Leases: Overview of ASC 842

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Introduction

Background

In February 2016, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) 2016-02, Leases, its long-awaited final standard on the accounting for leases, which was codified in Topic 842, Leases, of the FASB’s Accounting Standards Codification (ASC 842). On its effective date, ASC 842 replaces the legacy U.S. generally accepted accounting principles (GAAP) for leases in ASC 840, Leases, for both lessees and lessors.

As 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 In addition, the FASB and SEC staff provided limited effective date relief for ASC 842 and the SEC staff superseded almost all of its preexisting guidance on accounting for leases (which was included in the S99 sections of ASC 840).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 840, the FASB has issued the following seven ASUs:

- ASU 2017-13, 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, Leases (Topic 842): Land Easement Practical Expedient for Transition to Topic 842
- ASU 2018-10, Codification Improvements to Topic 842, Leases
- ASU 2018-11, Leases (Topic 842): Targeted Improvements
- ASU 2018-20, Leases (Topic 842): Narrow-Scope Improvements for Lessors
- ASU 2019-01, Leases (Topic 842): Codification Improvements
- ASU 2019-10, Financial Instruments—Credit Losses (Topic 326), Derivatives and Hedging (Topic 815), and Leases (Topic 842): Effective Dates

This overview highlights certain aspects of ASC 842 and provides information about its effective date and transition provisions. For additional information, refer to our publication, A guide to lessee accounting under ASC 842 (our lessee guide), and our Lease Accounting Resource Center.

The effective date of ASC 842 for public business entities and certain not-for-profit entities and employee benefit plans with calendar year ends (with limited exceptions) has already passed—January 1, 2019. The effective date of ASC 842 for private companies with calendar year ends is their annual financial statements for the year ending December 31, 2021. Private companies should not delay their implementation of ASC 842 given the complexities involved. Additional information about the effective date of ASC 842 is provided later in this overview.

Significant changes

The most significant change introduced by ASC 842 requires lessees to recognize right-of-use (ROU) assets and lease liabilities for most leases.

Middle Market Insights

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

Relatively speaking, ASC 842 introduces limited changes to the lessor accounting model, none of which rise to the same level of significance as the changes made to the lessee accounting model.

**Highlights**

These highlights summarize certain aspects of ASC 842 that apply to both lessees and lessors, certain aspects of the lessee accounting model under ASC 842 and certain aspects of the lessor accounting model under ASC 842.

**Guidance applicable to both lessees and lessors**

**Definition of a lease**

The definition of a lease in ASC 842 is “a contract, or part of a contract, that conveys the right to control the use of identified property, plant, or equipment (an identified asset) for a period of time in exchange for consideration.”

Numerous factors must be considered in determining whether the contract includes an identified asset, including the nature of the asset, whether the asset has been explicitly or implicitly identified in the contract and whether the supplier has substantive substitution rights. In addition, to the extent the contract provides the right to use a capacity portion of an asset, consideration must be given to whether the capacity portion represents an identified asset.

Numerous factors must also be considered in determining whether the contract conveys to the customer the right to control the identified asset over the period of use (or for at least a portion of the period of use). Two of those factors include: (a) whether 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 and (b) whether the customer has the right to direct the use of the identified asset over the period of use.

Chapter 3 of our lessee guide provides considerable guidance on the definition of a lease from a lessee’s perspective, along with several examples illustrating application of the definition to various fact patterns.

**Lease classification**

Application of ASC 842 results in lessees classifying their leases (or separate lease components) as either financing or operating leases and lessors classifying their leases (or separate lease components) as sales-type, direct-financing or operating leases. The lease classification criteria used by both lessees and lessors in this regard are the following:

- Ownership of the underlying asset transfers to the lessee by the end of the lease term.
- An option exists under which the lessee may purchase the underlying asset and exercise of that option is reasonably certain.
- When the lease does not commence at or near the end of the underlying asset’s economic life, the lease term makes up a major part of the underlying asset’s remaining economic life.
- 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 underlying asset’s specialized nature is expected to result in it not having an alternative use to the lessor at the end of the lease term.
If one or more of these lease classification criteria are met at lease commencement, the lessee should classify the lease (or separate lease component) as a finance lease and the lessor should classify the lease (or separate lease component) as a sales-type lease. If none of these lease classification criteria are met, the lessee should classify the lease (or separate lease component) as an operating lease and the lessor’s classification of the lease (or separate lease component) depends on whether both of the following additional classification criteria are met:

- The sum of the present values of the following amounts is the same as or more than substantially all of the underlying asset’s fair value: (a) the lease payments, (b) any residual value guaranteed by the lessee that is not already included in the lease payments and (c) any residual value guaranteed by a third party that is unrelated to the lessor.

- Collection of the following by the lessor is probable: (a) lease payments and (b) any amount necessary to satisfy a residual value guarantee.

If both of these additional classification criteria are met, then the lessor should classify the lease (or separate lease component) as a direct-financing lease. Otherwise, the lessor should classify the lease (or separate lease component) as an operating lease.

While the first four lease classification criteria in ASC 842 are similar in principle to those found in ASC 840, they do not draw any quantitative bright lines. However, the implementation guidance in ASC 842 for certain of the classification criteria includes the following observations:

- For purposes of determining whether the lease term makes up a major part of the underlying asset’s remaining economic life, one reasonable approach would be to use a threshold of 75 percent or more.

- For purposes of determining whether the lease commences at or near the end of the underlying asset’s economic life, one reasonable approach would be to use a threshold of 25 percent or less of the underlying asset’s total economic life.

- For purposes of determining what represents substantially all of the underlying asset’s fair value, one reasonable approach would be to use a threshold of 90 percent or more.

Lessees and lessors should adopt and consistently apply reasonable accounting policies related to their application of the principles-based lease classification criteria included in ASC 842.

Chapter 6 of our lessee guide discusses each of the five lease classification criteria used by both lessees and lessors in significant detail.

Lease term

Under ASC 842, the lease term begins at the commencement date 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, whether an option to extend or terminate a lease, or to purchase the underlying asset, should be reflected in the lease term depends on which party (or parties) has the right to exercise the option, and in some cases, the likelihood that the option will be exercised. The lease term may also be affected by the existence of a fiscal funding clause within the contract.

Section 5.3 of our lessee guide includes in-depth discussion of the factors that should be considered in determining the lease term from the lessee’s perspective and numerous examples illustrating the effects of various factors on a lessee’s determination of the lease term.

Lease payments

Lease payments are used by lessees and lessors for both classification and measurement purposes. Fixed payments, including variable payments that are in-substance fixed payments, are included in lease payments. Fixed payments include payments for insurance or taxes that are fixed. Payments for
insurance or taxes that are variable should be evaluated as variable lease payments. Variable lease payments that depend on an index or rate are included in lease payments and measured initially by reference to the index or rate at the commencement date. Examples of other types of payments lessees and lessors should evaluate to determine whether they should be included or excluded from lease payments include the following:

- Lease incentives.
- Purchase option exercise price.
- Termination penalty.
- Renewal option exercise price.
- Residual value guarantees.
- Maintenance and security deposits.
- Payments to dismantle and remove an underlying asset.
- Payments to return an underlying asset to its pre-lease condition.

Whether each of these payment types should be included in lease payments depends on specific factors.

Variable lease payments that vary after the commencement date based on other than an index or rate are not included in lease payments. For example, lease payments that vary based on the sales of a retail location are variable lease payments that are not included in lease payments for classification and measurement purposes. Payments that vary solely based on the passage of time (e.g., escalating rents) are not considered variable lease payments.

Section 5.5 of our lessee guide discusses whether each of the payment types listed or discussed earlier, as well as others, should be included in the lease payments used by a lessee and provides numerous examples of how a lessee should measure its lease payments in specific facts and circumstances. Section 5.5 also discusses the difference between the lease payments used by a lessee for classification vs. measurement purposes.

**Definition of initial direct costs**

Under ASC 842, only incremental costs to obtain a lease that the entity (i.e., the lessee or lessor) would not have incurred if the lease had not been entered into should be considered initial direct costs of the lease. For example, a commission due to an employee only after the lease has been executed meets the definition of an initial direct cost under ASC 842.

In general, any costs incurred prior to signing a lease are not considered initial direct costs under ASC 842. Examples of costs that do not meet the definition of initial direct costs include the costs associated with performing credit checks, negotiating lease terms and preparing and processing lease documents that are incurred by an internal department of the lessor.

Section 7.1.3.1 of our lessee guide provides additional discussion related to the definition of initial direct costs.

**Leases involving real estate**

ASC 842 eliminates the additional requirements in ASC 840 that had to be applied by lessees and lessors to leases involving real estate. As a result, the same guidance is used under ASC 842 to account for leases involving real estate as is used to account for leases of other types of underlying assets within the scope of ASC 842. For a lessor, depending on the facts and circumstances, this could mean that it will recognize initial selling profit on real estate leases classified as sales-type leases.
Lease modifications

Under ASC 842, modification of a contract that includes a lease is accounted for as a separate contract if it grants the lessee an additional right of use that was not included in the original lease provided the lease payments for that additional right of use increase commensurate with the standalone price of the additional right of use (which should be adjusted to take into consideration the circumstances of that particular contract). When a lease modification is not accounted for as a separate contract, the accounting for the modified lease varies for lessees and lessors and depends on a number of factors, including the nature of the modifications and the classification of the lease.

Section 7.2.5 of our lessee guide provides a decision tree to assist a lessee in identifying the appropriate accounting model for a lease modification and several examples illustrating how to identify and apply the appropriate accounting model.

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 related-party lease should be the same as the classification and accounting would have been if that lease were with an unrelated party (except with respect to a specific aspect of accounting for a sale-leaseback transaction).

When understanding the legally enforceable terms and conditions of a lease, consideration should be given to whether there are any implicit legally enforceable terms and conditions. For example, if a lessee leases a manufacturing facility from a related-party lessor 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, both the lessee and lessor should consider 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.

Section 7.6 of our lessee guide discusses related-party leases in more detail.

Sale-leaseback transactions

With respect to determining whether a sale has occurred in a sale-leaseback transaction under ASC 842, the seller-lessee should use the guidance in ASC 606, Revenue from Contracts with Customers, related to whether a contract exists and whether control of the asset has transferred to the customer. In applying this guidance, the existence of a leaseback in and of itself does not preclude a seller-lessee from concluding that a sale of the underlying asset has occurred. However, a sale has not occurred if the leaseback is a financing lease for the seller-lessee or a sales-type lease for the buyer-lessor. Additional criteria must be met to achieve sale treatment when a repurchase option is involved in a sale-leaseback transaction.

When a sale-leaseback transaction does not result in a sale, the failed sale is treated as a financing transaction by both the seller-lessee and buyer-lessee.

When a sale-leaseback transaction results in a sale, ASC 842 provides guidance related to: (a) the buyer-lessee’s accounting for the purchase of the asset, (b) the seller-lessee’s accounting for the sale of the asset and (c) the buyer-lessee’s and seller-lessee’s accounting for the leaseback. ASC 842 also addresses the accounting implications of any potential off-market terms in a sale-leaseback transaction.

Chapter 8 of our lessee guide discusses sale-leaseback transactions in detail and provides examples illustrating the accounting for a sale-leaseback transaction when there is a sale and when there is a failed sale.

Disclosures

The overall disclosure objective for both lessees and 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 in ASC 842 that
lessees and lessors must comply with by providing a variety of qualitative and quantitative information about their leases in the notes to the financial statements. Many of these disclosure requirements are incremental to those in ASC 840.

Appendix D in our lessee guide provides a disclosure checklist for lessees. The disclosure requirements specific to lessors are included in ASC 842-30-50.

**Guidance applicable to lessees**

**Determining the units of account in the contract and allocating the contract consideration**

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

- **Determine whether two or more contracts should be combined for accounting purposes.** ASC 842 provides specific conditions under which contracts should be combined for accounting purposes.

- **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 (including common area maintenance services involved in real estate leases). Noncomponents do not provide an additional good or service to the lessee, and therefore, cannot be a unit of account. Common examples of noncomponents include reimbursements for the lessor’s real estate taxes and building insurance.

- **Identify the separate lease components in the contract(s).** ASC 842 provides specific criteria to use in determining whether a contract that includes more than one right to use an underlying asset includes a separate lease component for each one of those rights or one lease component for two or more rights to use underlying assets.

- **Identify the units of account by separating (or combining) the separate lease components from (with) any related nonlease components.** When a contract includes both lease and nonlease components, the lessee either: (a) treats each separate lease component as a unit of account apart from the nonlease components or (b) elects an accounting policy by class of underlying asset to treat each separate lease component together with the nonlease component(s) related to it as one combined unit of account. If the lessee elects this accounting policy, the combined unit of account is accounted for as a lease component under ASC 842. If the lessee does not elect this accounting policy, the nonlease components are accounted for as one or more unit(s) of account in accordance with other applicable U.S. GAAP. While electing the accounting policy means the lessee does not have to spend the effort and cost related to separating lease components from nonlease components, it also typically means the lessee recognizes a larger ROU asset and lease liability than it otherwise would have.

- **When there is more than one unit of account, allocate the contract consideration to each unit of account.** The lessee first determines the contract consideration and then allocates that contract consideration to the units of account using the relative standalone prices for each unit of account. Because noncomponents cannot be units of account, no contract consideration is allocated to them. Instead, the lessee must consider whether payments it will or has made related to noncomponents (e.g., payments for real estate taxes and insurance) should be included in the lease payments and contract consideration.
Chapter 4 of our lessee guide provides in-depth discussion related to each of these steps and includes multiple examples illustrating how to determine the units of account in a contract and allocate the contract consideration to those units of account.

Discount rate

The lessee uses a discount rate for present value purposes when determining the classification of a lease and the initial carrying amount of a lease liability. The following describes the three discount rates in ASC 842 for lessees and when each should or may be used:

- **Rate implicit in the lease.** The rate implicit in the lease should be used by the lessee if it is readily determinable. Given that determining the rate implicit in the lease requires knowing lessor-specific information, this rate is not readily determinable by lessees in most cases.

- **Incremental borrowing rate.** The incremental borrowing rate should be used by the lessee if the rate implicit in the lease is not readily determinable. The lessee’s incremental borrowing rate for this purpose is the interest rate the lessee would be charged for a loan that: (a) is collateralized (i.e., secured by the lessee’s aggregate collateral), (b) has a term similar to the lease term, (c) is for an amount equal to the lease payments and (d) occurs in a similar economic environment. In addition, the hypothetical loan on which the incremental borrowing rate is based should reflect payment terms that are consistent with those of the lease (e.g., monthly principal and interest payments).

- **Risk-free rate.** Lessees that are not public business entities may elect an accounting policy to use the risk-free rate for a period comparable to the lease term. In the U.S., the risk-free rate is the rate of a zero coupon U.S. Treasury instrument for the same period of time as the lease term. If the lessee elects to use the risk-free rate as the discount rate, it must use that rate in accounting for all of its leases.

Additional detailed discussion about determining the discount rate, including how to address the complexities that may arise in determining the incremental borrowing rate for a lease, as well as determining the discount rate on a portfolio basis, is provided in Section 5.2 of our lessee guide. In addition, our white paper, ASC 842: Calculating the incremental borrowing rate as a lessee, provides in-depth discussion on the considerations and mechanics involved in calculating the lessee’s calculation of its incremental borrowing rate for a lease.

Initial accounting

ASC 842 requires lessees to recognize ROU assets and lease liabilities for all leases other than those for which the lessee has elected the short-term lease accounting policy. By definition, a short-term lease is one in which: (a) the lease term is 12 months or less and (b) there is not an option to purchase the underlying asset that the lessee is reasonably certain to exercise. For short-term leases, lessees may elect an accounting policy by class of underlying asset under which: (a) ROU assets and lease liabilities are not recognized, (b) lease payments are generally recognized over the lease term on a straight-line basis and (c) variable lease payments based on other than an index or rate are recognized as lease costs in the period in which they are incurred (which is consistent with how such payments are recognized when the short-term lease accounting policy is not elected).

For leases other than those for which the short-term lease accounting policy has been elected:

- For initial measurement of the lease liability, the lessee discounts the lease payments not yet paid over the lease term using the appropriate discount rate as of the commencement date. For this purpose, lease incentives payable on or after the commencement date (but not yet paid on that date) should reduce lease payments.

- For initial measurement of the ROU asset, the lessee starts with the amount of the lease liability and adjusts it for the following: (a) any lease payments already made to the lessor on or before the
commencement date, (b) any initial direct costs incurred by the lessee and (c) any lease incentives received from the lessor on or before the commencement date.

The initial accounting for a lease is discussed and illustrated in detail in Chapter 7 of our lessee guide.

**Subsequent accounting**

The lease liability is accounted for as a financial liability by accreting the lease liability using the discount rate used to initially measure the lease liability.

The subsequent measurement of lease costs (and their presentation in the income statement) and amortization of the ROU asset depends on whether the lease is classified as a finance or operating lease:

- **Finance lease.** The ROU asset for a finance lease is typically amortized on a straight-line basis over the lease term or the useful life of the underlying asset, depending on the facts and circumstances. Unless the amortization is capitalized in accordance with other U.S. GAAP (e.g., the amortization of the ROU asset for the lease of a crane being used in the construction of a building), it is reflected as an expense on the income statement. In addition, interest costs are recognized for the accretion of the lease liability. Interest costs are recognized as interest expense unless capitalized in accordance with other U.S. GAAP.

- **Operating lease.** The determination of lease costs for an operating lease depends on whether the ROU asset has been impaired in a prior period. If not, lease costs for the period are determined based on amortizing the remaining lease costs typically on a straight-line basis over the remaining lease term. For this purpose lease costs include initial direct costs. Unless the lease costs are capitalized in accordance with other U.S. GAAP (e.g., leases costs related to the lease of a crane being used in the construction of a building), they are recognized as an expense on the income statement. Recognizing lease costs in this manner results in amortization of the ROU asset on other than a straight-line basis. If the ROU asset has been impaired in a prior period, lease costs and ROU amortization are calculated similar to a finance lease; however, amortization of the ROU asset and accretion of the lease liability are recognized as one single lease cost in the income statement (unless capitalized in accordance with other U.S. GAAP).

For both finance and operating leases, variable lease payments not included in lease payments because they depend on something other than an index or rate are recognized in the period in which the obligation to make the payments is incurred. In addition, ROU assets recognized for either a finance lease or operating lease are subject to the long-lived asset impairment models in ASC 360, *Property, Plant, and Equipment*.

The subsequent accounting for a lease is discussed and illustrated in detail in Chapter 7 of our lessee guide. In addition, the circumstances under which a lessee may be required to remeasure a measurement (e.g., lease payments) or reassess a conclusion (e.g., lease classification) made in the accounting for a lease are summarized in Appendix C of our lessee guide.

**Presentation of lease balances and activities on the balance sheet, income statement and cash flow statement**

For ROU assets and lease liabilities recognized under ASC 842, lessees should either present the assets and liabilities as separate line items on the balance sheet or disclose them separately in the notes to the financial statements. If a lessee does not present them as separate line items on the balance sheet, it must disclose which line items in the balance sheet include those assets and liabilities. The ROU assets and lease liabilities related to finance leases cannot be included in the same balance-sheet line items that include the ROU assets and lease liabilities related to operating leases. In addition, the portion of a lease liability expected to be paid within 12 months (or if longer, the lessee’s operating cycle) should be classified as current.
Presentation of lease costs recognized under ASC 842 on the income statement depends on the classification of the lease. If the lease is classified as a finance lease, presentation of the portion of the lease costs related to the amortization of the ROU asset and the portion of the lease costs related to interest on the lease liability should be consistent with how the lessee presents similar expenses on its income statement (e.g., depreciation and interest expense related to the financed purchase of property, plant or equipment). If the lease is classified as an operating lease, lease costs should be included in the lessee’s income from continuing operations, unless it is part of a component or group of components treated as discontinued operations.

Similar to the presentation of income statement activity, the classification of lease payments on the cash flow statement also depends on the classification of a lease. If the lease is classified as a finance lease, the lessee classifies: (a) the portion of the related lease payment representing repayment of principal as a financing activity, (b) the portion of the lease payment representing interest in the same manner that it classifies interest payments on debt (e.g., if none of the interest payment is capitalized in accordance with other U.S. GAAP, it is classified as an operating activity) and (c) variable lease payments not included in the lease liability (e.g., a variable lease payment based on other than an index or rate) as an operating activity. If the lease is classified as an operating lease, lease payments (including all variable lease payments) are classified as operating activities. However, the portion (if any) of those lease payments representing costs that were capitalized in accordance with other U.S. GAAP should be classified as investing activities. When the lessee has elected an accounting policy to not recognize ROU assets and lease liabilities for some (by class of underlying asset) or all of its short-term leases, lease payments under those leases are classified as operating activities.

Sections 9.1 to 9.3 of our lessee guide provide additional discussion of the presentation of a lessee’s lease balances and activities on its balance sheet, income statement and cash flow statement. In addition, there is one example that runs through all three sections that illustrates the presentation of a finance and operating lease on the lessee’s balance sheet, income statement and cash flow statement.

**Guidance applicable to lessors**

**Leveraged leases**

ASC 842 eliminates the leveraged lease accounting model in ASC 840 on a going forward basis. In other words, the accounting for leveraged leases with commencement dates prior to the effective date of ASC 842 have been grandfathered in. However, if a leveraged lease is modified on or after the effective date of ASC 842, leveraged lease accounting may no longer be applied. In those situations, the modified lease should be accounted for as a new lease using the guidance in ASC 842 applicable to lessors.

**Separation of lease and nonlease components**

A lessor must apply certain criteria to determine whether a contract that contains a lease includes one or more lease components that should be accounted for separately.

When a contract includes both lease and nonlease components, the lessor should treat each separate lease component as a unit of account apart from the nonlease components. However, when the following criteria are met, a lessor may elect an accounting policy by class of underlying asset to combine a separate lease component with the nonlease component(s) related to it:

- ASC 606 would apply to the lessor’s accounting for what would otherwise be the nonlease components.
- The timing and pattern of transfer would be the same for what would otherwise be the lease component under ASC 842 and the nonlease component under ASC 606.
- Separately accounting for what would otherwise be the lease component would result in operating lease classification.
When the accounting policy is elected, the combined component is treated as one unit of account. When the necessary criteria are not met or the practical expedient is not elected for the applicable class of underlying asset, the lease and nonlease components are separated from each other for accounting purposes. The contract consideration is allocated between the lease and nonlease components using the allocation model in ASC 606-10-32-28 to 32-41, which generally calls for the contract consideration to be allocated to the units of account using their relative standalone selling prices. The contract consideration allocated to the lease component(s) is accounted for in accordance with ASC 842 and the contract consideration allocated to the nonlease component(s) is accounted for in accordance with other applicable U.S. GAAP (e.g., ASC 606).

When the necessary criteria have been met and the lessor has elected the practical expedient for the applicable class of underlying asset, it accounts for a lease component and the nonlease components related to it as one unit of account. The accounting model applied when the lease and related nonlease components are treated as one unit of account depends on the predominant component. If the lease component is the predominant component, then the unit of account is accounted for as a lease under ASC 842. If the nonlease component is the predominant component, then the unit of account is accounted for as a contract with a customer under ASC 606.

Sales and other similar taxes

ASC 842 requires a lessor to determine whether it is a principal or agent with respect to the sales and other similar taxes it collects from lessees. If it is a principal, the lessor grosses up revenue and expense for the taxes. If it is an agent, the lessor recognizes the collection and payment of the taxes net on the income statement. However, given the difficulty in determining whether the lessor is a principal or agent with respect to the multitude of sales and other similar taxes it or its lessees may be subject to in the various jurisdictions in which it does business, a lessor may elect an accounting policy to account for sales and other similar taxes collected from lessees as an agent on a net basis. Certain disclosures are required if the lessor elects the accounting policy.

Lease classification

Based on the lease classification criteria applicable to lessors discussed earlier in this overview, the lessor’s classification of a lease is no longer driven by the existence of profit and loss, but instead is driven by the transfer of the risks and benefits associated with the underlying asset. As a result, we expect that some leases previously classified as direct-financing leases under ASC 840, will likely be classified as sales-type leases under ASC 842; all else otherwise being equal. In addition, uncertainty related to whether collectibility of lease payments is reasonably predictable will no longer drive classification. As a result, we expect more leases to be classified as sales-type leases, all else otherwise being equal. Because of these changes, we also expect there to be a greater likelihood that leases with mostly variable payments will be classified as sale-type or direct-financing leases under ASC 842 compared to ASC 840.

Collectibility

Under ASC 842, whether collectibility is probable may affect the lessor’s classification of the lease and (or) its accounting for the lease. For example, the accounting for a sales-type lease when collectibility is not probable follows the same model used when collectibility is not probable under ASC 606, which results in the recognition of lease payments received as a deposit liability until certain criteria are met.

Initial direct costs

The change in the definition of initial direct costs discussed earlier reduces the population of costs that lessors should treat as initial direct costs. In addition, for sales-type and direct-financing leases, ASC 842 requires lessors to include deferred initial direct costs in the determination of the rate implicit in the lease.
Recognition and allocation of variable lease payments based on other than an index or rate

If a variable lease payment based on other than an index or rate relates to a lease component in whole or in part, the variable payment is not recognized before whatever created the variability in the payment occurs. For example, if a lessee must pay the lessor a percentage of the sales generated from retail space leased from the lessor, that variable payment is not recognized before the sales are generated. At the point in time that whatever created the variability in the payment occurs, the variable lease payment is allocated to the units of account in the contract in the same manner the contract consideration was initially allocated to the units of account when the contract has not been modified (or in the same manner the contract consideration was allocated to the units of account in connection with the most recent contract modification not accounted for as a separate contract), unless there is a basis under ASC 606-10-32-40 to allocate the variable lease payment entirely to one or more lease components. The amount of the variable lease payment allocated to lease components should be accounted for in accordance with ASC 842, and the amount allocated to the nonlease components should be accounted for in accordance with other applicable U.S. GAAP (e.g., ASC 606).

Lessor costs paid by lessees

The treatment of lessor costs paid by lessees depends on whether the lessee pays a third party directly for those costs. When the lessee pays a third party directly for the lessor costs, the lessor should not consider the lessee’s payment of those costs variable payments or revenue. Conversely, when the lessor pays a third party directly for its costs and the lessee reimburses the lessor for those costs, the lessor should account for the lessee’s reimbursement of those costs as variable payments and revenue.

Loss allowance on the net investment in a lease.

Under ASC 842, for sales-type and direct-financing leases, lessors are required to assess the need for a loss allowance on the net investment in a lease in accordance with the guidance applicable to the impairment of receivables (which will require the application of the current expected credit loss model in ASC 326-20, Financial Instruments—Credit Losses – Measured at Amortized Cost, once ASC 326 is effective).

Effective date

With one limited exception for entities considered public business entities solely because their financial statements or financial information is included in another entity’s filing with the SEC pursuant to SEC rules and regulations, 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. For all other entities (and for entities to which the aforementioned exception applies), ASC 842 is effective in fiscal years beginning after December 15, 2020 and interim periods thereafter. Early application is permitted for all entities. Additional discussion about the effective date of ASC 842 is included in Section 10.1 of our lessee guide.

Lessees and lessors could have early adopted ASC 842 any time after ASU 2016-02 was issued. As discussed earlier, the FASB issued seven ASUs amending ASC 842 since its original issuance within ASU 2016-02. Each one of these ASUs provided effective date and transition guidance to the extent a lessee or lessor early adopted ASC 842 before the amending ASU was issued. This effective date and transition guidance is included in ASC 842-10-65.
Transition

Lessees and lessors 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.

When applying either Transition Method A or B, the lessees and lessors may elect one or more of the following practical expedients:

- **A package of transition practical expedients.** If a lessee or lessor elects this package of practical expedients, it does not reassess its prior conclusions under ASC 840 regarding the following: (a) whether a preexisting contract is or contains a lease, (b) whether a preexisting lease should be classified as an operating or finance lease and (c) whether the initial direct costs capitalized for a preexisting lease under ASC 840 qualify for capitalization. If a lessee or lessor elects the package of transition practical expedients, all of the expedients in the package must be applied to all of its leases.

- **Hindsight practical expedient.** If this practical expedient is elected, lessees and lessors use hindsight in determining the lease term on the date of initial application, and lessees use hindsight when evaluating ROU assets related to preexisting leases for impairment under ASC 360-10-35.

- **Land easement practical expedient.** If a lessee or lessor elects this practical expedient, it 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. However, the lessee or lessor must assess whether land easements entered into (or modified) on or after the date of initial application are or contain a lease under ASC 842.

If a lessee or lessor elects one (or more) of these practical expedients, it must apply the practical expedient to all of its preexisting leases (or easements). Section 10.3 of our lessee guide provides detailed discussion of each of these practical expedients from a lessee’s perspective.

The complexity of transitioning to ASC 842 depends on numerous factors, including the elections made by the lessee or lessor with respect to the transition method and practical expedients. In addition, the classification of the lease under ASC 840 and 842 also affects the complexity of transitioning to ASC 842. We discuss and illustrate the lessee transition provisions in significant detail in Chapter 10 of our lessee guide. Additional information about the lessor transition provisions can be found in ASC 842-10-65.

Both lessees and lessors are required to disclose transition-related information. The nature of that information depends on the transition method elected.
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