section 5.5.3.1) or are based on an index or rate (see Section 5.5.3.2). If they are based on something other than an index or rate (see Section 5.5.3.3), they are excluded from lease payments. Additionally, payments that vary solely based on the passage of time are not considered variable lease payments.

#### 5.5.3.1 In-substance fixed payments

An in-substance fixed payment is a payment that may appear to be a variable payment, but there is an unavoidable amount that must be paid, or there is an amount that will be paid because the variability lacks economic substance. These in-substance fixed payments are treated as fixed payments when determining lease payments.

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

#### 5.5.3.2 Variable lease payments based on an index or rate

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

The FASB explains the basis for including in lease payments those variable lease payments based on an index or rate in paragraph BC211 of ASU 2016-02. While the amount of the payment may vary, the FASB notes that the payment itself cannot be avoided, and as such, the obligation to make the payment should

be included in the lessee's lease liability. The FASB also notes that the variability in the amount of the obligation affects the measurement of the lease liability, not its recognition. In other words, the FASB did not think the obligation to make variable lease payments based on an index or rate should not be recognized due to the measurement uncertainty caused by the potential changes in the index or rate after the commencement date.

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

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

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

Variable lease payments that vary after the commencement date for reasons other than a change in an index or rate (e.g., lease payments that vary based on the sales of a retail location) are not included in the lease payments used for classification or measurement purposes.

### **5.5.4 Lease incentives**

Lease incentives include payments made to or on behalf of the lessee. Lease incentives also include the assumption by the lessor of a lessee's preexisting lease with a third party. In those situations, the lessor should estimate the losses it will incur, net of any expected benefits from the subleasing the underlying asset. While rent abatements are a type of lease incentive as that term is generally used, they are not considered a lease incentive for accounting purposes.

Generally speaking, payments made to or on behalf of the lessee should be treated as reductions of rental income by the lessor over the term of the new lease.

When the lessor incurs a loss as a result of assuming the lessee's previously existing lease, the lessor should estimate any loss attributable to the assumption of the lease should be recognized on a straight-line basis over the term of the new lease.

If, prior to lease commencement, a lessor pays a lease incentive to a lessee, the lessor would record the amount paid as a deferred cost. Upon commencement, the lessor would derecognize the deferred cost by reducing the selling profit (or increasing the selling loss) of a sales-type or direct financing lease. If the lease is classified as an operating lease, the deferred cost would be amortized over the lease term as a reduction of lease income.

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

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

When the lease term reflects the exercise of the termination option, whether any termination penalty is included in lease payments depends on whether the penalty is fixed or variable. If the termination penalty is fixed, it is included in lease payments. If the termination penalty is variable, it is treated like any other variable payment (see Section 5.5.3). If it is variable based on an index or rate, it is included in lease payments and measured at the index or rate at the commencement date (see Section 5.5.3.2). If it is

variable based on other than an index or rate, it is not included in lease payments used for classification or measurement purposes (see Section 5.5.3.3).

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

### **5.5.6 Residual value guarantees**

A residual value guarantee assures the lessor that when it gets back the underlying asset at the end of the lease term, its value will be at or above a specified amount. While payments under residual value guarantees that are probable of being owed by the lessee are included in lease payments by a lessee, in contrast, a lessor does not include any amount in lease payments.

### **5.5.7 Payment in connection with lessor put option**

When the lessor has the right to require the lessee to purchase the underlying asset by the end of the lease term for a stated purchase price, that right is referred to as a put option. The stated purchase price should be included in lease payments by the lessor.

### **5.5.8 Payments to dismantle and remove an underlying asset**

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

### **5.5.9 Payments to return an underlying asset to its pre-lease condition**

Payments to be made in accordance with lease provisions obligating the lessee to return an underlying asset to the condition it was in before the lessee made modifications to it (i.e., the underlying asset's pre-lease condition) include payments to remove leasehold improvements installed by the lessee. These types of payments generally would not meet the definition of lease payments or variable lease payments.

### **5.5.10 Payments related to indemnification of the lessor**

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

- **Tax indemnifications.** The following guidance is provided in ASC 460 and ASC 842 related to the accounting for tax-related indemnifications:
  - ASC 460-10-15-7(c) provides a scope exception for contracts that have the characteristics of a guarantee, but are accounted for as variable lease payments.
  - ASC 460-10-55-13(b) addresses whether two types of indemnifications for adverse tax consequences provided by the lessee to the lessor are within the scope of ASC 460. One is an indemnification for *a future change in tax laws*, which is within the scope of ASC 460 (notwithstanding the scope exceptions in ASC 460-10-15-7) because the lessee has no control over making changes to tax laws. The other is an indemnification for *the lessee's acts, omissions*

or *misrepresentations*, which does not fall within the scope of ASC 460 because the lessee is essentially guaranteeing its own future performance.

- ASC 842-10-55-38 indicates that while potential payments from the lessee to the lessor in connection with the lessee indemnifying the lessor for any adverse tax consequences that may arise from a *future change in tax laws* “may appear to meet the definition of variable lease payments, those payments are not of the nature normally expected to arise under variable lease payment provisions.”
- ASC 842-30-55-16 states that “Indemnification payments related to tax effects other than the investment tax credit should be reflected by the lessor in income consistent with the classification of the lease. That is, the payments should be accounted for as an adjustment of the lessor’s net investment in the lease if the lease is a sales-type lease or a direct financing lease or recognized ratably over the lease term if the lease is an operating lease.”
- *Environmental contamination.* ASC 842-10-55-15 indicates that the potential payments from the lessee to the lessor in connection with the lessee indemnifying the lessor for any environmental contamination should not affect the classification of the lease. If the classification of the lease should not be affected by these potential payments, neither should lease payments. Instead, this type of indemnification should be accounted for under ASC 460 or 410, depending on the facts and circumstances.

A lessor that commits to guarantee performance of the underlying asset or to protect the lessee from obsolescence should evaluate that commitment as a potential warranty. If the lessor’s commitment is more extensive than a typical product warranty, that is a possible indication that the commitment provides a service to the lessee that the lessor should be accounting for as a nonlease component.

#### **5.5.11 Contract consideration allocated to lease and nonlease components**

As discussed in more detail in Section 4.4, when a contract includes both lease and nonlease components, the lessor either: (a) treats each separate lease component as a unit of account apart from the nonlease components or (b) elects an accounting policy by class of underlying asset to treat each separate lease component together with the nonlease component(s) related to it as one combined unit of account (provided certain criteria have been met). If the lessor elects this accounting policy, the combined unit of account is accounted for as a lease component under ASC 842 if the lease component is predominant and under ASC 606 if the nonlease component is predominant. If treated as a lease component, the contract consideration allocated to that unit of account should be considered its lease payments. If the nonlease component is predominant, the contract consideration allocated to that (or those) unit(s) of account should *not* be considered lease payments.

#### **5.5.12 Remeasurement of lease payments**

The lessor remeasures lease payments only when the lease is modified and the modification is not accounted for as a separate contract. Accounting for lease modifications is discussed in detail in Section 7.2.6.

## 6. Classify the lease

At the commencement date, lessors classify their lease components as either operating, sales-type or direct financing leases, based on consideration of the following five criteria:

- Ownership of the underlying asset transfers to the lessee by the end of the lease term (see Section 6.1).
- An option exists under which the lessee may purchase the underlying asset and exercise of that option is reasonably certain (see Section 6.2).
- The lease term makes up a major part of the underlying asset's remaining economic life (see Section 6.3). (This criterion is not applicable if the lease commences at or near the end of the underlying asset's economic life.)
- The sum of the present value of the lease payments and any residual value guaranteed by the lessee that is not already included in the lease payments is equal to or exceeds substantially all of the underlying asset's fair value (see Section 6.4).
- The underlying asset is of such a specialized nature that it is expected to have no alternative use to the lessor at the end of the lease term (see Section 6.5).

If one or more of these lease classification criteria are met at lease commencement, the lessor classifies the lease as a sales-type lease. If none of these lease classification criteria are met, the lessor must consider two additional criteria:

- The present value of the sum of the lease payments plus any residual value guaranteed by any party that is not already reflected in the lease payments equals or exceeds substantially all of the present value of the underlying asset.
- It is probable that the lessor will collect the lease payments plus any amounts necessary to satisfy a residual value guarantee.

If both of those criteria are met, the lessor classifies the lease as a direct financing lease. If both are not met, the lessor classifies the lease as an operating lease.

### Spotlight on change: Lease classification

Under ASC 840, lessors classified a lease based on application of a series of criteria. First, the lessor considers the same classification criteria as applied by lessees:

- The lease transfers ownership of the property to the lessee by the end of the lease term.
- The lease contains a bargain purchase option.
- Lease term. The lease term is equal to 75% or more of the estimated economic life of the leased property. However, if the beginning of the lease term falls within the last 25% of the total estimated economic life of the leased property, including earlier years of use, this criterion shall not be used for purposes of classifying the lease.
- Minimum lease payments. The present value at the beginning of the lease term of the minimum lease payments, excluding that portion of the payments representing executory costs such as insurance, maintenance, and taxes to be paid by the lessor, including any profit thereon, equals or exceeds 90% of the excess of the fair value of the leased property to the lessor at lease inception over any related investment tax credit retained by the lessor and expected to be realized by the lessor. If the beginning of the lease term falls within the last 25% of the total estimated economic life of the leased property, including earlier years of use, this criterion shall not be used for purposes of classifying the lease.



In addition to the above criteria were met, a lessor considers two additional criteria:

- Collectibility of the minimum lease payments is reasonably predictable.
- No important uncertainties surround the amount of unreimbursable costs yet to be incurred by the lessor under the lease.

If any of the initial four criteria are met and both of the additional criteria are met, a lease is classified as follows:

The lease is classified as a sales-type lease if it gives rise to manufacturer's or dealer's profit or loss (i.e., the fair value of the underlying asset differed from its carrying amount at inception) and:

- It involves real estate and any of the initial four criteria are met.
- It does not involve real estate and it meets any of the initial four criteria and both of the additional criteria.

The lease is classified as a sales-type lease if:

- It meets any of the initial four criteria and both of the additional criteria.
- It does not give rise to manufacturer's or dealer's profit or loss.
- It does not meet the criteria to be classified as a leveraged lease.

If (a) none of the four criteria were met, the lease was classified as an operating lease. Additionally, leases were classified as operating leases if collectibility of the minimum lease payments was not reasonably predictable or if there were important uncertainties as to the amount of unreimbursable costs that the lessor would incur under the lease.

Additionally, a lessor classifies a lease as a leveraged lease if, in addition to meeting the criteria to be classified as a direct financing lease, the lease met the following criteria:

- It involves at least three parties: a lessee, a long-term creditor, and a lessor (commonly called the equity participant).
- The financing provided by the long-term creditor is nonrecourse as to the general credit of the lessor (although the creditor may have recourse to the specific property leased and the unremitted rentals relating to it). The amount of the financing is sufficient to provide the lessor with substantial leverage in the transaction.
- The lessor's net investment declines during the early years once the investment has been completed and rises during the later years of the lease before its final elimination. Such decreases and increases in the net investment balance may occur more than once.

Under ASC 842, a lessor classifies a lease as a sales-type lease if it meets any of the five lease classification criteria. If none of the five criteria are met, the lease will be classified as direct financing or operating.

In July 2021, the FASB issued ASU 2021-05, *Leases (Topic 842): Lessors—Certain Leases with Variable Lease Payments*. In accordance with ASU 2021-05, a lessor classifies and accounts for a lease as an operating lease if the lease contains variable lease payments that do not depend on a reference index or a rate as an operating lease if both of the following criteria are met:

- The lease would have been classified as a sales-type lease or a direct financing lease in accordance with the general classification criteria.
- The lessor would have otherwise recognized a day-one loss.

Leveraged lease classification and accounting has been eliminated prospectively under ASC 842.



## 6.1 Ownership transfers to the lessee

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

If the lease provides the lessee with an option to not pay a fee (nominal or otherwise), which, if elected, would result in the lessee not obtaining ownership of the underlying asset, this criterion is not met. Instead, an option to purchase the underlying asset exists, which may affect the classification of the lease in a different manner, as discussed in Section 6.2.

## 6.2 Lessee purchase option reasonably certain of exercise

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

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

The lease classification criterion focused on in this section is based on whether the lease term makes up a major part of the underlying asset's remaining economic life. However, this criterion does not apply to situations in which the lease's commencement date is at or near the end of the underlying asset's economic life, nor does it apply when the lease relates solely to land. For purposes of determining whether this criterion is met, one reasonable approach to assessing whether the lease term makes up a major part of the underlying asset's economic life would be to consider whether the lease term makes up 75% or more of the underlying asset's economic life. If so, this criterion has been met (and the lease should be classified as a sales-type lease). If not, this criterion has not been met.

For purposes of determining if this criterion applies in a particular situation, one reasonable approach to assessing whether the lease's commencement date is at or near the end of the underlying asset's economic life would be to consider whether the lease's commencement date falls within the final 25% of the underlying asset's economic life. If so, this criterion does not apply. If not, this criterion does apply, and the lessor considers whether the lease term makes up a major part of the underlying asset's remaining economic life. The difference between an asset's economic life and useful life is discussed in Section 6.3.1.

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

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

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

### **6.3.1 Economic life vs. useful life of an asset**

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

### **6.4 Present value of lease payments and residual value guarantee equals or exceeds substantially all of the asset's fair value**

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

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

The fair value of the underlying asset should be measured in accordance with ASC 820 if the lessor is a manufacturer or dealer. If the lessor is not a manufacturer or dealer, the fair value of the underlying asset is its cost, adjusted for volume or trade discounts. However, if there has been a significant lapse of time between the acquisition of the asset and the commencement of the lease, the lessor measures fair value in accordance with ASC 820.

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

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

### **6.5 Asset of a specialized nature and with no alternative use**

When the underlying asset is of a specialized nature, which is expected to result in it not having an alternative use to the lessor at the end of the lease term, the lease is classified as a sales-type lease. In

situations in which this criterion is met, we would typically expect one of the other lease classification criteria to also be met. As explained in paragraph BC71(e) of ASU 2016-02, “it is expected that lessors would lease specialized assets that have no alternative use to them at the end of the lease term only under terms that would transfer substantially all the benefits (and risks) of the asset to the lessee,” which would typically trigger one of the other lease classification criteria to be met (see Section 6.3 and Section 6.4).

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

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

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

## 6.6 Reassessment of a lease’s classification

A lessor only reassesses classification of a lease when the contract is modified and the modification is not accounted for as a separate contract (see Section 7.2.6.1).

## 7. Apply the appropriate accounting model

### 7.1 Initial accounting

On the commencement date, the lessor's accounting is dependent on the classification of the lease.

As discussed in Section 6, the lessor classifies the lease as a sales-type lease if any of the following criteria are met:

- Ownership of the underlying asset transfers to the lessee by the end of the lease term (see Section 6.1).
- An option exists under which the lessee may purchase the underlying asset and exercise of that option is reasonably certain (see Section 6.2).
- The lease term makes up a major part of the underlying asset's remaining economic life (see Section 6.3). (This criterion is not applicable if the lease commences at or near the end of the underlying asset's economic life.)
- The sum of the present value of the lease payments and any residual value guaranteed by the lessee that is not already included in the lease payments is equal to or exceeds substantially all of the underlying asset's fair value (see Section 6.4).
- The underlying asset is of such a specialized nature that it is expected to have no alternative use to the lessor at the end of the lease term (see Section 6.5).

If none of these lease classification criteria are met, the lessor must consider two additional criteria:

- The present value of the sum of the lease payments plus any residual value guaranteed by any party that is not already reflected in the lease payments equals or exceeds substantially all of the present value of the underlying asset. [Note that the difference between this present value test and the present value test included in the original five criteria above is that the residual value included in the test in the original five criteria is limited to amounts guaranteed by the lessee, while the residual value included in the test in the second set of criteria includes amounts guaranteed by any party, including the lessee.]
- It is probable that the lessor will collect the lease payments plus any amounts necessary to satisfy a residual value guarantee.

If both of those criteria are met, the lessor classifies the lease as a direct financing lease. If both are not met, the lessor classifies the lease as an operating lease.

As originally issued, Topic 842 does not permit a lessor to include variable lease payments that do not depend on a reference rate or index in the computation of the lease receivable. As a result, depending on the magnitude of the variable payments that do not depend on a reference rate or index, the net investment in the lease for a sales-type lease or a direct financing lease might have been less than the carrying amount of the underlying asset that the lessor would have derecognized, resulting in the recognition of a selling loss at lease commencement (a "day-one loss").

In July 2021, the FASB issued ASU 2021-05, *Leases (Topic 842): Lessors—Certain Leases with Variable Lease Payments*. Under the guidance in this ASU, lessors should classify and account for a lease with variable lease payments that do not depend on a reference rate or index as an operating lease if both of the following criteria are met:

- The lease would have been classified as a sales-type lease or a direct financing lease in accordance with the classification criteria discussed above.
- The lessor would have otherwise recognized a day-one loss.

### 7.1.1 Sales-type leases

For a sales-type lease for which collectibility is probable, the lessor recognizes a net investment in the lease and derecognizes the underlying asset. The net investment is made up of:

- Lease receivable—initially measured as the sum of the present value of future lease payments and the present value of the residual value guarantees. The present value is calculated using the rate implicit in the lease.
- Unguaranteed residual asset, also measured at present value using the rate implicit in the lease.

If the fair value of the underlying asset exceeds the carrying amount, the lessor defers any initial direct costs.

The lessor also recognizes any selling profit or loss. The selling profit or loss is calculated as follows:

- The lesser of (a) the fair value of the underlying asset or (b) the sum of the lease receivable plus prepaid lease payments [Note: the fair value of the asset depends on whether the lessor is a manufacturer or dealer. If the lessor is a manufacturer or dealer, the fair value is calculated in accordance with ASC 820, *Fair Value Measurement*. If the lessor is not a manufacturer or dealer, the fair value equals the cost of the underlying asset, adjusted for trade discounts and volumes.]
- Less the carrying amount of the underlying asset (adjusted for any unguaranteed residual asset thereon).
- Less any deferred initial direct costs of the lessor.

If collectibility is not probable, the lessor does not derecognize the underlying asset. If any payments have been received, the lessor recognizes a deposit liability. Any selling loss is recognized immediately. If the fair value of the underlying asset differs from the carrying amount, any initial direct costs are recognized immediately.

### 7.1.2 Direct financing leases

If the lease is classified as a direct financing lease, the lessor recognizes a net investment in the lease and derecognizes the underlying asset. The net investment is made up of:

- Lease receivable—initially measured as the sum of the present value of future lease payments and the present value of the residual value guarantees. The present value is calculated using the rate implicit in the lease.
- Unguaranteed residual asset, also measured at present value using the rate implicit in the lease.
- Less, any selling profit. The selling profit or loss is calculated in the same manner as for sales-type leases, as discussed in Section 7.1.1 above.

The lessor also recognizes selling loss, if any. Selling profit is deferred and recognized over the lease term.

### 7.1.3 Operating leases

If the lease is classified as an operating lease, the lessor defers any initial direct costs. If any lease payments have been paid, the lessor recognizes any such consideration as a deposit liability. The lessor defers any initial direct costs.

#### 7.1.3.1 Initial direct costs

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

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

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

If the fair value of the underlying asset differs from its carrying amount, initial direct costs related to a sales-type lease are expensed at commencement. If the fair value of the underlying asset equals its carrying amount, initial direct costs are deferred at the commencement date and are included in the recorded balance of the net investment in the lease. The implicit rate is defined so as to include initial direct costs that qualify for deferral in the net investment balance, so there is no need to adjust for them.

For direct financing leases, initial direct costs are deferred at the commencement date and included in the recorded balance of the net investment in the lease. As with sales-type leases, the implicit rate is defined so as to include initial direct costs that qualify for deferral in the net investment balance, so there is no need to adjust for them.

The lessor defers any initial direct costs in connection with operating leases.

#### Spotlight on change: Definition of initial direct costs

The definition of initial direct costs under ASC 842 is much narrower than the definition of such costs under ASC 840. Under ASC 842, initial direct costs include only those incremental costs to obtain a lease that a lessee would not have incurred if the lease had not been entered into. Under ASC 840, initial direct costs include incremental costs to obtain a lease, regardless of whether they would have been incurred if the lease had not been entered into. Provided below are examples of costs a lessor typically incurs when it enters into a lease and an indication as to whether the cost meets the definition of an initial direct cost under ASC 840 and (or) ASC 842.

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

## 7.2 Subsequent accounting

For sales-type leases, the subsequent accounting depends upon the lease classification.

### 7.2.1 Sales-type leases

The subsequent accounting for sales-type leases further depends on whether collectibility is probable. If collectibility is probable, the lessor does the following with respect to accounts on the balance sheet:

- Reduces the net investment in the lease for any payments received from the lessee
- Increases the net investment in the lease for interest income earned
- Reduces the carrying amount of the net investment in the lease for any impairment

The lessor does the following with respect to the income statement:

- Recognizes interest income, determined as the amount that produces a constant periodic discount rate on the remaining balance of the net investment in the lease
- Recognizes any variable lease payments that are not included in the net investment in the lease as income in profit or loss in the period when the changes in facts and circumstances on which the variable lease payments are based occur
- Recognizes any impairment

If collectibility remains not probable, the lessor continues to reflect the underlying asset on its balance sheet and does not record a net investment in lease. The lessor recognizes any consideration received as a deposit liability and continues to depreciate the underlying asset.

If collectibility becomes probable at some point during the lease term, the lessor would:

- Derecognize the underlying asset
- Derecognize any deposit liability
- Recognize a net investment in lease

### 7.2.2 Direct financing leases

The lessor's subsequent accounting for a direct financing lease is similar to that for a sales-type lease for which collectibility is probable. The lessor does the following with respect to accounts on the balance sheet:

- Reduces the net investment in the lease for any payments received from the lessee
- Increases the net investment in the lease for interest income earned
- Reduces the carrying amount of the net investment in the lease for any impairment

The lessor does the following with respect to the income statement:

- Recognizes interest income, determined as the amount that produces a constant periodic discount rate on the remaining balance of the net investment in the lease
- Recognizes any variable lease payments that are not included in the net investment in the lease as income in profit or loss in the period when the changes in facts and circumstances on which the variable lease payments are based occur
- Recognizes any impairment



### 7.2.3 Operating leases

The lessor's subsequent accounting for an operating lease includes the following:

The lessor does the following with respect to accounts on the balance sheet:

- Depreciates the underlying asset (if applicable)
- Recognizes deferred rent receivable or deposit liabilities
- Reduces the balance of initial direct costs to reflect amortization

The lessor does the following with respect to accounts on the income statement:

- Recognizes lease income on a straight-line basis (or by using another systematic and rational basis if more appropriate)
- Recognizes any variable lease payments that are not included in the net investment in the lease as income in profit or loss in the period when the changes in facts and circumstances on which the variable lease payments are based occur
- Amortizes any capitalized initial direct costs

### 7.2.4 Impairment of net investment

When assessing the loss allowance related to the net investment, the lessor should apply the guidance in ASC 326-20 for financial instruments measured at amortized cost. The impairment assessment is performed on the net investment in its entirety—no separate impairment evaluation is performed on the residual asset.

When performing the evaluation, the lessor should consider any collateral relating to the net investment in the lease. That collateral represents the cash flows that the lessor would expect to receive from the lease receivable and the unguaranteed residual asset during and following the remaining lease term.

### 7.2.5 Sale of lease receivable

When a lessor sells a lease receivable, it should consider the guidance in ASC 860 to determine if the transfer of the lease receivable qualifies for derecognition. However, if the lessor retains an interest in the unguaranteed residual asset, the lessor would no longer accrete the balance to its estimated value over the lease term. The lessor would report the asset at the carrying amount at the date of the sale of the lease receivable and would record any future impairments determined in accordance with ASC 360.

### 7.2.6 Lease modifications

#### 7.2.6.1 Determining factors and accounting consequences

Changes to a lease that are considered modifications for accounting purposes are those that change the lease's scope or consideration.

As discussed in ASC 842-10-25-8, an entity accounts for a lease modification as a separate contract when both of the following conditions are met:

- The modification grants the lessee an additional right of use not included in the original lease.
- The lease payments increase commensurate with the standalone price of the additional right of use, adjusted for the circumstances of the particular contract.

If the modification is not accounted for as a separate contract, the lessor reassesses classification as of the effective date of the modification. The accounting for the modification depends on the classification of the original lease and the modified lease.



Classification of original lease	Classification of modified lease	Accounting
Operating	Operating	Any prepaid or accrued balances pertaining to the original lease are carried forward into the modified lease. The lease payments, adjusted for any such prepaid or accrued balances, are generally recognized over the remaining lease term on a straight-line basis.
Operating	Sales-type or direct financing	Any deferred rent liability or accrued rent asset is derecognized, with a corresponding adjustment to selling profit or loss (which is deferred for direct financing leases).
Direct financing lease	Operating	The lessor records the underlying asset at a carrying amount equal to the net investment in the original lease immediately before the effective date of the modification. Subsequently, the underlying asset is accounted for in accordance with ASC 360.
Direct financing	Direct financing	The lessor 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.
Direct financing	Sales-type	The lessor applies the sales-type lease guidance with the commencement date of the modified lease being the effective date of the modification. The selling profit recognized in connection with the modification is equal to the difference between the fair value as of the modification date and the carrying value of the net investment in the original lease immediately before the effective date of the modification.
Sales-type	Operating	The underlying asset is recorded at a carrying amount equal to the net investment in the original lease immediately before the effective date of the modification. Subsequently, the underlying asset is accounted for in accordance with ASC 360.
Sales-type	Direct financing or Sales-type	The lessor 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.

A rent concession (such as forgiving past-due rent or reducing future rent payments) granted to a lessee might constitute a modification. When considering whether a rent concession is a modification, a lessor should consider the enforceable rights and obligations provided in the lease contract between the parties.

If the lessee does not have an enforceable right to the concession prior to it being granted (perhaps as a result of a force majeure clause in the contract or existing laws in the relevant jurisdiction), the rent concession constitutes a concession. Similarly, even if the lessee has an enforceable right to the

concession, if other terms of the contract that impact either the scope of or the consideration for the contract are changed, the concession constitutes a modification. Finally, even if no terms or conditions are exchanged, the lessor should still review the concession carefully to ensure that it relates to the force majeure event. If a determination is made that the concession is not solely related to the force majeure event, it is likely that the concession constitutes a modification.

In contrast, if the lessee has an enforceable right to the concession and no other terms or conditions of the lease contract have changed, a modification has not occurred. In that situation, the lessor would account for the concession in accordance with the contract, as negative variable rent.

In April 2020, in response to questions arising as a result of the COVID-19 pandemic, the FASB staff issued a FASB Staff Q&A, *Topic 842 and Topic 840: Accounting for Lease Concessions Related to the Effects of the COVID-19 Pandemic*. That Staff Q&A provided a practical expedient for concessions related to COVID-19 that do not result in a substantial increase in the rights of the lessor or the obligations of the lessee.

If a concession is related to COVID-19 and the lessor has elected to apply the practical expedient provided in the FASB Staff Q&A, the lessor is not required to analyze the contract to determine whether enforceable rights and obligations exist. Instead, the lessor may elect to apply or not apply the modification guidance of ASC 842 to those contracts.

#### 7.2.6.2 Initial direct costs, lease incentives and other payments

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

#### 7.2.7 Lease termination

When a sales-type lease or a direct financing lease is terminated before the end of the lease term, the lessor should test the net investment to determine if it is impaired. This test should be done under ASC 326, if adopted. If the lessor has not yet adopted ASC 326, the test should be performed under ASC 310.

The following table summarizes accounting for lease terminations:

Classification	Balance Sheet	Income Statement
Operating	Write off deferred rent receivable balances (or prepaid lease liability if the amount is nonrefundable to the lessee)  Write off initial direct costs	Recognize financial impact of the writeoffs
Direct financing lease	Test net investment for impairment in accordance with ASC 326 or ASC 310, whichever is applicable  Reclassify net investment in lease to appropriate category of asset in accordance with relevant ASC Topic(s), measured at the sum of (a) the carrying amount of the lease receivable (less any amounts still expected to be received by the lessor) and (b) the residual asset	Recognize any impairment loss identified

Classification	Balance Sheet	Income Statement
Sales-type lease	<p>If collectibility is probable:</p> <ul style="list-style-type: none"> <li>• Derecognize the net investment in lease</li> <li>• Reclassify the net investment to the appropriate asset category (in accordance with other GAAP)</li> <li>• Measure the asset recognized based on the sum of the lease receivable (less amounts still expected to be received) and the residual asset</li> <li>• Test the net investment for impairment under ASC 326 or ASC 310, whichever is applicable</li> </ul>	Recognize impairment if applicable
	<p>If collectibility is not probable:</p> <ul style="list-style-type: none"> <li>• Derecognize the deposit liability if it is not refundable to the lessee and either: <ul style="list-style-type: none"> <li>– The lease is terminated or</li> <li>– The lessor has repossessed the underlying asset and has no further obligations under the contract</li> </ul> </li> </ul>	Recognize any derecognized deposit liability as selling profit

### 7.2.8 Leveraged leases

ASC 842-50-20 defines a leveraged lease as follows:

From the perspective of a lessor, a lease that was classified as a leveraged lease in accordance with the leases guidance in effect before the effective date and for which the commencement date is before the effective date.

That definition refers to “leases guidance in effect before the effective date...,” which refers to ASC 840. According to ASC 840-10-25-43(c), a lease is a leveraged lease if it has all of the following characteristics:

- It meets the criteria to be classified as a direct financing lease under ASC 840-10-25-43(b).
- It involves at least three parties: in addition to the lessee and lessor, it involves a long-term creditor.
- The financing provided by the long-term creditor is nonrecourse as to the general credit of the lessor, and the amount of financing is sufficient to provide the lessor with substantial leverage in the transaction.
- The lessor's net investment declines during the early years once the investment has been completed and rises during the later years of the lease before its final elimination. Such decreases and increases in the net investment balance may occur more than once.

ASC 842 eliminates leveraged lease accounting prospectively. However, the FASB decided that the costs of requiring lessors to unwind leveraged leases would exceed the benefits to financial statement users. Consequently, the accounting for a leveraged lease that commenced prior to the effective date of ASC

842 has been grandfathered and would continue to be accounted for using the previously existing guidance, which was carried forward to ASC 842-50. If the leveraged lease is modified post-effective date, it becomes subject to ASC 842 at the effective date of the modification.

Because the guidance related to leveraged leases is only applicable for leases that existed prior to adoption of ASC 842, we have not provided any additional interpretive commentary on that guidance and instead refer readers to ASC 842-50.

### 7.3 Related-party leases

ASC 842 indicates that a related-party lease should be classified and accounted for based on its legally enforceable terms and conditions. In other words, the classification and accounting for a lease with a related party should be the same as the classification and accounting would have been if that lease were with an unrelated party. Additionally, lessors are required to apply the disclosure requirements of ASC 850.

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

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

### 7.4 Leases acquired in a business combination

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

With only one exception, the acquirer should retain the acquiree's lease classification as of the acquisition date, provided the acquiree appropriately determined the lease's classification. The only exception is if the lease is modified in conjunction with the business combination and the modification is not accounted for as a separate contract (see Section 7.2.6.1), in which case the classification of the lease should be reassessed on the acquisition date.

With respect to operating leases, the acquirer records the underlying asset at fair value. The lessor also recognizes an asset or liability for any off-market lease terms.

For sales-type and direct financing leases, the acquirer would recognize its net investment in the lease as the sum of the following:

- The lease receivable at the present value (discounted at the implicit rate) of the following (as if the acquired lease were a new lease at the acquisition date):
  - The remaining lease payments
  - The guaranteed residual value
- The unguaranteed residual asset for any difference between the fair value of the underlying asset and the lease receivable

## 8. Present and disclose leases in financial statements

### 8.1 Balance sheet

Lessors are required to present the aggregate of the net investment in sales-type and direct financing leases separately from other assets in the balance sheet.

For purposes of current and noncurrent classification, lease assets are subject to the same considerations as other assets.

For operating leases, lessors are required to present the underlying asset on the balance sheet subject to the guidance in other ASC Topics.

### 8.2 Income statement

Lessors are required to either present lease income in the income statement or disclose it in the notes to the financial statements. Lessors that do not separately present lease income in the income statement are required to disclose which line items in the income statement include lease income.

For sales-type and direct financing leases, a lessor is required to present selling profit at commencement in a manner that best reflects the lessor's business model. Lessors that use leasing as an alternative to selling their products should present revenue and cost of goods sold in separate line items. Revenue recognized is the lesser of (a) the fair value of the underlying asset at the commencement date or (b) the sum of the lease receivable and any prepaid lease payments. Cost of goods sold is the carrying amount of the underlying asset at commencement date, less the unguaranteed residual asset.

Lessors that use leasing for the purpose of providing financing should present the profit or loss as a single line item.

### 8.3 Cash flow statement

Lessors should present cash receipts from leases within operating activities. However, lessors that are financial institutions that are within the scope of ASC 842 should classify principal payments received from sales-type and direct financing leases within investing activities.

### 8.4 Disclosures

The overall disclosure objective for lessors is to provide information that enables users of the financial statements to assess the effects leases have on the amount, timing and uncertainty of cash flows. To satisfy this objective, there are a variety of disclosure requirements that lessors must comply with by providing a variety of qualitative and quantitative information about their leases in the notes to the financial statements. Examples of the information that must be provided to comply with the disclosure requirements in ASC 842 include:

- Information about the nature of an entity's leases
  - General description of leases
  - Basis and terms and conditions on which variable lease payments are determined
  - Terms and conditions of options to extend or terminate leases
  - Existence of terms and conditions for a lessee to purchase a leased asset
- Information about significant assumptions and judgments made when accounting for leases in accordance with ASC 842, including those significant assumptions and judgments used in:
  - Determining whether a contract includes a lease
  - The allocation of the consideration in a contract between lease and nonlease components

- Determining the amount that the lessor expects to derive from the underlying asset following the end of the lease term
- Lease income recognized in each annual or interim reporting period, in a tabular format, including the following:
  - For sales-type and direct financing leases, profit or loss recognized on commencement date and (interest income either in aggregate or separated by components of the net investment in the lease)
  - For operating leases, lease income related to lease payments
  - Lease income related to variable payments not included in the measurement of the lease receivable
- Information about how the lessor manages its risk associated with the residual value of its leased assets, as well as the carrying amounts of residual assets covered by residual value guarantees
- The components of the aggregate net investment in sales-type and direct financing leases
- Any lease transactions between related parties
- Residual assets and related risk management strategies

For a complete list of the disclosures lessors must provide under ASC 842, refer to the disclosure checklist included in Appendix C.

**Spotlight on change: More disclosure requirements**

Many of the disclosure requirements in ASC 842 are new compared to the disclosure requirements under ASC 840.

## 9. Effective date and transition

### 9.1 Effective date

With one exception, ASC 842 is effective for the following entities in annual reporting periods beginning after December 15, 2018 and the interim periods therein: (a) public business entities, (b) not-for-profit entities that have issued, or are conduit bond obligors for, securities that are traded, listed or quoted on an exchange or an over-the-counter market and (c) employee benefit plans that file or furnish financial statements to the SEC. As such, for a public business entity with a calendar year end, ASC 842 is effective on January 1, 2019 for both its interim and annual reporting periods, with the one exception. For all other entities (e.g., private companies), ASC 842 is effective in annual reporting periods beginning after December 15, 2021, and interim periods within fiscal years beginning after December 15, 2022. As such, for a private company with a calendar year end, ASC 842 is effective for the year ending December 31, 2022 and for interim periods in the year ending December 31, 2023. Early adoption is permitted for all entities.

### 9.2 Transition methods

A lessor may elect either of the following transition methods for purposes of its initial application of ASC 842.

- *Transition Method A.* ASC 842 is applied retrospectively to each prior reporting period presented in the financial statements with a cumulative-effect adjustment recognized as of the beginning of the earliest period presented.
- *Transition Method B.* ASC 842 is applied retrospectively to the beginning of the period of adoption through a cumulative-effect adjustment recognized as of the beginning of that period.

If the lessor elects Transition Method A, the date of initial application of ASC 842 for a particular lease is the later of the beginning of the earliest period presented and a lease's commencement date. If the lessor elects Transition Method B, the date of initial application of ASC 842 for a particular preexisting lease is the beginning of the reporting period in which ASC 842 is first applied. Regardless of the transition method selected, the effective date of ASC 842 is the first day of the annual financial reporting period in which the lessee transitions to ASC 842.

Consider a situation in which there is a private company lessor with a calendar year end that does not early adopt ASC 842 and includes one comparative period in its financial statements. In this situation, the transition methods translate to the following:

- *Transition Method A.* The effective date of ASC 842 is January 1, 2022. ASC 842 is retrospectively applied on a modified basis to 2021 with a cumulative-effect adjustment recognized as of January 1, 2021. The date of initial application for a lease with a commencement date prior to January 1, 2021 (e.g., June 1, 2019), is January 1, 2021. The date of initial application for a lease with a commencement date on or between January 1, 2021 and December 31, 2021 is the lease's commencement date. ASC 842 applies in its entirety to any leases with commencement dates of January 1, 2022 or later.
- *Transition Method B.* The effective date of ASC 842 is January 1, 2022. ASC 842 is retrospectively applied on a modified basis to January 1, 2022 with a cumulative-effect adjustment recognized as of January 1, 2022. The date of initial application for a lease with a commencement date prior to January 1, 2022 (e.g., June 1, 2020) is January 1, 2022. ASC 842 applies in its entirety to any leases with commencement dates of January 1, 2022 or later.



**What we expect: Election of Transition Method B**

Given the difficulty in retrospectively applying ASC 842, even on a modified retrospective basis under Transition Method A, we expect most lessors to select Transition Method B.

**9.3 Practical expedients**

When applying either Transition Method A or B, the lessor may elect the following practical expedients: (a) a package of transition practical expedients (see Section 9.3.1), (b) a hindsight practical expedient (see Section 9.3.2) and (c) a land easement practical expedient (see Section 9.3.3). A lessor may elect one or more of these practical expedients, but if elected, must apply the practical expedient to all preexisting leases (or easements).

**9.3.1 Package of transition practical expedients**

ASC 842-10-65-1(f) includes three practical expedients that, if elected, must be elected as a package. A lessor that elects the package of transition practical expedients does not reassess its prior conclusions under ASC 840 regarding the following:

- *Whether a preexisting contract is or contains a lease.* Determining whether a contract is or contains a lease is different under ASC 842 compared to ASC 840 (see Section 3). If the package of transition practical expedients is elected, and a preexisting contract was deemed to be or include a lease under ASC 840, upon transition to ASC 842, the contract is deemed to be or include a lease under ASC 842. The same would be true for the inverse situation in which a preexisting contract was not deemed to be nor to include a lease under ASC 840. In this situation, upon transition to ASC 842, the preexisting contract is not deemed to be nor to include a lease under ASC 842. If the package of transition practical expedients is not elected, the lessor must evaluate whether its preexisting contracts are or include one or more leases using the applicable guidance in ASC 842.
- *Classification of a lease.* The lease classification criteria of ASC 842 differ from those of ASC 840 (see Section 6). If the package of transition practical expedients is elected, the classification that was determined under ASC 840 does not change. If the package of transition practical expedients is not elected, the lessee must evaluate the classification of each of its preexisting leases using the applicable guidance in ASC 842, which could lead to changes in classification upon transition to ASC 842.
- *Whether the initial direct costs capitalized for a preexisting lease under ASC 840 qualify for capitalization.* The definition of initial direct costs was narrowed in ASC 842 compared to ASC 840 (see Section 7.1.3.1). If the package of transition practical expedients is elected, any initial direct costs capitalized under ASC 840 for a preexisting lease remain capitalized under ASC 842. If the package of transition practical expedients is not elected, any initial direct costs capitalized for a preexisting lease under ASC 840 prior to the date of initial application are written off to equity if they do not meet the definition of initial direct costs in ASC 842.

A lessor must elect these practical expedients as a package (i.e., either all or none), and if elected, must apply the package of transition practical expedients to all preexisting leases.

A lessor may not use election of the package of transition practical expedients to grandfather errors in the application of ASC 840. For example, all of the following should be considered errors in the application of ASC 840:

- *The lessor did not identify all leases under ASC 840 or misidentified contracts as leases under ASC 840.* For example, the lessor did not properly identify that a service arrangement included a lease under ASC 840.

- *The lessor did not properly classify a lease under ASC 840.* For example, a lessor classified a lease as a sales-type under ASC 840 when it should have been classified as an operating lease.
- *The lessor inappropriately applied the definition of initial direct costs in ASC 840.* For example, the lessor capitalized costs for a preexisting lease as initial direct costs and those costs did not meet the definition of initial direct costs under ASC 840.

An error in the application of ASC 840 should be carefully evaluated to understand its effects on the financial statements, and whether those effects warrant correction of an error before the adoption of ASC 842. For example, an error in which a service arrangement should have been identified as a lease (or as including a lease) under ASC 840 and classified and accounted for as an operating lease may not have significantly affected the financial statements if the accounting for the arrangement as a service contract closely mirrored what the accounting would have been if the arrangement were accounted for as an operating lease under ASC 840. Depending on the facts and circumstances, this error may not warrant correction before the adoption of ASC 842. In contrast, an error in which an operating lease should have been classified as a sales-type or direct financing lease under ASC 840 may significantly affect the financial statements given that the accounting for an operating lease and a sales-type lease or direct financing lease under ASC 840 do not mirror each other. Depending on the facts and circumstances, this error may warrant correction before the adoption of ASC 842. Paragraph BC393 of ASU 2016-02 notes that the package of transition practical expedients in ASC 842 only grandfathers *proper* assessments under ASC 840. Improper assessments should be evaluated as errors and corrected in accordance with ASC 250 as warranted.

### 9.3.2 Hindsight practical expedient

Lessors are permitted to make an election to use hindsight when determining the lease term. For example, if a lessor elects the hindsight practical expedient, it would evaluate options to renew or terminate the preexisting lease or purchase the underlying asset using hindsight. For another example, a lease might include a renewal option for which the actual exercise decision differs from the original expectation. In such cases, the lessor would reassess the lease term and any potential impact that a revision to the lease term might have on previously recognized lease revenue.

If a lessor elects the hindsight practical expedient, it should consider all facts and circumstances that have changed, through the effective date of ASC 842 (or the adoption date when the lessor early adopts ASC 842), in applying hindsight. In applying the hindsight practical expedient, lessors should not consider events that occurred after the effective (or adoption) date, but prior to the first time it issues its financial statements reflecting the adoption of ASC 842 (i.e., hindsight only extends to the effective [or adoption] date).

If a lessor does not elect the hindsight practical expedient, it would determine the lease term for preexisting leases based on the facts and circumstances in existence when those determinations were otherwise made.

The hindsight practical expedient may be elected separately or in conjunction with the package of transition practical expedients described in Section 9.3.1. A lessor must apply the hindsight practical expedient to all preexisting leases or apply it to none of them.

#### 9.3.2.1 Interaction of package of transition practical expedients and the hindsight practical expedient

As discussed in Section 9.3.2, when a lessor elects the hindsight practical expedient, the lease term and lease payments may change or there may be a change in the assessment as to whether a lessee is reasonably certain to exercise an option. Absent election of the package of transition practical expedients (see Section 9.3.1), the lessor would need to consider whether these changes result in a different classification for the lease under ASC 842. With the election of the package of transition practical expedients in addition to the hindsight practical expedient, we believe the package of transition practical

expedients takes precedence in that the lessor is not required to reassess the lease's classification under ASC 842 even if the lease term, lease payments or option exercise assessment change as a result of applying the hindsight practical expedient. While we believe the lessor would not be *required* to reassess the lease's classification under ASC 842 in this situation, we also believe they would not be *precluded* from doing so.

### 9.3.3 Land easement practical expedient

A land easement is a right of way that provides the lessee with the right to use, access or cross another entity's land for a specified purpose. When a lessor elects the land easement practical expedient:

- The lessor does not assess whether preexisting or expired land easements that were not previously accounted for as leases under ASC 840 are or contain a lease under ASC 842.
- The lessor does assess whether preexisting or expired land easements entered into (or modified) on or after the date of initial application are or contain a lease under ASC 842.

When a lessor does *not* elect the land easement practical expedient, the lessor must assess the following:

- Whether preexisting or expired land easements that were not previously accounted for as leases under ASC 840 are or contain a lease under ASC 842.
- Whether those land easements entered into (or modified) on or after the date of initial application are or contain a lease under ASC 842.

A lessor that accounted for preexisting or expired land easements as leases under ASC 840 may *not* elect the land easement practical expedient for those land easements.

The land easement practical expedient may be elected separately or in conjunction with either or both the package of transition practical expedients and (or) the hindsight practical expedient described in Section 9.3.2. A lessor must apply the land easement practical expedient to all preexisting land easements or apply it to none of them.

#### What we expect: Election of land easement practical expedient

We expect most lessors to elect the land easement practical expedient given: (a) lessors have not typically identified land easements as leases in the past and (b) the difficulties that would arise in assessing whether preexisting or expired land easements are or contain a lease under ASC 842.

## 9.4 Initial and subsequent measurement guidance for preexisting leases

### 9.4.1 Factors affecting the initial and subsequent measurement guidance for preexisting leases

If the lessor does not elect to apply the package of practical expedients, the transition requirements would depend on the classification of the lease under ASC 840 and the classification under ASC 842.

*A lease classified as an operating lease under ASC 840 that remains an operating lease under ASC 842.*

A lease that was classified as operating lease under ASC 842 might remain an operating lease under ASC 842 because either (a) the lessor elected the package of practical expedients (see Section 9.3.1) or because the classification assessment under ASC 842 resulted in operating classification. For these leases, the lessor continues to recognize the underlying asset and any prepaid or deferred rent, as well as initial direct costs. If the lessor did not elect the package of practical expedients, initial direct costs should be reassessed to determine if any of the capitalized amounts do not satisfy the revised definition of initial direct costs under ASC 842. Any such amounts should be written off through an adjustment to equity if they were incurred prior to the date of initial application, or as an expense in the comparative period if the lessor has applied Transition Method A.

*A lease classified as an operating lease under ASC 840 that is classified as a direct financing lease or sales-type lease under ASC 842.* For any lease that was classified as an operating lease under ASC 840 and is classified as either a direct financing lease or a sales-type lease under ASC 842, the lessor would:

1. Derecognize the underlying asset at the date of application;
2. Recognize a net investment in the lease at the application date as if the lease had been accounted for as a direct financing or sales-type lease since commencement; and
3. Account for any difference between 1 and 2 above as follows:
  - a. If the lessor has applied Transition Method A, as an adjustment to equity if the lease commencement date was before the beginning of the earliest period presented, or if the lease was acquired as part of a business combination, or as an adjustment to earnings if the commencement date was on or after the beginning of the earliest period presented; and
  - b. If the lessor has applied Transition Method B, as an adjustment to equity.

The lease is then accounted for in accordance with ASC 842 after the application date.

*A lease classified as a sales-type lease or direct financing lease under ASC 840 that is classified as a sales-type lease or direct financing lease under ASC 842.* For any lease that was classified as either a sales-type or direct financing lease under ASC 840 and is also classified as either a sales-type lease or a direct financing lease under ASC 842, the lessor would:

1. Continue to recognize a net investment in the lease at the application date at the carrying amount of the net investment as of that date (including any unamortized initial direct costs that had been capitalized under ASC 840);
2. If the lessor has applied Transition Method A before the effective date, account for the lease in accordance with ASC 840; and
3. Account for the lease in accordance with ASC 842 as of the effective date.

*A lease classified as a sales-type lease or direct financing lease under ASC 840 that is classified as an operating lease under ASC 842.* For any lease that was classified as either a sales-type or direct financing lease under ASC 840 and is classified as an operating lease under ASC 842, the lessor would:

1. Recognize the underlying asset at the carrying amount that would have resulted had the lease been accounted for as an operating lease under ASC 840;
2. Derecognize the carrying amount of the net investment in the lease;
3. Account for any difference between 1 and 2 as follows:
  - a. If the lessor has applied Transition Method A, as an adjustment to equity if the lease commencement date was before the beginning of the earliest period presented, or if the lease was acquired as part of a business combination, or as an adjustment to earnings if the commencement date was on or after the beginning of the earliest period presented; and
  - b. If the lessor has applied Transition Method B, as an adjustment to equity; and
4. Recognize a straight-line rent receivable balance for any amount that would have existed at the application date had the lease always been accounted for as an operating lease.

The lease is then accounted for in accordance with ASC 842 after the application date.

*A lease classified as a leveraged lease under ASC 840.* Because the leveraged leases model in legacy GAAP was not retained, any lease that commences (or is modified) after the effective date of ASC 842 will not be accounted for under the leveraged leasing model. However, leveraged leases under legacy GAAP will continue to be accounted for using that leveraged lease model, which was carried forward in

ASC 842-50. If a leveraged lease is modified on or after the effective date of ASC 842, that lease will be accounted for as a new lease as of the modification date.

## 9.5 Disclosures

Lessors are required to disclose certain transition-related information otherwise required by ASC 250 when an entity makes an accounting change. Lessors must also disclose the transition practical expedients they have elected (if any). In addition, lessees that have elected Transition Method B must provide the disclosures required by ASC 840 for those comparative periods included in the financial statements for which ASC 840 was applied to account for leases. These disclosure requirements and other disclosures required upon transition have been included in the disclosure checklist included in Appendix C of this white paper.

## 10. Differences between ASC 842 and IFRS 16

A long-standing joint project between the FASB and IASB resulted in the issuance of ASU 2016-02 and IFRS 16. While ASC 842 and IFRS 16 are converged in many important respects, there are significant differences between the two. For example:

- ASC 842 applies to leases that provide the customer with a right to use property, plant or equipment (see Sections 2.1 and 3.1). IFRS 16 applies to leases that provide the customer with a right to use a broader population of assets than just property, plant or equipment, including leases of intangible assets (unless they would be considered the license of intellectual property within the scope of IFRS 15).
- A short-term lease is defined under IFRS 16 as a lease: (a) with a lease term of 12 months or less and (b) without a purchase option. In other words, a lease with a purchase option is precluded from being considered a short-term lease under IFRS 16, regardless of the likelihood that the purchase option will be exercised by the lessee. Under ASC 842, a short-term lease with a lease term of 12 months or less may have a purchase option, but the lessee must not be reasonably certain to exercise that option (see Section 7.1.1).
- Under ASC 842, a lessor classifies a lease as sales-type, direct financing or operating. Selling profit on a sales-type lease is recognized at commencement, while selling profit for a direct financing lease is deferred and recognized over the lease term. Under IFRS 16, a lessor classifies leases as operating or finance, and recognizes income on all finance leases at commencement.
- Under ASC 842, a lessor performs the lease classification test at the commencement date, applying the criteria in Section 6. Under IFRS 16, a lessor performs the lease classification test as of the inception date, and it is classified as a finance lease if it transfers substantially all of the risks and rewards of ownership. If it does not transfer substantially all of the risks and rewards of ownership, the lease is classified as an operating lease. Classification is not dependent on specific criteria, but the criteria that exist in ASC 842 are provided as examples of situations or circumstances that would indicate that finance classification is appropriate. Additional examples of such situations are provided.
- Under ASC 842, lessors may elect not to separate lease and nonlease components if certain criteria are met. Lessors are not allowed to make such an election under IFRS 16.
- Under ASC 842, lessors may elect to present sales taxes collected from lessees on a net basis. Lessors are not allowed to make such an election under IFRS 16.
- Under ASC 842, any lessor costs that are paid directly to a third party by a lessee are excluded from variable payments. IFRS 16 does not contain a similar requirement.
- The lessor's accounting for lease modifications differs, as summarized below:
  - Modification of an operating lease not accounted for as a separate contract:
    - Under ASC 842, the lessor's accounting depends on the classification of the modified lease. If it is classified as an operating lease, the lessor includes prepaid or accrued rentals in the lease payments of the new lease. If it is classified as sales-type or direct financing, the lessor derecognizes any accrued rent asset or deferred rent liability and adjusts selling profit or loss.
    - Under IFRS 16, the lessor accounts for the modification as a new lease from the modification date. Any prepaid or accrued balances are included in the lease payments for the new lease.

- Modification of a sales-type or direct financing lease:
  - Under ASC 842, the accounting depends on the lease classification pre- and post-modification.
    - If the original lease is a sales-type lease and the modified lease is either a sales-type or a direct financing lease, the lessor adjusts the discount rate so that the net investment in the new lease equals the carrying amount of the net investment in the original lease immediately before the modification date.
    - If the original lease is a sales-type lease and the modified lease is an operating lease, the net investment in the original lease immediately before the modification date is used as the carrying amount of the underlying asset upon the modification.
    - If the original lease is a direct financing lease, and the modified lease is direct financing, the lessor adjusts the discount rate so that the net investment in the new lease equals the carrying amount of the net investment in the original lease immediately before the modification date.
    - If the original lease is a direct financing lease, and the modified lease is a sales-type lease, the lessor calculates the selling profit or loss, the fair value of the asset and the carrying amount of the asset immediately before the modification date.
    - If the original lease is a direct financing lease, and the modified lease is an operating lease, the net investment in the original lease immediately before the modification date is used as the carrying amount of the underlying asset upon the modification.
  - Under IFRS 16, the lessor accounts for the lease based on how it would have been classified had the modified terms been in effect at inception.
    - If the modified lease would have been an operating lease, the lease is accounted for as a new lease from the modification date. The net investment in the original lease immediately before the modification date is used as the carrying amount of the underlying asset upon the modification.
    - If the modified lease would not have been classified as operating, the lessor applies the provisions of IFRS 9.

For additional information about the differences between ASC 842 and IFRS 16, refer to pages 7 through 9 of the “Summary” in ASU 2016-02.



## Appendix A: Acronyms and literature references

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

### Acronym legend

Acronym	Definition
ASC	FASB's Accounting Standards Codification
ARO	Asset retirement obligation
ASU	Accounting Standards Update
FASB	Financial Accounting Standards Board
GAAP	Generally accepted accounting principles
IASB	International Accounting Standards Board
IFRS	International Financial Reporting Standards
IT	Information technology
PV	Present value
ROU (asset)	Right-of-use (asset)
SAB	SEC Staff Accounting Bulletin
SEC	U.S. Securities and Exchange Commission

### ASC topics and subtopics

ASC topic or subtopic	Title
210-20	Balance Sheet – Offsetting
250	Accounting Changes and Error Corrections
250-10	Accounting Changes and Error Corrections – Overall
270	Interim Reporting
270-10	Interim Reporting – Overall
310-10	Receivables – Overall
326	Financial Instruments—Credit Losses
326-20	Financial Instruments—Credit Losses – Measured at Amortized Cost
330	Inventory
340-40	Other Assets and Deferred Costs – Contracts with Customers
350-30	Intangibles—Goodwill and Other – General Intangibles Other than Goodwill
360	Property, Plant, and Equipment
360-10	Property, Plant, and Equipment – Overall
410	Asset Retirement and Environmental Obligations
410-20	Asset Retirement and Environmental Obligations – Asset Retirement Obligations

ASC topic or subtopic	Title
420	Exit or Disposal Cost Obligations
460	Guarantees
460-10	Guarantees – Overall
605	Revenue Recognition
606	Revenue from Contracts with Customers
606-10	Revenue from Contracts with Customers – Overall
805	Business Combinations
805-20	Business Combinations – Identifiable Assets and Liabilities, and Any Noncontrolling Interest
805-50	Business Combinations – Related Issues
815-10	Derivatives and Hedging – Overall
815-15	Derivatives and Hedging – Embedded Derivatives
820	Fair Value Measurement
830-10	Foreign Currency Matters – Overall
835-20	Interest – Capitalization of Interest
840	Leases
840-30	Leases – Capital Leases
840-40	Leases – Sale-Leaseback Transactions
842	Leases
842-10	Leases – Overall
842-20	Leases – Lessee
842-30	Leases – Lessor
842-40	Leases – Sale and Leaseback Transactions
850-10	Related Party Disclosures – Overall
853	Service Concession Arrangements
853-10	Service Concession Arrangements – Overall
958-810	Not-for-Profit Entities – Consolidation

#### Other literature and guidance

Other literature	Issued by	Title
ASU 2016-02	FASB	Leases (Topic 842)
ASU 2017-13	FASB	Revenue Recognition (Topic 605), Revenue from Contracts with Customers (Topic 606), Leases (Topic 840), and Leases (Topic 842): Amendments to SEC Paragraphs Pursuant to the Staff Announcement at the July 20, 2017 EITF Meeting and Rescission of Prior SEC Staff Announcements and Observer Comments
ASU 2018-01	FASB	Leases (Topic 842): Land Easement Practical Expedient for Transition to Topic 842

Other literature	Issued by	Title
ASU 2018-10	FASB	Codification Improvements to Topic 842, Leases
ASU 2018-11	FASB	Leases (Topic 842): Targeted Improvements
ASU 2018-20	FASB	Leases (Topic 842): Narrow-Scope Improvements for Lessors
ASU 2019-01	FASB	Leases (Topic 842): Codification Improvements
ASU 2019-10	FASB	Financial Instruments—Credit Losses (Topic 326), Derivatives and Hedging (Topic 815), and Leases (Topic 842): Effective Dates
ASU 2020-02	FASB	Financial Instruments—Credit Losses (Topic 326) and Leases (Topic 842)—Amendments to SEC Paragraphs Pursuant to SEC Staff Accounting Bulletin No. 119 and Update to SEC Section on Effective Date Related to Accounting Standards Update No. 2016-02, Leases (Topic 842) (SEC Update)
ASU 2020-04	FASB	Reference Rate Reform (Topic 848): Facilitation of the Effects of Reference Rate Reform on Financial Reporting
ASU 2020-05	FASB	Revenue from Contracts with Customers (Topic 606) and Leases (Topic 842): Effective Dates for Certain Entities
IFRS 9	IASB	Financial Instruments
IFRS 15	IASB	Revenue from Contracts with Customers
IFRS 16	IASB	Leases
Regulation S-X, Rule 3-05	SEC	Financial Statements of Businesses Acquired or to Be Acquired
SAB Topic 11M	SEC staff	Miscellaneous Disclosure – Disclosure of the Impact That Recently Issued Accounting Standards Will Have on the Financial Statements of the Registrant When Adopted in a Future Period
SEC staff speech (Pidgeon 2018)	SEC staff	Remarks before the 2018 AICPA Conference on Current SEC and PCAOB Developments, Andrew W. Pidgeon, Professional Accounting Fellow, Office of the Chief Accountant
SEC staff speech (Berrigan 2017)	SEC staff	Remarks before the 2017 AICPA Conference on Current SEC and PCAOB Developments, Michael P. Berrigan, Professional Accounting Fellow, Office of the Chief Accountant

## Appendix B: Accounting policy, practical expedient and transition elections

<b>Portfolio approach</b>	<ul style="list-style-type: none"> <li>• Advantage: Reduces costs and level of effort.</li> <li>• Disadvantage: Requires supporting its use and having processes to create and monitor portfolios both initially and on an ongoing basis.</li> </ul>
<b>Separating lease and nonlease components accounting policy election</b> (see Section 4.3)	<ul style="list-style-type: none"> <li>• Advantage: Eliminates complexity and reduces level of effort.</li> <li>• Disadvantage: Increases amount of lease liabilities and ROU assets recognized. <u>Need lessor disadvantage</u></li> </ul>
<b>Sales tax (and other similar taxes)</b> (see Section 4.4)	<ul style="list-style-type: none"> <li>• Advantage: Reduces costs and level of effort.</li> </ul>
<b>Transition: Alternative method</b> (see Transition Method B in Section 9.2)	<ul style="list-style-type: none"> <li>• Advantage: Reduces costs and level of effort.</li> <li>• Disadvantage: Results in lack of comparability to prior years.</li> </ul>
<b>Transition: Package of transition practical expedients</b> (see Section 9.3.1)	<ul style="list-style-type: none"> <li>• Advantage: Reduces costs and level of effort.</li> <li>• Disadvantage: Lease modification reduces benefits.</li> </ul>
<b>Transition: Hindsight practical expedient</b> (see Section 9.3.2)	<ul style="list-style-type: none"> <li>• Advantage: Reduces the impact of modifications after the effective date.</li> <li>• Disadvantage: Increased cost and level of effort.</li> </ul>
<b>Transition: Land easement practical expedient</b> (see Section 9.3.3)	<ul style="list-style-type: none"> <li>• Advantage: Reduces costs and level of effort.</li> <li>• Disadvantage: Potential lack of comparability between the accounting for preexisting land easements and new land easements.</li> </ul>

## Appendix C: Disclosure checklist

The following table lists the disclosure requirements applicable to lessors (ASC 842-30-50):

842-	Disclosure requirement	Yes/No	Remarks
<b>Lessor</b>			
General			
30-50-3	1. A lessor shall disclose both of the following:		
20-50-3(a)	a. Information about the nature of its leases, including:		
20-50-3(a)(1)	(1) A general description of the leases.		
20-50-3(a)(2)	(2) The basis and terms and conditions on which variable lease payments are determined.		
30-50-3(a)(3)	(3) The existence and terms and conditions of options to extend or terminate the lease.		
30-50-3(a)(4)	(4) The existence and terms and conditions of options for a lessee to purchase the underlying asset.		
30-50-3(b)	b. Information about significant assumptions and judgments made in applying the requirements of this Topic, which may include the following:		
30-50-3(b)(1)	(1) The determination of whether a contract contains a lease (as described in paragraphs 842-10-15-2 through 15-27).		
30-50-3(b)(2)	(2) The allocation of the consideration in a contract between lease and nonlease components (as described in paragraphs 842-10-15-28 through 15-32), unless a lessor elects the practical expedient in paragraph 842-10-15-42A and all nonlease components in the contract qualify for that practical expedient.		
30-50-3(b)(3)	(3) The determination of the amount the lessor expects to derive from the underlying asset following the end of the lease term.		
30-50-3A	2. An entity that elects the practical expedient in paragraph 842-10-15-42A on not separating nonlease components from associated lease components (including an entity that accounts for the combined component entirely in Topic 606 on revenue from contracts with customers) shall disclose the following by class of underlying asset:		
30-50-3A(a)	a. Its accounting policy election and the class or classes of underlying assets for which it has elected to apply the practical expedient.		
30-50-3A(b)	b. The nature of: <ul style="list-style-type: none"> <li>(1) The lease components and nonlease components combined as a result of applying the practical expedient.</li> </ul>		

842-	Disclosure requirement	Yes/No	Remarks
	(2) The nonlease components, if any, that are accounted for separately from the combined component because they do not qualify for the practical expedient.		
30-50-3A(c)	c. The Topic the entity applies to the combined component (this Topic or Topic 606).		
30-50-4	3. A lessor shall disclose any lease transactions between related parties (see Topic 850 on related-party disclosures).		
30-50-5	4. A lessor shall disclose lease income recognized in each annual and interim reporting period, in a tabular format, to include the following:		
30-50-5(a)	a. For sales-type leases and direct financing leases: (1) Profit or loss recognized at the commencement date (disclosed on a gross basis or a net basis consistent with paragraph 842-30-45-4). (2) Interest income either in aggregate or separated by components of the net investment in the lease.		
30-50-5(b)	b. For operating leases, lease income relating to lease payments.		
30-50-5(c)	c. Lease income relating to variable lease payments not included in the measurement of the lease receivable.		
30-50-6	5. A lessor shall disclose in the notes the components of its aggregate net investment in sales-type and direct financing leases (that is, the carrying amount of its lease receivables, its unguaranteed residual assets, and any deferred selling profit on direct financing leases).		
30-50-7	6. A lessor shall disclose information about how it manages its risk associated with the residual value of its leased assets. In particular, a lessor should disclose all of the following:		
30-50-7(a)	a. Its risk management strategy for residual assets.		
30-50-7(b)	b. The carrying amount of residual assets covered by residual value guarantees (excluding guarantees considered to be lease payments for the lessor, as described in paragraph 842-30-30-1(a)(2)).		
30-50-7(c)	c. Any other means by which the lessor reduces its residual asset risk (for example, buyback agreements or variable lease payments for use in excess of specified limits).		
<b>Sales-Type and Direct Financing Leases</b>			
30-50-8	7. In addition to the disclosures required by items 1 through 6 of this checklist, a lessor also shall		

842-	Disclosure requirement	Yes/No	Remarks
	provide the disclosures in items 9 and 10 of this checklist for sales-type leases and direct financing leases.		
30-50-9	8. A lessor shall explain significant changes in the balance of its unguaranteed residual assets and deferred selling profit on direct financing leases.		
30-50-10	9. A lessor shall disclose a maturity analysis of its lease receivables, showing the undiscounted cash flows to be received on an annual basis for a minimum of each of the first five years and a total of the amounts for the remaining years. A lessor shall disclose a reconciliation of the undiscounted cash flows to the lease receivables recognized in the statement of financial position (or disclosed separately in the notes).		
<b>Operating Leases</b>			
30-50-11	10. In addition to the disclosures required by items 1 through 6 of this checklist, a lessor also shall provide the disclosures in items 11 and 12 for operating leases.		
30-50-12	11. A lessor shall disclose a maturity analysis of lease payments, showing the undiscounted cash flows to be received on an annual basis for a minimum of each of the first five years and a total of the amounts for the remaining years. A lessor shall present that maturity analysis separately from the maturity analysis required by item 9 of this checklist for sales-type leases and direct financing leases.		
30-50-13	12. A lessor shall provide disclosures required by Topic 360 on property, plant and equipment separately for underlying assets under operating leases from owned assets.		
<b>Separating Components of a Contract</b>			
30-50-14	13. A lessor that makes the accounting policy election in paragraph 842-10-15-39A shall disclose its accounting policy election and comply with the disclosure requirements in paragraphs 235-10-50-1 through 50-6.		



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