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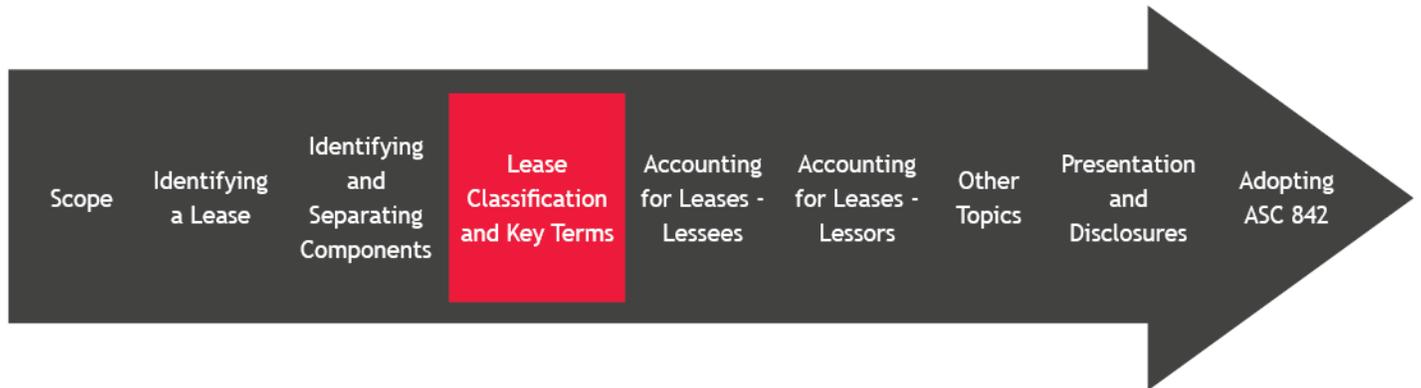
Accounting for Leases Under ASC 842

UPDATED SEPTEMBER 2021





BDO Knows Lease Classification and Key Terms



OVERVIEW

In the previous article, [Identifying and Separating Components](#), we discussed how an entity identifies and separates components in a lease contract. An entity then generally accounts for the lease component(s) under ASC 842, and the nonlease component(s) under other GAAP (e.g., ASC 606 for a lessor). An entity also applies the guidance in ASC 842 at the lease component level, and the accounting for that lease component is governed by how that lease component is classified.

In some cases, however, as we discussed in the [previous article](#) an entity may elect a practical expedient by asset class not to separate the nonlease component(s) from the associated lease component. In those situations:

- ▶ A lessee generally applies the practical expedient without regard to conditions, and accounts for the combined component as a single lease component. The lessee then applies the guidance in ASC 842, including lease classification, to that single (combined) lease component. Accordingly, a lessee applies the lease classification guidance after it combines the lease and related nonlease component(s).
- ▶ A lessor must meet certain conditions to apply the practical expedient not to separate. One condition is that the lease component, *if accounted for separately*, would be classified as an operating lease. Accordingly, a lessor applies the lease classification guidance at the individual lease component before it combines the lease and related nonlease component(s). This lease classification assessment will determine whether the lessor meets the scope conditions to apply the practical expedient not to separate. If the lessor meets all the scope conditions, the accounting for the combined component then depends on which component of the contract is predominant. If the nonlease component(s) are predominant, the lessor accounts for the combined component under ASC 606. Otherwise, it accounts for the combined component as an *operating* lease. In other words, a lessor does not reassess lease classification once the components are combined.

This is summarized in the following table:

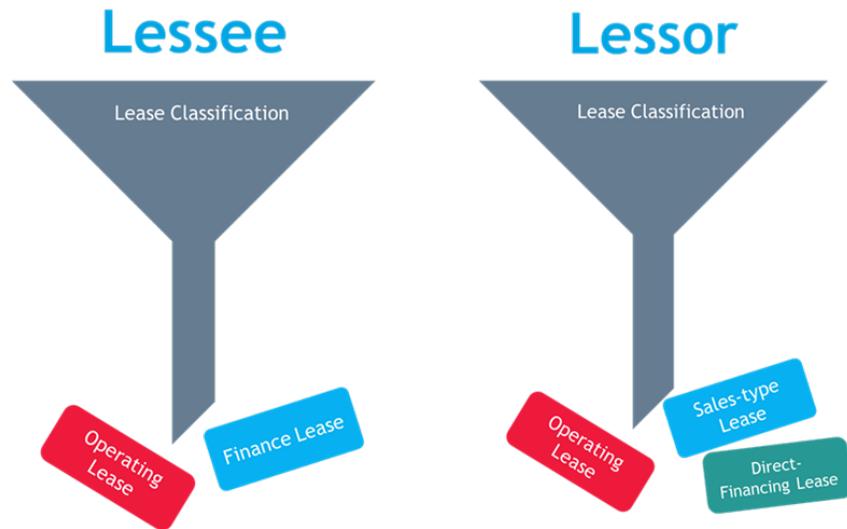
Lessee	Lessor
<ul style="list-style-type: none"> ▶ Assess lease classification at the <i>combined</i> lease component level, if the lessee elected the practical expedient not to separate for the asset class. 	<ul style="list-style-type: none"> ▶ Assess lease classification at the <i>individual</i> lease component level, irrespective of whether the lessor elected the practical expedient to not separate for the asset class.

A lease component is initially classified and recognized in the financial statements at the commencement date. For example, a lessee assesses lease classification, and recognizes the lease on balance sheet, at the commencement date. It is therefore important for an entity to appropriately identify that date. That analysis is not always straightforward, including for example when the lease involves construction of improvements.

An entity will also need to answer several other questions to perform the lease classification tests and determine the accounting for the lease component. Some of those questions include:

- ▶ What is the lease term? For example, in a lease with a noncancelable period of five years with a one-year renewal option, is the lease term five years, or six years? What should be considered in making that determination?
- ▶ What are the lease payments? For example, are variable payments based on sales of the lessee included? Do all payments from the lessor to the lessee (e.g., incentives) affect the accounting for the lease component?
- ▶ What is the discount rate for the lease, and how is it determined? For example, is the discount rate for the lease the same for all entities, or are there differences between lessees and lessors, and between public business entities and other entities? Is it based on the lease term, or should it consider other options (e.g., renewal options) not included in the lease term?
- ▶ What is the fair value of the underlying asset? For example, is fair value the same for all entities, whether lessee or lessor, or are there specific exceptions for certain entities (e.g., lessors that are not manufacturers or dealers)?

We will discuss those questions in further detail in this article, along with how to determine lease classification once those questions have been answered. For lessees, leases are classified as either an operating or a finance lease. For lessors, leases are classified as either a sales-type, a direct financing, or an operating lease. ASC 842 no longer includes leveraged lease classification for lessors for leases that are entered into or modified after ASC 842's effective date. Existing leveraged leases are grandfathered into ASC 842 and continue to be accounted by the lessor under prior guidance until they expire or are modified.



Note that in this article we will discuss only the initial assessment (i.e., at the commencement date). Subsequent changes to the lease term, lease payments, discount rate, etc. are discussed in [Accounting for Leases - Lessees](#) and [Accounting for Leases - Lessors](#) in this series.

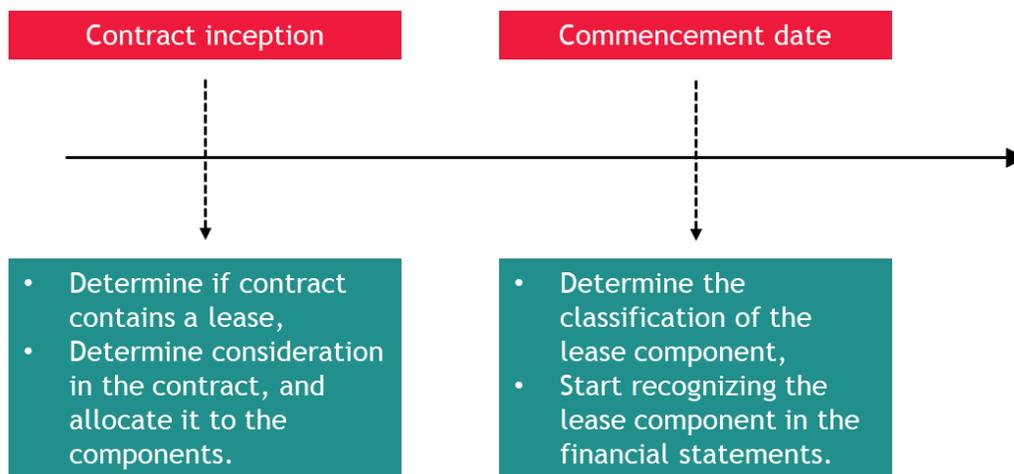
COMMENCEMENT DATE

The glossary defines the commencement date as:

The date on which a lessor makes an underlying asset available for use by a lessee. See paragraphs 842-10-55-19 through 55-21 for implementation guidance on the commencement date.

The commencement date of a lease is when the lessee takes possession of or is given control over the use of the underlying asset. The commencement date is not always stated in the contract. Often, a lessee and lessor negotiate an expected commencement date based on availability of the asset. Other times, there will be a contractual commencement date in the contract, but that date may not coincide with the commencement date for accounting purposes. Example documents to consider in determining the commencement date include letters acknowledging the transfer of possession, certificates of occupancy, construction start dates, etc. It is important to note that the commencement date may or may not coincide with the date at which payments under the lease begin.

The commencement date of the lease also may be different from the inception date of the contract, which is usually the date that the contract was executed. ASC 842 makes a distinction between those two dates and provides for different accounting requirements at those two dates as illustrated below.



Paragraph 842-10-55-19 highlights that the lessor makes the underlying asset available for use by the lessee when the lessee is given control over the use of the underlying asset. Accordingly, in evaluating the commencement date of a lease, we believe it is useful to look to the definition of a lease, and more specifically, at what comprises the right to control the use of the asset, which is discussed in paragraph 842-10-15-4. That paragraph provides for two conditions: (a) the right to obtain substantially all of the economic benefits from use of the identified asset, and (b) the right to direct the use of the asset. In many cases, those two conditions are met when the lessee has exclusive use of the asset - even if the lessee is using the period to construct leasehold improvements (lessee assets) and has not yet commenced operations - and therefore the lease typically has commenced at that date.

Sometimes, an agreement may involve leases of multiple assets that are determined to be separate lease components (generally referred to as master lease arrangements). In those cases, there may be multiple commencement dates, which affects the timing of lease classification and recognition of each lease component in the financial statements. Although a master lease agreement may specify that the lessee must take a minimum number of units or dollar value of equipment, there will be multiple commencement dates, unless all of the underlying assets subject to that minimum are made available for use by the lessee on the same date.

Accounting Owner of Improvements Affects Commencement Date and Lease Payments

Paragraph 842-10-55-19 explains that in some lease arrangements, the lessor may make the underlying asset available for use by the lessee before the lessee begins operations or makes lease payments. During this period, the lessee may have the right to use the underlying asset to construct a **lessee asset** (for example, leasehold improvements). Paragraph 842-10-55-20 then notes that the terms of the contract may vary as to whether the lessee is required to make lease payments before or after construction is completed and the lessee begins operations, but that the timing of the payments does not impact the determination of the lease commencement date.

ASC 842 does not explicitly discuss how to determine whether improvements are a lessee asset or a lessor asset. However, it is important to determine if the improvements relate to a lessee asset (e.g., leasehold improvements), or a lessor asset (e.g., lessor constructs its own improvements, or the lessee performs services on behalf of the lessor) as it may affect the determination of the commencement date, and of the consideration in the contract (and therefore the lease payments). Determining the accounting owner of the improvements will require the use of professional judgment based on the terms of the lease contract and the nature of the improvements made. Questions to consider include, but are not limited to:

- ▶ Does the lease or other contract require the lessee to construct specific improvements, including to the lessor's design? A "yes" answer would be an indicator that the lessor controls the improvements, whereas the lessee's discretion about whether to construct the improvements and/or their design may indicate that the lessee controls the improvements.
- ▶ Is the lessee permitted to remove or alter the improvements without the lessor's approval? A "yes" answer would be an indicator that the lessee controls the improvements.
- ▶ Does the lessor legally own upon completion any improvements, alterations and additions made by the lessee? A "yes" answer would be an indicator that the lessor controls the improvements.
- ▶ Are the improvements specific to the lessee such that they do not have an economic value to the lessor at the end of the lease term (e.g., the lessor would not be able to use the improvements in arrangements with other lessees)? A "yes" answer would be an indicator that the lessee controls the improvements.

If the lessee is the accounting owner of the improvements, any payments from the lessor, including those made directly to a third party providing the construction services, are considered an incentive to the lessee which reduce the consideration in the contract consistent with the guidance in paragraphs 842-10-15-35(a) and 842-10-30-5(a). The lessee being the accounting owner of the improvements also affects the commencement date of the lease, which is when the lessor makes the underlying asset available for use by the lessee (e.g., when the lessee takes possession of the underlying asset and starts constructing its leasehold improvements). There is also no distinction between the right to use the underlying asset during and after the construction period. In other words, lease costs (or income) associated with building and ground leases incurred (or earned) during and after the construction is complete are both for the right to use the underlying asset and therefore are recognized by the lessee (or lessor) in accordance with the guidance in Subtopics 842-20 and 842-30, respectively. The timing of when lease payments begin does not affect the commencement date.

If the lessor is the accounting owner of the improvements, payments made by the lessor generally do not affect the consideration in the contract (e.g., payments from the lessor to the lessee to reimburse the lessee for costs incurred on behalf of the lessor to construct the lessor asset). But in that scenario, the commencement date of the lease will likely not occur until construction of the lessor improvements is substantially complete, and the lessee obtains control over the use of the underlying asset, including the improvements. Also, lessee payments for the right to use the underlying asset are lease payments, regardless of the timing of those payments or the form of those payments.

Example 1 - Retail Store

FACTS

- ▶ Retail Lessee enters into a lease with Realty Lessor on December 1, 2019 for the use of a retail store for five years.
- ▶ As part of the contract, Realty Lessor pays Retail Lessee \$50,000 as reimbursement for improvements to the retail space, which are specific to Retail Lessee. Retail Lessee has the right to remove or alter the improvements made throughout the lease term without Realty Lessor's permission.
- ▶ Realty Lessor gives Retail Lessee the keys to the store on January 1, 2020, at which point Retail Lessee can start constructing the improvements.
- ▶ Retail Lessee completes the construction of the improvements, and opens its retail store, on March 1, 2020.
- ▶ The contract requires Retail Lessee to make monthly payments in arrears of \$10,000 starting on March 31, 2020.

WHO IS THE ACCOUNTING OWNER OF THE IMPROVEMENTS?

- ▶ Retail Lessee is the accounting owner of the improvements because the improvements are specific to Retail Lessee's brand and therefore the improvements could not be used by Realty Lessor in arrangements with other lessees. Retail Lessee also has the right to remove or alter the improvements at any time during the lease term without Realty Lessor's permission.
- ▶ Because Retail Lessee is the accounting owner of the improvements, the \$50,000 payment from Realty Lessor to Retail Lessee is a lease incentive in accordance with paragraph 842-10-55-30.
- ▶ The lease incentive reduces the consideration in the contract, and reduces the amounts allocated to the lease component and nonlease component(s), if any.
- ▶ Retail Lessee separately accounts for the leasehold improvements as an asset in accordance with ASC 360.

WHAT IS THE COMMENCEMENT DATE?

- ▶ Since Retail Lessee is the accounting owner of the improvements, the commencement date of the lease is January 1, 2020, which is the date at which Realty Lessor makes the space available for use by Retail Lessee and at which point Retail Lessee can start constructing its improvements. Starting at that date, including during the construction of its leasehold improvements, Retail Lessee has exclusive use of the retail store and directs its use.
- ▶ In accordance with paragraph 842-10-55-20, the timing of when Retail Lessee is required to make lease payments is not relevant to this analysis. Recognition of the lease liability and right-of-use asset, as well as lease expense, begins on January 1, 2020.

Example 2 - Medical Office Building

FACTS

- ▶ Medical Lessee enters into a lease with Healthcare Lessor on December 1, 2018 for the use of a medical office building for ten years.
- ▶ At contract inception, the medical office building was in relatively poor condition, and required significant renovations. As part of the negotiations with Medical Lessee, Healthcare Lessor agrees to spend up to \$6.0 million to renovate the building, including mechanical upgrades, roof replacement, replacing and reconfiguring certain interior walls, and making other improvements. The renovations are expected to take between 12 to 15 months.
- ▶ The lease indicates that all improvements are the legal property of Healthcare Lessor, and Medical Lessee cannot remove or alter the improvements during the lease term without Healthcare Lessor's approval, which Healthcare Lessor may reject at its sole discretion.
- ▶ The improvements have an average expected economic life of 20 years and are not specific to Medical Lessee. That is, the improvements could be used by Healthcare Lessor in arrangements with other lessees operating in the medical and healthcare industry.
- ▶ Healthcare Lessor provides Medical Lessee with limited access to the building on October 31, 2019 so that Medical Lessee can inspect the renovations and plan for construction of its own leasehold improvements. However, Medical Lessee does not yet have the right to construct its leasehold improvements.
- ▶ Healthcare Lessor substantially completes the renovations on January 1, 2020, at which point Medical Lessee is given full access to the building to install its own leasehold improvements.
- ▶ Medical Lessee starts operations in the building on March 1, 2020.
- ▶ The contract requires Medical Lessee to make monthly payments in arrears of \$150,000 once construction is substantially complete, with fixed annual increases of 5%.

WHO IS THE ACCOUNTING OWNER OF THE IMPROVEMENTS?

- ▶ Healthcare Lessor is the accounting owner of the improvements (renovations) because the improvements are not specific to Medical Lessee. Healthcare Lessor can use the improvements at the end of the lease term for other lessees in the medical and healthcare field. Healthcare Lessor also controls whether alterations are made to the improvements and is the legal owner of the improvements.
- ▶ Healthcare Lessor's payments for the improvements do not affect the consideration in the contract and the lease payments.

Note 1: We believe the above conclusions would be true even if Medical Lessee made the improvements on behalf of Healthcare Lessor and Healthcare Lessor reimbursed Medical Lessee for costs incurred on its behalf because, in substance, Medical Lessee acted as an agent for Healthcare Lessor.

Note 2: If Medical Lessee made payments to Healthcare Lessor to fund some or all of the construction costs related to the improvements owned by Healthcare Lessor, those payments would be considered lease payments (assuming there are no nonlease components). This is because payments by a lessee for the right to use the underlying asset are lease payments, regardless of the timing of those payments or the form of those payments. Alternatively, if Healthcare Lessor also constructed Medical Lessee's improvements on its behalf, then any related payments would be accounted for under ASC 360 by Medical Lessee. It may require judgment in order to determine which payments relate to the lease and which relate to assets owned by the lessee in similar situations.

WHAT IS THE COMMENCEMENT DATE?

- ▶ Since Healthcare Lessor is the accounting owner of the improvements, the commencement date of the lease is January 1, 2020, which is the date at which Healthcare Lessor substantially completes the improvements and makes the space available for use by Medical Lessee.
- ▶ The lease does not commence on October 31, 2019 because Healthcare Lessor only provides limited access to Medical Lessee (for it to plan for its own leasehold improvements). From October 31, 2019 up to January 1, 2020, Medical Lessee does not obtain substantially all of the economic benefits from use of the building, nor does it direct its use.
- ▶ The date at which Medical Lessee starts operations is also not relevant in determining the commencement date, consistent with paragraph 842-10-55-19. This is because Medical Lessee has exclusive use of the building and directs its use even during the construction of its own leasehold improvements.

Example 3 - Restaurant Space

FACTS

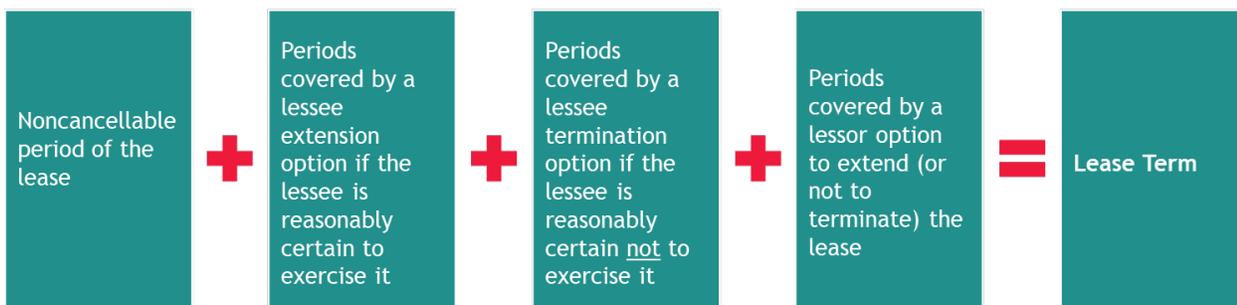
- ▶ Burgers R Us enters into a lease for a new restaurant on May 1, 2019, at which time both lessee and lessor begin the work to obtain the relevant permits required to operate a Burgers R Us restaurant in that location.
- ▶ The lease provides for payments of \$16,000 per month if Burgers R Us begins operations in the location on or before November 1, 2019. Monthly lease payments increase by \$500 for every month the grand opening is delayed beyond November 1, 2019.
- ▶ The lease term ends ten years after the first payment, which is due when the restaurant opens for business.
- ▶ The relevant permits are obtained, and the lessor grants access to Burgers R Us to the site on August 1, 2019. At that time, Burgers R Us begins constructing leasehold improvements to conform the building to its brand requirements. Assume the improvements are a lessee asset.
- ▶ The restaurant opens for business on December 1, 2019, at which time payments under the lease begin.

WHAT IS THE COMMENCEMENT DATE?

- ▶ The commencement date of the lease is August 1, 2019 because it is the date at which Burgers R Us has the right to control access to and use of the building, as evidenced by its starting construction of leasehold improvements.
- ▶ In accordance with paragraph 842-10-55-20, the timing of when Burgers R Us is required to make lease payments is not relevant to this analysis. However, because Burgers R Us does not know at lease commencement when lease payments will begin and, therefore, what the payment amounts will be and what the end of the lease term is; the total payments and term must be estimated. Burgers R Us should update its estimates and remeasure the payments when the contingency upon which the payments are based is resolved (i.e., when Burgers R Us begins operations) to reflect any difference between the estimates at lease commencement and the final determinations.

LEASE TERM

The lease term begins at the commencement date and includes any rent-free periods provided to the lessee by the lessor. Paragraph 842-10-30-1 addresses how to determine the lease term as follows:



The following table provides additional guidance on how to determine the lease term:

Step	Additional Guidance
Determine the noncancellable period of the lease.	Paragraph 842-10-55-23 explains that when an entity assesses the length of the noncancellable period of a lease, it should apply the definition of a contract and determine the period for which the contract is enforceable. See below for additional discussion and analysis.
If there is a lessee extension option, determine if the lessee is reasonably certain to exercise the option. If so, the extension period is included in the lease term.	<p>“Reasonably certain” is a high threshold that is intended to be interpreted consistently with “reasonably assured” under ASC 840 and is generally understood to be as encompassing economic compulsion. However, ASC 842 provides the following additional implementation guidance: In determining whether it is reasonably certain that a lessee option will be exercised (or not exercised), an entity considers all relevant economic and contractual factors (contract-based, asset-based, entity-based, and market-based) consistent with paragraph 842-10-55-26, which include:</p> <ul style="list-style-type: none"> ▶ Contractual terms and conditions, such as amount of lease payments or variable lease payments in optional periods compared with current market rates, ▶ Significant leasehold improvements that are expected to have significant economic value for the lessee when the lessee option becomes exercisable, ▶ Costs related to exiting the lease and signing a new lease, including negotiating costs, relocation costs, costs of returning the underlying asset in a contractually specified condition and/or location, installation costs for the new leased asset, and ▶ The importance of the underlying asset to the lessee’s operations, including whether the asset is specialized and/or in a remote location, lost revenue or other economic losses (e.g., when the lessee does not have an equivalent asset and must identify and locate a replacement asset).
If there is a lessee termination option, determine if the lessee is reasonably certain not to exercise the option. If so, the period covered by the termination option is included in the lease term.	<p>The assessment requires the use of professional judgment and will often consider a combination of the above factors, along with how far in the future the option is exercisable (e.g., an option exercisable in one year versus one exercisable in five or ten years). All things equal, the further away the option is exercisable, the more evidence will be needed to conclude that a lessee is reasonably certain to exercise (or not exercise) the option. Also, an expectation of exercise alone (and without a significant economic incentive to do so) is not sufficient, and a company’s historical practice of exercising renewal options may not indicate the existence of significant economic factors, and therefore should not be determinative.</p> <p>See also Example 26 in ASC 842-10-55 for an illustration of the assessment of a lessee termination option.</p>
If there are periods covered by a lessor option to extend (or not to terminate), include those periods in the lease term.	Periods controlled by a lessor are included in the lease term, irrespective of likelihood of exercise.

Noncancellable Period and Enforceability of the Contract

Assessing the noncancellable period and enforceability of a lease are critical in the determination of the lease term. A lease is no longer enforceable when **both** the lessee and the lessor each have the right to terminate the lease without permission from the other party with no more than an insignificant **penalty**. Thus, the lease term cannot be longer than the enforceable period of the contract. For example, assume a lease that has an initial term of five years that neither the lessee nor the lessor can cancel and, after the initial five years, the lessee has a one-year extension option. In this example the noncancellable period of the lease is five years, and the lease is enforceable for six years because if the lessee elects to extend the lease for one year after the initial term, the lessor is obligated to make the underlying asset available for use by the lessee. Once the noncancellable and enforceable periods are determined, the entity can then assess the lease term, which will either be five years (the noncancellable period only) or six years (the noncancellable period plus the one-year extension period) depending on whether the lessee is reasonably certain to extend; but the lease term cannot be longer than six years (the period the contract is enforceable).

The enforceability of a contract depends in part on whether both parties can cancel the contract with no more than an insignificant penalty. The term penalty is not limited to cash payments nor contractual penalties, but is more broadly defined as shown below:

Any requirement that is imposed or can be imposed on the lessee by the lease agreement or by factors outside the lease agreement to do any of the following:

- a. Disburse cash
- b. Incur or assume a liability
- c. Perform services
- d. Surrender or transfer an asset or rights to an asset or otherwise forego an economic benefit or suffer an economic detriment. Factors to consider in determining whether an economic detriment may be incurred include, but are not limited to, all of the following:
 1. The uniqueness of purpose or location of the property
 2. The availability of a comparable replacement property
 3. The relative importance or significance of the property to the continuation of the lessee's line of business or service to its customers
 4. The existence of leasehold improvements or other assets whose value would be impaired by the lessee vacating or discontinuing use of the leased property
 5. Adverse tax consequences
 6. The ability or willingness of the lessee to bear the cost associated with relocation or replacement of the leased property at market rental rates or to tolerate other parties using the leased property.”

If only the lessee has the right to terminate a lease, it is evaluated like an option to terminate consistent with the previous table.

If only the lessor has the right to terminate the lease, the lease term includes the period covered by the option to terminate the lease.

Example 1 - Retail Store (Continued)**FACTS**

- ▶ Let's continue with Example 1 in which Retail Lessee enters into a lease with Realty Lessor for the use of a retail store for five years and for which Retail Lessee must pay \$10,000 monthly in arrears.
- ▶ The initial term of five years cannot be terminated by either party.
- ▶ The contract includes two one-year extension options. If Retail Lessee elects to extend the term, it must pay \$11,000 monthly in arrears in the first extension period, and \$12,000 in the second extension period.

WHAT IS THE LEASE TERM?

- ▶ The starting point is to determine the noncancellable period of the lease. In this example, it is five years.
- ▶ Then, Retail Lessee and Realty Lessor each evaluate Retail Lessee's extension options. In this example, there are no economic factors that would indicate Retail Lessee is reasonably certain to exercise its extension options, and, therefore, both Retail Lessee and Realty Lessor conclude that Retail Lessee is not reasonably certain to extend the lease for either one or two years.
- ▶ Accordingly, the lease term is initially five years.

Example 1A - Retail Store (Continued)**FACTS**

- ▶ Assume the same as in Example 1, except that:
 - The lease has a fixed term of five years, but there are no extension options. Instead, Retail Lessee can terminate the lease with a six months' notice prior to exiting the space.
 - There is no stated termination penalty for Retail Lessee should it decide to exit the space early.
 - Retail Lessee did not construct significant leasehold improvements because the store is in a new geographical area and market that Retail Lessee is testing.

WHAT IS THE LEASE TERM?

- ▶ In this example, Retail Lessee has no significant economic penalty that would require it to stay in the lease for longer than the notice period. As such, the lease term is initially six months.

Example 1B - Retail Store (Continued)**FACTS**

- ▶ Assume the same as in Example 1, except that:
 - The lease has a fixed term of five years, but after the fifth year, the lease converts to a month-to-month arrangement with rent at \$11,000 per month in arrears.
 - Either party can cancel the lease after the initial term without permission from the other party. There is no stated penalty in the contract for canceling.
 - The retail location is important to Retail Lessee, and it constructed significant leasehold improvements such as retail shelving, reception counters, and other layout and design specific to Retail Lessee, for which Realty Lessor did not provide reimbursement to Retail Lessee.
 - If Retail Lessee were to terminate the lease before the end of the eighth year, the shelving and other leasehold improvements would be dismantled and abandoned prior to the end of their useful lives, and Retail Lessee would incur a more than insignificant economic penalty.

WHAT IS THE LEASE TERM?

- ▶ The starting point is to determine the noncancellable period of the lease and how long the contract is enforceable. Consistent with paragraph 842-10-55-23, an entity applies the definition of a contract and determines the period for which the contract is enforceable. A lease is no longer enforceable when both the lessee and the lessor each have the right to terminate the lease without permission from the other party with no more than an insignificant penalty.
- ▶ The determination of whether a penalty exists, and its magnitude, are important and require the use of professional judgment. In this example, the presence of significant leasehold improvements results in Retail Lessee incurring a more than insignificant penalty through the end of the eighth year. Therefore, based on the economic penalty the lessee would continue to renew (not cancel) the contract on a month-to-month basis through the end of the eighth year and thus the contract is enforceable for eight years.
- ▶ After the eighth year, the contract is no longer enforceable because either party may terminate the lease without permission from the other with no more than an insignificant penalty.
- ▶ Retail Lessee also determines that it is reasonably certain not to terminate the lease until the end of the eighth year.
- ▶ The fact that Realty Lessor could terminate the lease between the end of the fifth year and eighth year is not relevant because the lease term includes any periods covered by a lessor's option to terminate the lease in accordance with paragraph 842-10-30-1c.
- ▶ Accordingly, the lease term is initially eight years.

Example 1C - Lease with Nonconsecutive Periods**FACTS**

- ▶ Assume the same as in Example 1, except that:
 - Retail Lessee specializes in selling accessories (tablecloths, décor, etc.) for Thanksgiving.
 - The contract with Realty Lessor is for a space in a shopping mall, rather than a specific retail store, and the contract meets the definition of a lease.
 - The lease has a fixed term of five years, but Retail Lessee controls the use of the space in the mall only during the months of October and November of each year.
 - There are no extension or termination options.

WHAT IS THE LEASE TERM?

- ▶ The definition of a lease in ASC 842 depends in part on whether the customer has the right to control the use of an identified asset throughout the period of use (paragraph 842-10-15-4). The “period of use” is defined as the total period of time that an asset is used to fulfill a contract with a customer (including the sum of any nonconsecutive periods of time).
- ▶ As noted previously, the lease term includes the noncancelable period for which the lessee has the right to use an underlying asset. If the period of use of a lease includes nonconsecutive periods, the lease term will also include those nonconsecutive periods. Conversely, the lease term cannot include periods for which a lessee does not have the right to use the underlying asset (in this example, the months other than October and November, for which Realty Lessor has the right to lease the space to other lessees).
- ▶ Accordingly, the lease term is the aggregate period of use for which Retail Lessee has the right to use the underlying asset, which in this example is two months per year for five years, for a total of a ten- month lease term.

Example 1D - Retail Store (Continued)**FACTS**

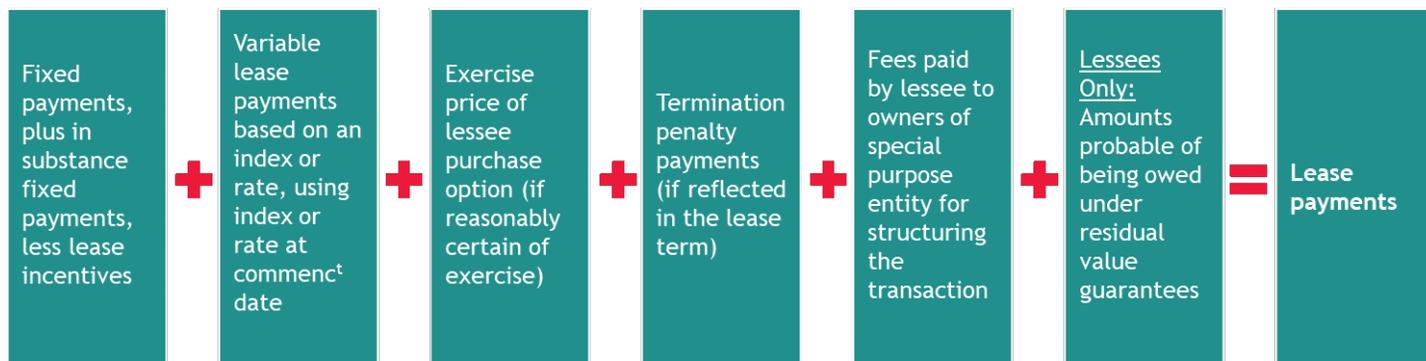
- ▶ Assume the same as in Example 1, except that:
 - The lease is initially for five years, and neither party can cancel the lease without significant cancellation fees.
 - After the initial term, there are two additional extension periods. However, Retail Lessee and Realty Lessor must both agree on the renewal terms, including rental payments.
- ▶ There is no penalty to either party for not agreeing to one or both of extension options.
- ▶ There are ample other retail stores or spaces that are available in the marketplace to consider after the fifth year.

WHAT IS THE LEASE TERM?

- ▶ The lease term is the noncancellable period of five years as neither party can cancel the lease without significant cancellation fees.
- ▶ Since both parties must agree on the terms of the renewal period, including rental payments, the periods after the initial term are not enforceable and therefore are not included in the lease term. The lease term is five years.

LEASE PAYMENTS

Once the lease term is identified, the lease payments can be determined. Paragraph 842-10-30-5 defines lease payments, which are the following payments related to the use of the underlying asset during the lease term:



Step	Additional Guidance
<p>Determine the fixed payments, including in-substance fixed payments, less lease incentives paid or payable to the lessee.</p>	<ul style="list-style-type: none"> ▶ In-substance fixed payments are payments that may appear to contain variability, but they are unavoidable. Examples include: <ul style="list-style-type: none"> • Payments with no genuine variability (i.e., clauses with no economic substance). • Lower of set of payments for which the lessee has a choice, but it must make at least one set of payments. <p>See below for further discussion of in-substance fixed payments.</p> <ul style="list-style-type: none"> ▶ In some leases, the lessee may provide noncash consideration (e.g., equity shares of the lessee). Noncash lease payments should be treated the same as cash for purposes of determining whether they represent fixed payments or variable payments. See also below for further discussion. ▶ Deduct lease incentives paid or payable to the lessee, which include: <ul style="list-style-type: none"> • Payments made to (or on behalf of) the lessee, • Losses incurred by the lessor for assuming a lessee’s preexisting lease. <p><i>See Commencement Date section above for a discussion of the assessment of the accounting owner of improvements, which affects whether payments by the lessor are considered lease incentives.</i></p> <p><i>See Example 4 below for whether certain lease incentives are considered payable.</i></p>
<p>Add variable lease payments based on an index or a rate.</p>	<ul style="list-style-type: none"> ▶ Variable payments based on an index or a rate are included using the index or rate at the commencement date. ▶ Examples of variable payments based on an index or a rate include payments based on the consumer price index (CPI), the London Interbank Offered Rate (LIBOR) or Secured Overnight Financing Rate (SOFR), and market rental rates. ▶ Subsequent changes in the index or rate are generally recognized as variable lease payments. See Accounting for Leases - Lessees and Accounting for Leases - Lessors for further details. ▶ See Example 25 Case A in ASC 842-10-55 for an illustration of the accounting for variable lease payments based on an index or a rate.

Step	Additional Guidance
Add the exercise price of a lessee purchase option (if reasonably certain of exercise).	<ul style="list-style-type: none"> ▶ Assess the lessee purchase option the same way as a lessee extension or termination option, as discussed in Lease Term section above. Because “reasonably certain” is a high threshold, also consider the significance of any discount between the fixed price of the purchase option and the expected fair value of the underlying asset when the option is exercisable, and how consistent expected values have historically been for the underlying asset. ▶ See Examples 23 and 24 in ASC 842-10-55 for illustrations of the assessment of lessee purchase options.
Add termination penalty payments (if reflected in the lease term).	<ul style="list-style-type: none"> ▶ See Lease Term section above for discussion of lessee termination options.
Add fees paid by lessee to owners of special purpose entity for structuring the transaction.	<ul style="list-style-type: none"> ▶ Note that the fees are added to the lease payments but are excluded from the fair value of the underlying asset.
For lessees only , determine and add the amount probable of being owed under residual value guarantees.	<ul style="list-style-type: none"> ▶ “Probable” means that the future event or events are likely to occur. ▶ This requirement is applicable for lessees only. ▶ See below for discussions on in-substance residual value guarantees and other guarantees provided by a lessee.

Noncash Lease Payments

In some instances, the lessee may provide noncash consideration to the lessor in lieu of cash lease payments for the right to use the underlying asset. For example, the lessee may grant equity instruments to the lessor, or it may contribute goods or services (for example, materials, equipment, or labor) to facilitate the construction of the lessor controlled asset, as payment for the use of the underlying asset.

In those situations, we believe the entity (lessee or lessor) should generally recognize the fair value of the noncash consideration as lease payments, unless specifically excluded from the definition of lease payments.

It is also important for the entity to assess whether the transfer of noncash assets is within the scope of other accounting standards. For example, if the lessee issues shares or other equity instruments such as warrants to the lessor, that grant will be in the scope of ASC 718 on stock compensation subsequent to the adoption of ASU 2018-07, *Compensation - Stock Compensation: Improvements to Nonemployee Share-Based Payment Accounting*. ASC 718 addresses measurement and classification (equity versus liability) of the award but does not address the periods or the manner (capitalize versus expense) in which an entity granting the share-based payment award to a nonemployee should recognize the cost of the share-based payment award that will be issued. It only requires that an asset or expense be recognized (or previous recognition reversed) in the same periods and in the same manner as if the grantor had paid cash for the goods or services instead of paying with or using the share-based payment award.

The following are **not** considered lease payments:

- ▶ Variable lease payments other than those based on an index or a rate (e.g., payments based on a percentage of sales of the lessee, payments based on energy produced by a solar farm, etc.).
- ▶ Lessee guarantees of the lessor's debt, which a lessee generally accounts for under ASC 460 on guarantees. However, consistent with practice under ASC 840, if the guarantee is in-substance a residual value guarantee, a lessee should apply the guidance in the table on the previous page on estimating amounts probable of being owed under residual value guarantees. This could occur for example if the lender has recourse only to the leased asset (i.e., the debt is nonrecourse to the lessor), or if the lessor entity does not have significant assets other than the underlying asset subject to the lease.



Remember that the amount of lease payments results from an *allocation* of the consideration in the contract to the lease and nonlease component(s). Amounts allocated to the nonlease components are therefore not considered lease payments, unless:

- For a lessee, it elected the practical expedient not to separate for the asset class.
- For a lessor, it elected the practical expedient not to separate for the asset class, it met the scope conditions, and the nonlease component(s) are not the predominant component(s).

See article 3 for further discussion of [separation of components](#), allocation of the consideration in the contract to the components, and the lessee and lessor practical expedients not to separate.

Identifying Unavoidable Fixed Payments

Leases may include in-substance fixed payments and other unavoidable payments that must be included in the lease payments. In-substance fixed payments include for example payments that require the lower of two payments to be made when a lessee has a choice about a set of payments it makes, and payments that do not create genuine variability (such as those that result from clauses that do not have economic substance). For example, if a lease contract includes payments based on the lower of (a) X times a change in CPI, and (b) Y% (a fixed percentage), this may not have any economic substance if based on historical changes in the CPI, the application of the leverage (X) results in Y% always being reached. In those situations, the increase based on Y% should be included in the lease payments.

In-substance fixed payments do not include payments based on performance of the asset, such as sales of a retail store, energy produced by a solar plant, or units produced by a machinery, even if there is a high likelihood based on historical and other data that a certain amount of sales, energy, or units, will be produced. This is because those payments relate directly and proportionately to the use or performance of the underlying asset. The variable payments have economic substance.

Reviewing the terms of the lease are important, and an entity should focus on identifying payments that are unavoidable. For example, in a lease whereby lease payments increase by the greater of (i) the change in CPI, or (ii) a fixed percentage, such as 2%, the payments will always increase by at least 2%, making an increase of 2% an unavoidable payment that should be included as lease payments. Similarly, in a lease whereby lease payments are a fixed percentage of sales of the lessee subject to a floor, such as \$1,000, the \$1,000 represents an unavoidable payment that should be included as lease payments.

When assessing whether payments are unavoidable, an entity should determine whether there is a minimum or floor amount that the lessee must pay. If so, the payments are in effect unavoidable and therefore should be included as lease payments. Common phrases to look for in leases that may signal those payments include: "...the greater of...", "...not to be less than ...", and "...minimum amount of ...". But entities should also be mindful about phrases like the "...the lower of..." particularly when a multiplier is applied, as illustrated with the CPI example above.

Example 4 - Accounting for Contingent Lease Incentives

FACTS

- ▶ Lessee enters into a lease contract with a lessor for a retail store.
- ▶ The lease is an operating lease and there are no nonlease components.
- ▶ Lessee is entitled to a lease incentive from the lessor for leasehold improvements, which are to be constructed by Lessee.
- ▶ At the commencement date of the lease, Lessee intends to construct the improvements, the construction is within its control, and it is reasonably certain that the cost of the improvements will equal or exceed the maximum incentive amount specified in contract.
- ▶ Lessee completes the improvements two months after the commencement date of the lease.

HOW SHOULD LESSEE ACCOUNT FOR THE CONTINGENT LEASE INCENTIVE?

Scenario 1 - Monthly rent is a fixed amount and the lease payments exceed the lease incentive amount

- ▶ We believe one acceptable approach would be to include the lease incentive amount as being receivable at the commencement date. In this situation, the lease incentive is included in the determination of the lease payments at the commencement date, which will affect the initial measurement of the lease liability and the right-of-use asset (essentially reduce the amounts reported on the balance sheet).
- ▶ We believe it would also be acceptable to account for the lease incentive as a contingent lease incentive which is not included in the lease payments at the commencement date, but for which the lessee applies paragraph 842-10-35-4(d) on resolution of a contingency. In that case, the lessee would remeasure the lease payments when the contingency on which the variable lease incentive is based is resolved.

Scenario 2 - Monthly rent is a fixed percentage of lessee's gross sales each month

- ▶ Because the payments to the lessor are entirely variable, there are no lease payments at the commencement date in accordance with paragraph 842-10-30-6(a).
- ▶ Because ASC 842 does not specifically address this question, we believe there are two approaches to accounting for these contingent lease incentives (like in scenario 1 above). However, the analysis differs from scenario 1 because in this scenario there are no lease payments (i.e., there is no lease liability or right-of-use asset against which to offset the lease incentive amounts):

Approach 1: Consider the lease incentive as being receivable at the commencement date. Therefore, recognize a lease receivable and a corresponding liability for the lease incentive at the commencement date. When/as the lessor reimburses the lessee, the lessee reduces the amount of the lease receivable initially recognized. The liability should be reduced on a straight-line basis over the lease term as an offset to lease expense, not to exceed the amount of lease expense recognized for the current period.

Approach 2: Lessee does not recognize any lease incentive at the commencement date. When the contingency on which the lease incentive is based is resolved, the lessee would remeasure the lease payments. Since there continues to be no lease payments other than the incentive, we believe the recognition of the incentive should be recorded as a liability, rather than as a contra-asset (i.e., a right-of-use asset that is less than zero). The liability should then be reduced on a straight-line basis over the lease term as an offset to lease expense, not to exceed the amount of lease expense recognized for the current period.

RESIDUAL VALUE GUARANTEES

As previously discussed, a lessee includes in the lease payments the amounts probable of being owed under residual value guarantees. However, there may be additional factors for a lessee to consider, depending on the terms of the lease contract:

Facts	Analysis
Contract requires the lessee to make up a residual value deficiency for damage, extraordinary wear and tear, or excessive usage.	This provision does not constitute a lessee residual value guarantee. Any payments are instead treated like variable lease payments.
Contract provides for lessor the right to require lessee to purchase the underlying asset by the end of the lease term.	The lessee is obligated (i.e., it is outside its control) to pay the guaranteed residual value. Therefore, the stated purchase price is included in lease payments.
Lessee obtains a residual value guarantee from an unrelated third-party for lessor's benefit.	The existence of a third-party guarantee should not reduce the estimate of lessee's amounts probable of being owed under residual value guarantees, unless the lessor releases the lessee from obligation (including secondary obligation). Also, the amounts paid by a lessee for third-party residual value guarantees are executory costs of the lessee (i.e., they are not included in lease payments).

OBLIGATIONS IMPOSED AT END OF LEASE TERM

Some lease contracts impose obligations on the lessee to return the underlying asset to specific conditions at the end of the lease term. The accounting for such obligations depends on which asset (lessor or lessee asset) the obligation relates to:

- ▶ If the lessee has an obligation to return the underlying asset to its original condition because the lessee modified it (i.e., a lessee asset such as lessee installed leasehold improvements), payments to repair the underlying asset generally do not meet the definition of lease payments or variable lease payments. Instead, the obligation is accounted for under ASC 410-20 on asset retirement and environmental obligations.
- ▶ If the lessee has an obligation for costs to dismantle and remove the underlying asset at the end of the lease term (i.e., a lessor asset), those costs generally are considered lease payments or variable lease payments. Because the accounting for such payments is governed by ASC 842, the guidance in ASC 410-20 does not apply, as noted in paragraph 410-20-15-3(e).

TAX BENEFIT INDEMNIFICATIONS

Some leases contain indemnification clauses that indemnify a lessor on an after-tax basis for certain tax benefits that the lessor may lose if a change in the tax law precludes realization of those tax benefits. Those payments are not of the nature normally expected to arise under variable lease payment provisions and, because of the close association of the indemnification payments to specific aspects of the tax law, any payments should be accounted for in a manner that recognizes the tax law association. The lease classification should not be changed.

INITIAL DIRECT COSTS

Initial direct costs are defined as:

Incremental costs that would not have been incurred if the lease had not been obtained.

Initial direct costs include, for example, commissions and payments made to an existing tenant to incentivize that tenant to terminate its lease.

Costs to prepare a lease that would have been incurred regardless of whether the lease was obtained are not considered initial direct costs and therefore should be expensed as incurred. Those include:

- ▶ Fixed employee salaries (e.g., allocation of employee costs for time negotiating lease terms and conditions),
- ▶ General overheads such as depreciation, occupancy and equipment costs, unsuccessful origination efforts, and idle time,
- ▶ Costs for advertising and similar activities, and
- ▶ Other costs related to activities that occur before a lease is obtained, such as external legal and tax fees, costs of evaluating a prospective lessee's financial condition, travel costs related to the lease proposal.

The guidance in ASC 842 about initial direct costs represents a significant change from ASC 840, and is aligned with the definition of costs to acquire a contract under ASC 606. See Example 27 in ASC 842-10-55 for an illustration of the determination of initial direct costs for a lessee and a lessor.

A lessee allocates initial direct costs to the separate lease components on the same basis as the lease payments. A lessor allocates any capitalized costs (for example, initial direct costs or contract costs capitalized under ASC 340-40 on other assets and deferred costs) to the separate lease components or nonlease components to which those costs relate.

DISCOUNT RATE

DEFINITIONS

	Discount Rate for the Lease	Rate Implicit in the Lease	Incremental Borrowing Rate
	<p>For a lessee, the discount rate for the lease is the rate implicit in the lease unless that rate cannot be readily determined. In that case, the lessee is required to use its incremental borrowing rate.</p> <p>For a lessor, the discount rate for the lease is the rate implicit in the lease.</p>	<p>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.</p> <p>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.</p>	<p>The rate of interest that a lessee would have to pay to borrow on a collateralized basis over a similar term an amount equal to the lease payments in a similar economic environment.</p> <p>A lessee that is not a public business entity is permitted to use a risk-free discount rate for the lease, determined using a period comparable with that of the lease term, as an accounting policy election (see section below for additional details).</p>
	<p><i>Except for certain leases (for example, some related party leases), a lessee typically cannot readily determine the rate implicit in the lease because it does not have all required inputs. Accordingly, a lessee will typically use its incremental borrowing rate.</i></p>	<p><i>How the rate is calculated as it relates to initial direct costs will depend on the lease classification test performed (see Lease Classification section below for additional details).</i></p> <p><i>If the residual value of the underlying asset is expected to increase over the lease term (e.g., land), we believe a lessor should use the fair value at the commencement date in determining the rate implicit in the lease.</i></p>	<p><i>A risk-free rate is typically lower than a collateralized rate and as such, will result in a higher right-of-use asset and lease liability for lessees. It could also result in a different classification of the lease.</i></p>

INCREMENTAL BORROWING RATE

ASC 842	What the standard says...	What it means...
	The rate of interest that a lessee would have to pay	The rate should be based on the credit standing of the lessee (which may also be the credit standing of the parent entity - see further discussion below).
	to borrow on a collateralized basis	It is a secured (recourse) rate that is fully collateralized (i.e., it cannot be under-collateralized). The lessee is not limited to the underlying asset (i.e., other collateral may work if accepted by a lender) although the lessee should consider the nature and quality (liquidity) of the collateral used.
	over a similar term	ASC 842 does not explicitly refer to the “lease term”. We believe a lessee may use either the lease term or consider the lease term plus options not reasonably certain of exercise, as an accounting policy - see observation below for additional details.
	an amount equal to the lease payments	Payments are determined based on ASC 842’s definition of lease payments in paragraph 842-10-30-5. Accordingly, variable payments other than those based on an index or a rate are not considered. See Lease Payments section above for additional discussion on lease payments.
	in a similar economic environment.	It should reflect a rate that would be paid by the entity on borrowings that are entered into at or near the same time, in the same or similar jurisdiction, and in the same currency.

In determining the incremental borrowing rate, a lessee may find the following useful:

- ▶ A lessee may consider its existing debt arrangements and whether those can be used to derive the incremental borrowing rate, with appropriate adjustments to materially comply with the definition of the incremental borrowing rate as described above (for example, adjusted to reflect a similar term as the lease, etc.). If a lessee borrows on an unsecured basis only, the entity may still use that rate as a starting point with further appropriate adjustments.
- ▶ A lessee with little or no debt may use published reference rates such as government rates as a starting point, and adjust those rates for the lessee’s credit risk, financing term, and quality of collateral, etc.
- ▶ A lessee with a high volume of leases may consider constructing a synthetic corporate yield curve in which it considers an appropriate risk-free rate and a credit spread (whether based on its public credit rating or implied credit rating). Further adjustments would be made, for example, for the collateral, for which the lessee may use a “notching approach” or a “recovery rate approach” to reflect a secured rate. A lessee using yield curves to determine its incremental borrowing rate should develop processes and controls to periodically review and update the assumptions used in the development of the yield curve. For example, a lessee could develop a process to periodically pull market data and compare that market data to the inputs used in the yield curve to monitor for changes, and establish appropriate thresholds for determining whether/when to update the inputs of the yield curve. A lessee would also need to periodically monitor for changes in its credit profile (i.e., enhancements or deterioration in credit profile).
- ▶ A lessee may use a portfolio approach when determining the incremental borrowing rate of multiple leases when the leases have similar characteristics, such as a similar lease term, similar lease payments, and similar economic environment, as illustrated in Example 2 of ASC 842-20-55. A single discount rate applied to all leases in a portfolio should not result in a materially different answer than using a discount rate determined for each lease.

We also believe that the determination of the incremental borrowing rate should be consistent with the pattern of lease payments and how such payments are reflected in the measurement of the lease liability, which generally should result in the use of a rate that reflects an amortizing loan.

The following rates typically cannot be used as the incremental borrowing rate:

- ▶ Weighted-average cost of capital,
- ▶ Property yields,
- ▶ Cost of money,
- ▶ Blended rate (e.g., mix of secured and unsecured rate) as it may have been used under ASC 840.

A Rate Determined Over a Similar Term

ASC 842 notes that the incremental borrowing rate is the rate of interest that a lessee would have to pay to borrow on a collateralized basis over a **similar term** an amount equal to the lease payments in a similar economic environment. However, questions may arise as to whether “similar term” is intended to mean the “lease term”, as defined in ASC 842.

When the lease includes options (such as a lessee extension option) and those are not reasonably certain of exercise at the commencement date, we believe a lessee may use either (a) the lease term as defined in ASC 842 and described in paragraph 842-10-30-1, or (b) a rate that reflects the existence of the option(s). This is consistent with the guidance in paragraph 842-20-35-5(a) on subsequent remeasurement of the lease liability which indicates that the discount rate does not have to be updated for a change in lease term or assessment of a purchase option if the rate already reflects that the lessee had such option. We believe that this is a policy election that should be applied consistently to all leases.

However, if a lessee that is not a public business entity elects to use the risk-free discount rate (see section below), it should use the lease term only. This is because paragraph 842-20-30-3 explicitly notes that the risk-free rate is determined over a period comparable with that of the lease term.

Use of Parent Versus Subsidiary Rate

Paragraph BC201 of ASU 2016-02 discusses that in some situations, it may be reasonable for a subsidiary to use a parent entity’s incremental borrowing rate. The example given is when the subsidiary does not have its own treasury function and the parent entity provided a guarantee of the lease payments. In concluding on that example, the FASB noted that pricing of the lease was more significantly influenced by the credit standing of the parent than the subsidiary. Example 2 in Subtopic 842-20-55 also illustrates the use of a parent’s incremental borrowing rate because pricing of the lease was influenced by the parent’s credit standing although the parent entity did not provide a guarantee in that example.

A lessee subsidiary should consider its specific facts and circumstances in determining whether it can use the parent rate or is required to use its own (subsidiary) rate. We believe a lessee subsidiary may use its parent rate in situations in which pricing of the lease was more significantly influenced by the credit standing of the parent than that of the subsidiary (for example, when the lessee subsidiary does not have its own treasury function and the parent entity was involved in negotiations for the lease).

DISCOUNT RATE FOR LESSEES THAT ARE NOT PUBLIC BUSINESS ENTITIES

The FASB initially provided lessees that are not public business entities with an accounting policy to use a risk-free discount rate applicable for all leases. The discount rate is an important input in the accounting for a lease as it may impact lease classification and it directly affects the amounts of leases recognized on the balance sheet and the amounts of interest and amortization expense reported for finance leases. However, because the practical expedient had to be elected for all leases, some private companies were reluctant to elect it based on those financial statement impacts resulting from the current economic environment in which the risk-free rate is very low.

In September 2021, the FASB decided to finalize proposed amendments to permit lessees to make the risk-free rate election by asset class rather than for all leases. Accordingly, a lessee will have more flexibility in electing the risk-free rate accounting policy. For example, a lessee may elect to use the risk-free discount rate for asset classes that have lower values and/or greater volumes of leases (e.g., some office equipment leases), while using their incremental borrowing rate for more material asset classes (such as real estate). Some Board members and FASB staff observed at the September 15, 2021 public meeting that there is no prescribed requirements for determining asset classes, and that therefore a lessee has flexibility in identifying its asset classes for purposes of applying ASC 842.

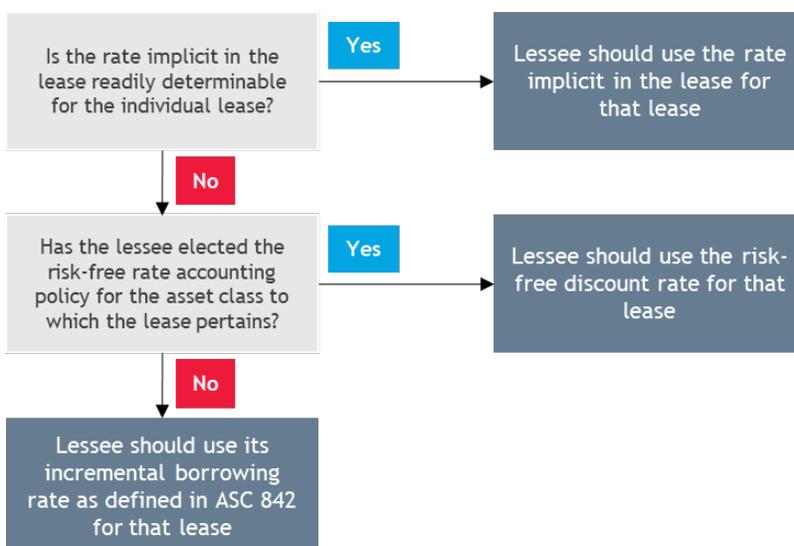
The accounting policy is limited to entities that are not public business entities. Because not-for-profit entities (including conduit bond obligors) and employee benefit plans are not *public business entities* (according to the definition in the Master Glossary), they are permitted to make the risk-free discount rate election. A lessee that elects the practical expedient should disclose that fact and the asset classes for which it has elected it.



Rate Implicit in the Lease and Risk-Free Rate Election

In considering changes to the risk-free rate election, the FASB learned that the interaction between a lessee's requirement to use the rate implicit in the lease when readily determinable and the lessee's application of the risk-free rate election was unclear under ASC 842 because the risk-free rate election initially applied to all leases. The FASB therefore decided to clarify that a lessee should use the rate implicit in the lease when it is readily determinable, even if the lessee elects the risk-free rate election. While the rate implicit in the lease is typically not readily determinable, it may be in certain leases (for example, common control leasing transactions).

The following flowchart summarizes a lessee's decision steps in determining the discount rate for the lease for a lessee that is not a public business entity:



ECONOMIC LIFE

ASC 842 defines economic life as:

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.

We believe this definition is largely consistent with the prior definition of economic life in ASC 840 for lease classification purposes and therefore should lead to similar determinations of economic life.

FAIR VALUE

ASC 842 defines fair value as:

The price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.

This is the same definition of fair value used in ASC 820 on fair value measurement. As a result, an entity should apply the guidance in ASC 820 when determining the fair value of an underlying asset. However, for lessors that are not a manufacturer or dealer (i.e., generally financial institutions and captive finance companies), the fair value of the underlying asset at lease commencement is defined as its cost, reflecting any volume or trade discounts that apply. This exception applies only if there has not been a significant lapse of time between the acquisition of the underlying asset and lease commencement. If there has been a significant lapse of time, the lessor must apply the ASC 820 definition of fair value. This fair value exception is consistent with the fair value exception that existed under ASC 840, which the FASB added to ASC 842 with the issuance of ASU 2019-01 following feedback from lessors previously qualifying for the exception in ASC 840.

Determining Fair Value Without Undue Costs and Efforts

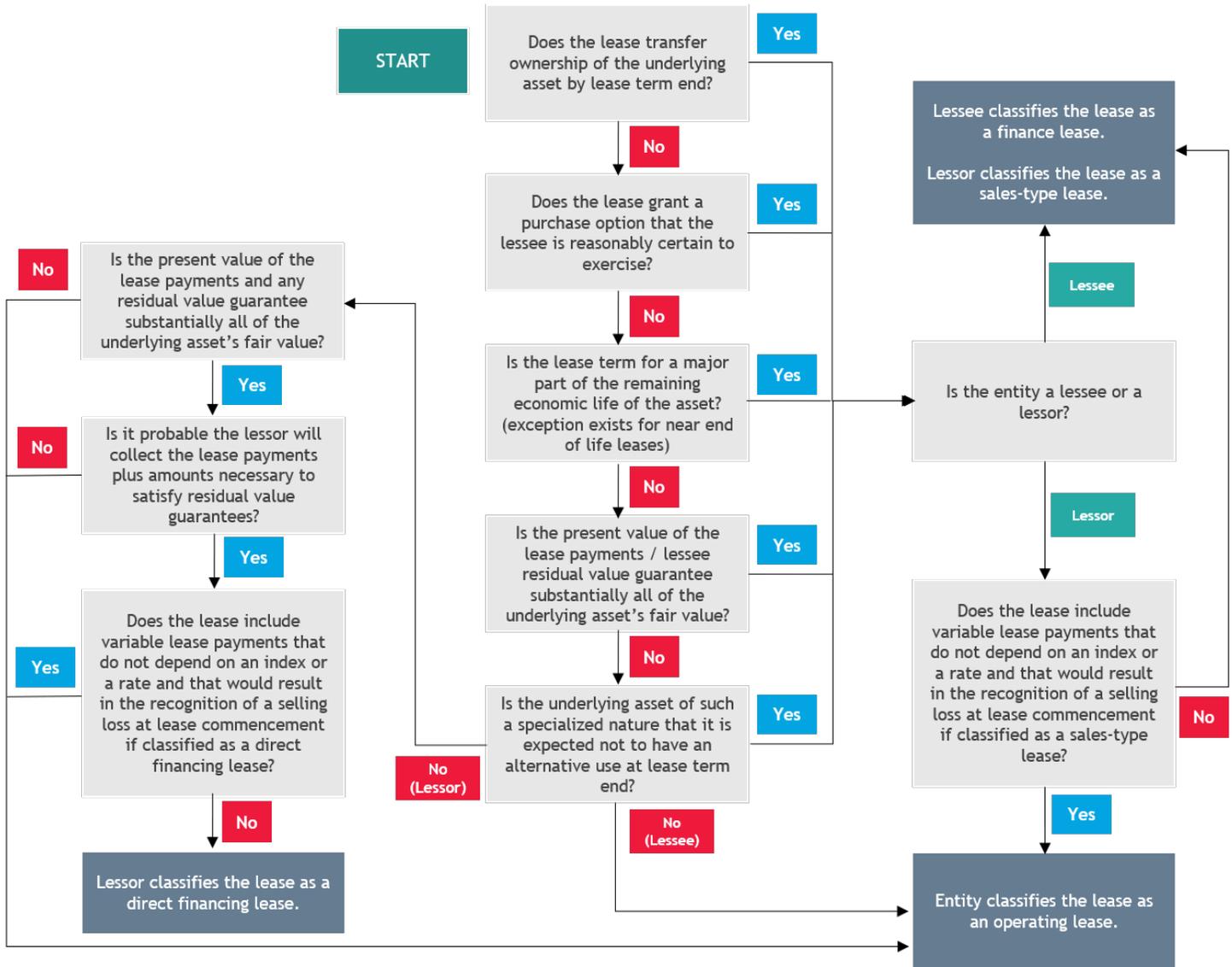
Paragraph 842-10-55-3 notes that in some cases, it may not be practicable for an entity to determine the fair value of an underlying asset, meaning that a reasonable estimate cannot be made without undue cost or effort. That paragraph also notes that if it is not practicable for an entity to determine the fair value of an underlying asset, lease classification should be determined without consideration of the present value classification criteria (i.e., paragraphs 842-10-25-2(d) and 842-10-25-3(b)(1) which we discuss further below in the Lease Classification section).

We believe fair value can be determined without undue cost or effort in most cases. However, an entity is not *always* required to obtain an appraisal or similar valuation. Instead, in many cases an entity may be able to make a reasonable estimate of fair value. For example, for the lease of one floor of a building, it may be appropriate to determine fair value of the portion leased by taking the fair value of the building as a whole and applying an appropriate percentage based on floors leased to total number of floors, or square feet leased to total square feet of the building if more representative of the space used, with appropriate adjustments as needed (for example, if a market participant would ascribe more value to higher floors in the building). However, a more precise estimate of fair value generally should be made (and appraisal or similar valuation may need to be obtained) if it is likely that lease classification could change, and such change in classification would be significant to the financial statements.

One exception is for leases of spaces owned by a governmental unit or authority. For leases involving terminal space and other airport facilities, ports and bus terminals and similar spaces owned by a governmental unit or authority, it may not be practicable to determine the fair value of the underlying asset. In those situations, paragraph 842-10-55-13 notes that such leases are classified as operating leases if they do not provide for a transfer of ownership or a lessee purchase option that is reasonably certain of exercise. However, certain conditions must be met to apply that guidance as outlined in paragraph 842-10-55-13.

LEASE CLASSIFICATION

Once an entity has obtained all relevant inputs described above, it can perform the lease classification assessment. Lease classification is determined at the commencement date of the lease. The analysis is summarized in the following flowchart based on paragraphs 842-10-25-2 through 25-3A.



The following table provides additional guidance on the lease classification analysis described in the above graph:

Step	Additional Guidance
Transfer of ownership criterion	<ul style="list-style-type: none"> ▶ This criterion is met in leases that provide that the lessor execute and deliver to the lessee such documents (including, if applicable, a bill of sale) as may be required to release the underlying asset from the lease and to transfer ownership to the lessee, upon the lessee's performance in accordance with the terms of the lease. ▶ This criterion is also met when the lease requires the payment by the lessee of a nominal amount (e.g., minimum fee required by statutory regulation to transfer ownership) in connection with the transfer of ownership. ▶ But if the lease transfers ownership of the asset if the lessee elects to pay a specified fee (whether nominal or otherwise) to complete the transfer, it does not satisfy the transfer-of-ownership criterion. Instead, an entity assesses it as an option to purchase the underlying asset (see below).
Purchase option criterion	<ul style="list-style-type: none"> ▶ If a lessee is reasonably certain to exercise a purchase option, the exercise price of the option is included in the lease payments and the lease is classified as a finance lease by the lessee and a sales-type lease by the lessor (unless there are variable lease payments not based on an index or a rate and it would result in a selling loss). See Lease Payments section for a discussion of the assessment of purchase options.
Lease term criterion	<ul style="list-style-type: none"> ▶ One reasonable approach to assess this criterion is that 75% or more of the remaining economic life of the asset represents a major part of the asset's remaining economic life, and that a commencement date that falls within the last 25% of the total economic life of the underlying asset results in a commencement date that falls at or near the end of the asset's economic life. ▶ If the lease contract includes the right to use multiple underlying assets that represent a single lease component under paragraphs 842-10-15-28 and 15-29 (see Identifying and Separating Components), use the remaining economic life of the predominant asset.
Present value criteria	<ul style="list-style-type: none"> ▶ One reasonable approach to assess these criteria is that 90% or more of the asset's fair value amounts to substantially all. ▶ Any related investment tax credit retained by the lessor and expected to be realized by the lessor reduces the fair value of the underlying asset. ▶ Fees paid by a lessee to owners of a special purpose entity for structuring the transaction, while included in lease payments, are not included in the fair value of the underlying asset when assessing the sales-type lease present value criterion. ▶ For a lessor only, for the sales-type lease present value criterion the rate implicit in the lease should exclude any initial direct costs if the fair value of the underlying asset differs from its carrying amount. For assessing the direct-financing lease present value criterion, initial direct costs are included in all cases. We illustrate this further in Accounting for Leases - Lessors from this series on lessor accounting. ▶ Residual value guarantees of a portfolio of underlying assets (for which settlement is not solely based on the residual value of the individual underlying assets, and for which excess is offset against shortfalls in residual value that exist in other assets in the portfolio) preclude a lessor from determining the amount of the guaranteed residual value of any individual underlying asset within the portfolio and, therefore, no such amounts should be considered by the lessor when evaluating these criteria.

Step	Additional Guidance (<i>Continued</i>)
Alternative Use Criterion	<ul style="list-style-type: none"> ▶ In assessing this criterion, an entity considers the effects of (1) contractual restrictions and (2) practical limitations on the lessor’s ability to readily direct that asset for another use (e.g., selling it or leasing it to an entity other than the lessee). ▶ A contractual restriction on a lessor’s ability to direct an underlying asset for another use must be substantive for the asset not to have an alternative use to the lessor. A contractual restriction is substantive if it is enforceable. ▶ A practical limitation on a lessor’s ability to direct an underlying asset for another use exists if the lessor would incur significant economic losses to direct the underlying asset for another use, such as if the lessor either would incur significant costs to rework the asset, or would only be able to sell or re-lease the asset at a significant loss. Examples include when the underlying asset has design specifications unique to the lessee or the asset is in a remote area. ▶ The possibility of the contract with the customer being terminated does not affect the assessment of this criterion.
Probability of Collection Criterion	<ul style="list-style-type: none"> ▶ The question of collectibility is no longer relevant for determining whether a lease is classified as a sales-type lease, which is a change from prior GAAP. However, the collectibility assessment is still relevant for determining whether a lease is classified as a direct-financing lease. If collection is not probable, the lease is classified as an operating lease by the lessor.

The following guidance is also important for specific transactions or provisions in lease contracts:

Transaction	Additional Guidance
Business combinations or acquisition by not-for-profit entity	<ul style="list-style-type: none"> ▶ The acquiring entity should retain the previous lease classification unless there is a lease modification that is not accounted for as a separate contract. ▶ For asset acquisitions, refer to article 7 from this series on Other Topics.
Related party leases	<ul style="list-style-type: none"> ▶ These leases are classified in accordance with the lease classification criteria applicable to all other leases based on the legally enforceable terms and conditions of the lease. In the separate financial statements of the related parties, the classification and accounting for the leases should be the same as for leases between unrelated parties. ▶ Legally enforceable terms and conditions should be utilized even if they are not consistent with rates or terms that would be required in a transaction between unrelated market participants. ▶ It is important to consider whether provisions beyond those included in the written contract are legally enforceable, which may require judgment and sometimes input from legal counsel.
Lessee indemnification for environmental contamination	<ul style="list-style-type: none"> ▶ A provision that requires lessee indemnification for environmental contamination, whether for environmental contamination caused by the lessee during its use of the underlying asset over the lease term or for preexisting environmental contamination, should not affect lease classification. Those indemnifications are accounted for under other GAAP (ASC 410-20 or ASC 460-10 depending on the indemnification).

Classification with Removal of the Legacy “Bright Lines”

The lease classification tests in paragraphs 842-10-25-2 and 25-3 do not refer to bright-line thresholds as previously required under ASC 840. Instead, those bright lines were replaced with terminologies such as “major part” when discussing the lease term criterion, or “substantially all” when discussing the present value criteria. When determining how to apply this guidance, paragraph 842-10-55-2 permits the continued use of those bright lines. This was provided to assist companies in establishing internal accounting policies and controls and in applying the requirements in an operational and scalable manner. While application of those bright lines is not required, if an entity deviates from those bright lines, it should consider how best to articulate accounting policies in order to achieve consistent classification for similar leases, while adhering to the economic structure of the arrangement and the lease classification principles in ASC 842. While companies could adopt a policy that establishes ranges, like the approach taken when determining whether a contingent liability is probable under ASC 450-20, entities should also consider how those terms are applied in other areas of GAAP and ensure consistent application. For example, “substantially all” is used in many other areas of GAAP and is understood to generally be at or around 90%. A reporting entity should document its definition of “substantially all” and “major part.” Deviating from the use of the bright lines allowed by paragraph 842-10-55-2 will require an entity to document its considerations in arriving at the thresholds used, and to demonstrate that the use of such thresholds is appropriate.

Alternative Use Test

ASC 842 added a classification criterion on whether a lease is a finance lease for a lessee or a sales-type lease for a lessor that did not exist under ASC 840; specifically, whether the underlying asset is of such a specialized nature that it is expected to have no alternative use to the lessor at the end of the lease term. We expect that for leases of this nature, most lessors would structure such contracts to ensure that they recover their investment in the underlying asset through the required lease payments, and that therefore the present value of the lease payments would represent substantially all of the fair value of the underlying asset, thereby meeting at least one other lease classification criterion. However, this may not always be the case, such as when a significant portion of the payments are variable. Even so, an inability by the lessor to repurpose the asset without undue cost at the end of the lease term will result in finance/sales-type lease treatment for the lessee and for the lessor (unless there are variable lease payments not based on an index or a rate and it would result in a selling loss), respectively.

Example 5 - Alternative Use Criterion Met

FACTS

- ▶ Widget Co. enters into a lease agreement with Bob’s Custom Manufacturing.
- ▶ Under the agreement, Bob’s will construct a piece of equipment to be used in Widget’s production process.
- ▶ The requirements for the asset will be provided by Widget and are subject to a U.S. patented design.
- ▶ It would also be cost prohibitive for Bob’s to modify the equipment in such a way that it no longer complies with the patented design requirements.

WHAT IS THE CLASSIFICATION OF THE LEASE?

- ▶ Because of the existence of the patent, Bob’s would be precluded from reusing the equipment at the end of the lease through redirecting it through a sale or subsequent lease.
- ▶ The alternative use criterion is met. Widget Co. should account for the lease as a finance lease, and Bob’s should account for the lease as a sales-type lease (unless there are variable lease payments not based on an index or a rate and it would result in a selling loss).

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