ESSENTIAL GUIDEBOOK

ASC 842: Leases
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Introduction

Many organizations previously structured lease transactions to achieve off balance sheet treatment. In fact, the U.S. Securities and Exchange Commission (SEC) estimated that SEC registrant companies held approximately $1.25 trillion in off-balance-sheet lease obligations in 2005. The effect of this widespread practice, according to the Financial Accounting Standards Board (FASB), was that users of financial statements had difficulty comparing companies that own their productive assets with those that lease their productive assets.

Because of this, the FASB updated leases accounting to effectively bring leases onto the balance sheet and make financial statements more comparable. The new standard under Accounting Standards Codification Topic 842, Leases (ASC 842), changes the financial reporting obligations of companies that engage in leasing for assets such as real estate, vehicles, and equipment.

While the new standard is intended to make it easier for users of financial statements to compare different companies, it will likely have a range of other repercussions for the companies themselves. We recognize adopting the new standard will require a high level of effort from most entities. The standard is far-reaching and calls for increased documentation and disclosures.

Baker Tilly can help. Our specialized professionals use a highly customizable methodology to aid you in assessing the impact, developing a plan right-sized to your needs and implementing this plan across your organization.

It is our pleasure to provide this comprehensive guidebook to help you understand the new leases accounting standard. We trust you will find value in all of the information and insights presented.

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Identifying a Lease

The new requirements for lessee’s presented by Accounting Standards Codification (ASC) Topic 842, Leases, was issued by the Financial Accounting Standards Board (FASB) in February 2016. Virtually all leases now must be brought onto the balance sheet of lessees in accordance with requirements of the standard. After initial recording, the leases are then accounted for as an operating lease or a finance lease, with different requirements for reporting in the income statement.

Simple enough? The devil is in the details.

Determining if a contract contains a lease
The first step in applying ASC 842 is determining whether a contract, which is defined as an agreement between two parties which creates enforceable rights and obligations, contains a lease. Basically the contract contains a lease if it conveys the right to control the use of identified property or equipment for a period of time.

In order to determine whether a customer has the right to control the use of the specified asset, for a period of time, the customer determines that it has both:

— The right to obtain substantially all of the economic benefits from the use of the asset, and
— The right to direct the use of such asset.

An asset is identified, usually by specific terms in the contract; however, absent description in the contract, an asset can be implicitly identified at the time the asset is made available to the customer. For example, a lease for a forklift could be worded in two different ways:

— The contract could specify the type, make and serial number of a specific forklift which is then provided to the customer, or
— The contract could specify that a forklift will be provided and at the time of delivery.

In both cases, the customer has a specifically identified asset.
Substantive substitution right

It is possible that the contract permits the supplier to substitute one asset for another. In this situation, the customer must determine whether this is a substantive substitution right. If so, then the contract does not contain a lease. The supplier has a substantive right if both of these conditions exist:

— The supplier has the practical ability to substitute alternative assets throughout the period of use (for example, the customer cannot prevent the supplier from substituting an asset, and alternative assets are readily available to the supplier or could be sourced by the supplier within a reasonable period of time).

— The supplier would benefit economically from the exercise of its right to substitute the asset (that is, the economic benefits associated with substituting the asset are expected to exceed the costs associated with substituting the asset).\(^1\)

An entity should evaluate at the inception of the lease whether the rights are substantive and should exclude consideration of future events which are unlikely to occur. Certain indicators are noted in the ASC which make it unlikely that the supplier has a substantive right:

— If the asset is physically located at the customer premises, the cost of substitution tends to be higher and may make it more likely the supplier would not substitute.

— If the supplier can only substitute after a certain period or after the occurrence of a specified event, the right would not be considered substantive.

— An obligation to substitute another asset in order to make repairs or maintenance is not a substantive right.

— If it is not determinative if the supplier has such a right, the customer should assume it does not.

“Basically the contract contains a lease if it conveys the right to control the use of identified property or equipment for a period of time.”
Examples: substantive substitution concept

**Contract CONTAINS a lease**

A trucking company enters into a contract with a supplier of refrigerated trailers for ten trailers to be used for a period of five years. The contract specifies the trailers. The trailers are to be maintained at the customer’s premises. The customer determines when the trailers are used and the freight carried; or may not place them into service, but uses them for terminal storage. The supplier cannot retrieve the trailers until the five years are completed.

This contract contains a lease of ten trailers, because the customer:

1. Controls the use of specific trailers;
2. Has the right to substantially all of the economic benefits of the use of the trailers; and
3. Has a right to direct use of the trailers for transport or storage.

**Contract DOES NOT CONTAIN a lease**

A customer enters into a contract with a supplier for transport of goods in refrigerated trailers for a period of five years. The volume specified in the contract will require the use of ten trailers at dates specified in the contract. The trucks and trailers are only at the customer’s premises for purposes of pickup and delivery. The supplier has the ability to substitute other trucks and trailers throughout the period. The supplier would benefit economically from the right of free substitution of equipment.

This contract does not contain a lease, because:

1. The assets employed in the contract are not specified; the supplier’s only obligation is to provide transport services;
2. The customer does not control the use of specific assets; and, thus,
3. The customer does not receive substantially all of the economic benefits associated with the equipment, as the supplier can freely substitute other equipment to fulfill the transport obligation.
Right to control the use of the identified asset

There are two requirements to meet this condition. The customer must have the right to obtain economic benefits from the use of the asset and the customer has the right to direct the use of the asset. These conditions are met as follows:

**Right to obtain economic benefits**

- The customer has the exclusive right to use the asset through the life of the contract.
- The customer obtains economic benefits by using, holding or subleasing the asset.
- These economic benefits include the direct output of the asset and the related cash flows or other benefits resulting from contracts with third parties.
- Conditions that may limit the scope of economic benefits, such as mileage limits on a vehicle, do not impair the economic benefits obtained. If so, the customer assesses whether substantially all of the economic benefits have been obtained for the period through the mileage limit, but not beyond.
- Additional payments made to the supplier above the base rate, such as a percentage of sales, do not offset the consideration of economic benefits; they are simply considered additional consideration for the use of the asset.

**Right to direct the use of the asset**

- The customer determines how the asset is used through the life of the contract; or
- The use of the asset is predetermined per the terms of the contract and the terms cannot be changed by the supplier during the life of the contract, or the customer has designed the asset in such a way that the use of the asset is predetermined by virtue of such design.

Separating the components of a contract

It is not uncommon for a contract that contains a lease to have other components included. A customer must analyze the contract to determine if there are other components. Typically, the lease is a separate component of the contract if the following conditions are met:

1. The lessee can benefit from the right of use either on its own or together with other resources that are readily available to the lessee. Readily available resources are goods or services that are sold or leased separately (by the lessor or other suppliers) or resources that the lessee already has obtained (from the lessor or from other transactions or events).
2. The right of use is neither highly dependent on nor highly interrelated with the other right(s) to use underlying assets in the contract. A lessee’s right to use an underlying asset is highly dependent on or highly interrelated with another right to use an underlying asset, if each right of use significantly affects the other.2
The standard specifies lease contracts that include land, as well as other assets, must be separated with the right to use the land (sometimes referred to as a land easement or right of way) as a separate lease component.³

Other lease contract components could include the transfer of other goods and services to the customer. If present, these obligations must be considered separately from the lease, and the consideration in the contract shall be allocated among the components. However, consideration should not be allocated to routine administrative costs in setting up the contract or reimbursements for payments of the lessor’s costs, as they are not considered the transfer of goods or services.

If the contract contains separate components, then the lessee must allocate the consideration specified in the lease as follows:

- The customer shall determine the standalone selling price of the components based on observable prices; if observable prices are not available, the lessee shall estimate the standalone price maximizing the use of observable information.
- The lessee shall allocate the consideration based on the standalone selling prices.⁴

The consideration to be allocated includes all of the fixed payments, as well as variable payments based on an index or rate as determined at the inception of the lease.⁴

The standard provides a practical expedient. The customer need not account for the components separately if it makes an accounting policy election to the treat the components as one lease obligation.

Lease identification conclusion

Despite the detailed guidance provided in the standard for the most common leasing transaction, such as for space or equipment, the assessment of whether or not a contract contains a lease will be straightforward and unlikely to result in an answer different from current practice. More complex arrangements such as service contracts, which may have not been considered as containing a lease, may need to be reviewed to determine if the customer, as part of the service agreement, obtains the right to use a specified asset which provides substantially all of its economic benefit to the customer.

Making the relevant assessments and allocating lease consideration (when multiple components are elected to be accounted for separately) will need to be addressed as part of an entity’s internal control over financial reporting. For accelerated filers, this will likely be a focus for external auditors conducting an integrated audit.

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1 ASC 842-10-15-10
2 ASC 842-10-15-28
3 See page 41 for updates on land easements
4 Note that these concepts are similar to those contained in ASC 606 Revenue from Contracts with Customers
Lease classification

Once you have determined there is a lease, the next step is to determine the classification of the lease (or lease component of a contract with multiple components). ASC 842, requires each separate lease to be classified at its commencement date, which is the date that the lessee has the leased asset available for use. That classification will be retained throughout the life of the lease, unless there is a contract modification, or there is a change in either the estimated lease term or the initial determination of whether a purchase option will be exercised.

Although all lease obligations are required to be reflected on the balance sheet as a “right to use” asset and a related lease liability, U.S. generally accepted accounting principles (GAAP) requires initial classification to determine how an entity will account for the lease through the income statement. Leases classified as finance leases will recognize depreciation and interest expense as with the current capital lease model, thus recognizing more expense in the early part of the lease and less expense later in the term. Operating leases will recognize a rent expense on a straight line basis over the expected term. As such, the classification is an important issue with respect to operating metrics.

The classifications

**Finance lease**

The first classification option is a finance lease. This term is defined in the glossary as: *

*From the perspective of a lessee, a lease that meets one or more of the criteria in ASC 842-10-25-2. These criteria are:*

1. The lease transfers ownership of the underlying asset to the lessee by the end of the lease term.

2. The lease grants the lessee an option to purchase the underlying asset that the lessee is reasonably certain to exercise.

3. The lease term is for the major part of the remaining economic life of the underlying asset. However, if the commencement date falls at or near the end of the economic life of the underlying asset, this criterion shall not be used for purposes of classifying the lease.

4. The present value of the sum of the lease payments and any residual value guaranteed by the lessee that is not already reflected in the lease payments in accordance with paragraph 842-10-30-5(f) equals or exceeds substantially all of the fair value of the underlying asset.

5. 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.\(^1\)
It is notable that the finance lease requirements do not differ significantly from the previous leases guidance in ASC 840 for classification as a capital lease. The new standard, ASC 842, changes the terminology to finance lease and, as expected, uses principle based requirements. Where ASC 840 specifies 75 percent of the estimated economic life, ASC 842 states major part. Where ASC 840 specifies the present value of the sum of the lease payments to be 90 percent of the fair value of the leased asset at inception, ASC 842 states the present value of the lease payments equals or exceeds substantially all of the fair value of the asset.

These concepts, however were not eliminated entirely. The implementation guidance provides the following:

When determining lease classification, one reasonable approach to assessing the criteria in paragraphs 842-10-25-2(c) through (d) and 842-10-25-3(b) (1) would be to conclude:

- Seventy-five percent or more of the remaining economic life of the underlying asset is a major part of the remaining economic life of that underlying asset.
- A commencement date that falls at or near the end of the economic life of the underlying asset refers to a commencement date that falls within the last 25 percent of the total economic life of the underlying asset.
- Ninety percent or more of the fair value of the underlying asset amounts to substantially all the fair value of the underlying asset.²

So while the standard is meant to be principle based, some of the existing “rules” still ended up in the final Financial Accounting Standards Board (FASB) standard.³ As such, applying the classification should not differ substantially from current practice.

Operating lease

When none of the finance lease criteria is met, the lessee shall classify the lease as an operating lease.
Components of the classification

In order to make the determination as to whether the lease is a finance lease, the entity must consider several variables and apply judgment to the assessment of whether any of the conditions noted previously are met.

<table>
<thead>
<tr>
<th>Classification components</th>
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</thead>
<tbody>
<tr>
<td>1. Transfer of ownership</td>
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<tr>
<td>2. Purchase options</td>
</tr>
<tr>
<td>3. Remaining economic life of the asset</td>
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<tr>
<td>4. The expected term of the lease</td>
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<tr>
<td>5. Lease payments</td>
</tr>
<tr>
<td>6. Rate implicit in the lease (discount rate)</td>
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<tr>
<td>7. Fair value of the underlying asset</td>
</tr>
</tbody>
</table>

**Transfer of ownership**

If the terms of the lease call for a transfer of ownership at the end of the term the lease is a finance type lease. This would also apply even if the lessee was required to pay a nominal fee for legal transfer of ownership. However, if the lessee does not agree to the payment of such a fee, the transfer of ownership criteria cannot be assumed.

**Purchase options**

If the purchase option is reasonably certain to be exercised, the lease is a finance lease. FASB has determined that “reasonably certain,” is a high threshold, such as a probability exceeding 75-80 percent. Some indicators of the reasonably certain criteria are: an economic penalty for not exercising, the uniqueness of the asset, cost of moving, cost of disruption to operations, cost of abandoning leasehold improvements, etc. All of the relevant facts and circumstances should be considered.

**Remaining economic life**

Determining the economic life of an asset is similar to the process an entity would use in assigning depreciable lives to purchased assets. The historical approach would be a logical starting point for new leased assets. For leased assets that have been used, the entity would consider its experiences as to how much life is remaining before the economic functionality of the asset will be used up. Obviously this is an area of judgment.

Once the economic life has been estimated, as noted above, the application guidance states that a reasonable approach for applying the “major portion” criteria would be 75 percent, and that leases that commence in the last 25 percent of economic life, would not be considered finance leases.

In order to apply the present value test noted in criteria (d) above, the entity needs specific information to make the calculation. These are:

- The expected term of the lease;
- Lease payments; and
- Rate implicit in the lease (discount rate).
The expected term of the lease

Leases often contain an initial term with options to extend the initial term. Entities need to determine what the probability is of exercising any or all of the options. The FASB uses the reasonably certain criteria again for this judgment. The lease term is considered the noncancellable period of the lease, which includes:

- Periods covered by an option to extend the lease if the lessee is reasonably certain to exercise that option
- Periods covered by an option to terminate the lease if the lessee is reasonably certain not to exercise that option
- Periods covered by an option to extend (or not to terminate) the lease in which exercise of the option is controlled by the lessor.\(^4\)

The entity should consider all of the relevant facts and circumstances and the associated economic impacts of not exercising options or of early termination penalties when determining the estimated term of the lease for purposes of the present value calculation.

For instance, if an entity constructs a building on leased land for an initial period that is shorter than the economic life of the building, it may be reasonably certain that the entity will exercise extension terms in order to realize the full economic benefit of the building it constructed. And therefore, the expected lease term will include options.

Conversely, if an entity leases a forklift, with an economic life of five years, for a term of four years and option for an additional four year term, the entity might conclude that it was unlikely to exercise the option due to the remaining life of the asset.

Once again judgment will be required in making the assessment.
Lease payments

Lease payments at commencement consist of the following:

- Fixed payments, including in substance fixed payments, less any lease incentives paid or payable to the lessee (see paragraphs 842-10-55-30 through 55-31).

- **Variable lease payments** that depend on an index or a rate (such as the Consumer Price Index or a market interest rate), initially measured using the index or rate at the commencement date.

- The exercise price of an option to purchase the underlying asset if the lessee is reasonably certain to exercise that option (assessed considering the factors in paragraph 842-10-55-26).

- Payments for **penalties** for terminating the lease if the lease term (as determined in accordance with paragraph 842-10-30-1) reflects the lessee exercising an option to terminate the lease.

- Fees paid by the lessee to the owners of a special-purpose entity for structuring the transaction. However, such fees shall not be included in the fair value of the underlying asset for purposes of applying paragraph 842-10-25-2(d).

- For a lessee only, amounts **probable** of being owed by the lessee under **residual value guarantees** (see paragraphs 842-10-55-34 through 55-36).\(^5\)

The types of variable lease payments to include in the calculation, are only those that are determined based on the application of an index or rate. Variable leases payments related to the use of the asset, such as excess mileage costs or sales percentage overrides, should not be considered.

Variable lease payments tied to an index or rate should be calculated at inception based on the then current rate without any adjustment for future changes in the index or rate. Note the subtle difference in the following scenario:

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**Example: Variable lease payments**

- An entity leases office space for five years at an annual rent of $10,000.
- The lease has a feature that increases the rent for the change in the consumer price index (CPI). At the commencement of the lease, the CPI is 250. At the end of year one, the CPI has increased to 260.
- Therefore the year 2 lease is $10,000*260/250=$10,400.
- The entity assumes lease payments of $50,000 for the PV calculation as the increases in CPI cannot be known or estimated.

**Alternate with prime rate**

Alternatively, if the rent increase was based on a rate such as the prime rate of interest, the calculation would be based on the rate at the commencement of the lease. In the example above, instead of the CPI, the rent is increased by applying the prime rate of interest. At commencement the prime rate is 3.25 percent; therefore, the entity should inflate the initial rent by 3.25 percent per year through the term of the lease. The series of rents would be $10,000, $10,325, $10,661, $11,007 and $11,365. Estimates of future increases or decreases in the prime would not be a factor.
Payments for non-lease components

The only payments that should be considered when making the determination are payments related to the right of use of the underlying asset. ASC 842 provides the following on what types of payments are not lease components:

— Administrative tasks to set up a contract or initiate the lease that do not transfer a good or service to the lessee
— Reimbursement or payment of the lessor’s costs. For example, a lessor may incur various costs in its role as a lessor or as owner of the underlying asset. A requirement for the lessee to pay those costs, whether directly to a third party or as a reimbursement to the lessor, does not transfer a good or service to the lessee separate from the right to use the underlying asset.

In a real estate lease, it is common to have other required payments such as for common area maintenance. Typically, these would be considered non-lease components and not included in the total lease payments. Another example is related to an equipment lease, where as part of the lease payment, the lessor provides periodic maintenance throughout the life of the lease.

Often the lease contract states one rent payment to cover both the lease components, as well as the non-lease components. In those situations, you must allocate the payments using relative standalone selling price for the components. However, the standard provides a practical expedient (available to all entities):

A lessee may, as an accounting policy election by class of underlying asset, choose not to separate non-lease components from lease components and instead to account for each separate lease component and the non-lease components associated with that lease component as a single lease component.

Rate implicit in the lease (discount rate)

The discount rate to be used is the “rate implicit in the lease,” which the ASC 842 Glossary defines as:

The rate of interest that, at a given date, causes the aggregate present value of (a) the lease payments and (b) the amount that a lessor expects to derive from the underlying asset following the end of the lease term to equal the sum of:

1. The fair value of the underlying asset minus any related investment tax credit retained and expected to be realized by the lessor and
2. Any deferred initial direct costs of the lessor.
A lessee may be unable to easily obtain the fair value of the underlying asset. As such, a lessee may use its incremental borrowing rate in the calculation, which is defined in the Glossary as:

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.

The FASB has also provided a practical expedient for nonpublic business entities to use the risk free interest rate for a comparable period. This will result in a higher lease liability, while reducing the interest expense for a finance lease. This is an accounting policy election that must be used consistently for all leases once elected.

**Fair value of the underlying asset**

In order to undertake the present value calculation, the entity must determine the fair value of the underlying asset, rather than the fair value of the right to use asset. This is defined in the Glossary as:

Fair value (second definition): 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.

In many cases, determining the fair value of the underlying asset may not be practical for the lessee. As such the standard provides some relief:

In some cases, it may not be practicable for an entity to determine the fair value of an underlying asset. In the context of this Topic, practicable means that a reasonable estimate of fair value can be made without undue cost or effort. It is a dynamic concept; what is practicable for one entity may not be practicable for another, what is practicable in one period may not be practicable in another, and what is practicable for one underlying asset (or class of underlying asset) may not be practicable for another. In those cases in which 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 criteria in paragraphs 842-10-25-2(d) and 842-10-25-3(b)(1).²

Here again, judgment will need to be applied in making this determination.
Other matters

Related party leases

Leases between related parties should be classified in the same manner as with other parties, based on the legally enforceable terms and conditions of the lease contract.

Portfolio approach

The standard permits entities to group similar leased assets into a portfolio for purposes of determining classification and measurement as long as the result is not materially different from applying the standard to individual contracts. Necessarily this will most likely be limited to portfolios of homogenous assets.

Enhanced need for ICFR

As noted previously, the classification determination of a lease as financing or operating is little changed from concepts well established in ASC 840. However, entities will need to carefully evaluate their internal control over financial reporting (ICFR) over lease classification decisions to establish policies supporting the significant judgments necessary in applying the reasonably certain criteria to purchase options and expected term. These decisions will ultimately determine the relative size of the right to use asset and related liability, as well as the expense recognized in the income statement.

1 ASC 842-10-25-2
2 ASC 842-10-55-2
3 IFRS #16 Leases does not retain the two classifications, so this concept is not included. All leases are considered finance leases.
4 ASC 842-10-30-1
5 ASC 842-10-30-5
6 ASC 842-10-15-30
7 ASC 842-10-15-37
8 ASC 842-10-55-3
Measurement and re-measurement

You have learned how to identify a lease in a contract and how to classify a lease (as operating or finance type) based on the terms of the lease contract. Now, we will discuss the initial recognition and measurement of leases and how re-measurement is made when changes occur in the contract during the estimated initial period of the lease.

What is newsworthy about the lease standard is the recording of a lease liability and a related right-of-use asset. These are defined, at right, in the ASC 842 Glossary.

Lease liability
A lessee's obligation to make the lease payments arising from a lease, measured on a discounted basis.

Right-of-use asset
An asset that represents a lessee's right to use an underlying asset for the lease term.

Determining the lease liability

In order to determine the lease liability, as with any present value calculation, the lessee requires lease payments information, including:

1. Fixed payments, including in substance fixed payments, less any lease incentives paid or payable to the lessee (see paragraphs 842-10-55-30 through 55-31).
2. Variable lease payments that depend on an index or a rate (such as the Consumer Price Index or a market interest rate), initially measured using the index or rate at the commencement date.
3. The exercise price of an option to purchase the underlying asset if the lessee is reasonably certain to exercise that option (assessed considering the factors in paragraph 842-10-55-26).
4. Payments for penalties for terminating the lease if the lease term (as determined in accordance with paragraph 842-10-30-1) reflects the lessee exercising an option to terminate the lease.
5. Fees paid by the lessee to the owners of a special-purpose entity for structuring the transaction. However, such fees shall not be included in the fair value of the underlying asset for purposes of applying paragraph 842-10-25-2(d).
6. For a lessee only, amounts probable of being owed by the lessee under residual value guarantees (see paragraphs 842-10-55-34 through 55-36).
At the lease commencement date, the lessee shall evaluate the terms of the lease as to what payments are due and what the timing of the payments are. The purchase option needs to be evaluated based on the nature of the leased asset, and the likelihood that the lessee will exercise the option due to the underlying economics. Payments expected to be paid for early termination should be included and any probable residual value guarantees should also be part of the expected cash outflow.

The payments are then discounted at the implicit rate in the lease or, if that cannot be determined due to the inability of the lessee to obtain the fair value of the leased asset at inception, the lessee shall use its incremental borrowing rate.

Generally, the payments used to determine lease classification will be the same as used for the initial measurement. Except, residual value payments are included for the purpose of lease classification but excluded for the lease liability calculation unless they are probable of being paid.

Determining the right-of-use asset

The asset is recorded as the sum of the following amounts:

- The lease liability
- Any payments made to the lessor prior to commencement date (prepaid rent) less any incentives received from the lessor
- Any initial direct costs associated with the lease

Initial direct costs are those incremental costs that a lessee may incur in connection with entering into a lease. Some examples would be: commissions paid to agents, legal fees related to executing the lease, payments paid to tenants to move out, or consideration paid to a third party to guarantee the residual value. Generally, internal incremental costs such as salaries, advertising, other origination efforts, may not be considered initial direct costs.
**Example: Initial measurement**

To illustrate the initial measurement, here is an example derived from ASC-842:

Assume an entity enters into a lease of office space for a period of five years with annual lease payments of $100,000 payable at the beginning of the year. The lease states that the annual payment increases each year based on the increase in the Consumer Price Index (CPI). At inception the CPI is 125. The interest rate implicit in the lease is not readily determinable, so the entity uses its incremental borrowing rate, which is 8 percent, to discount the cash flows.

The entity makes the initial payment of $100,000, and then records a lease liability of $331,213 (which is the present value of four payments of $100,000 discounted at 8 percent). The entity does not make any adjustment for the CPI escalation, as it is indeterminate how much that increase would be.

The entity records a corresponding right-of-use asset of $431,213, which is the present value of the future lease payments plus the initial upfront payment of $100,000.$\textsuperscript{2}

Let’s take the above assumptions and add some additional factors.

In order to convince the entity to enter into the lease, the lessor provides an incentive of $35,000 to the entity. In addition, the entity used a broker to locate the property and paid the broker a commission of $10,000. With these facts, the right-of-use asset now would be the sum of the $431,213 above, less $35,000 (lease incentive), plus $10,000 (initial direct costs), or $406,213.

Let’s continue the analysis to reflect the accounting as the property is used. At inception, the opening entry is as follows:

<table>
<thead>
<tr>
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<th>DR</th>
<th>CR</th>
</tr>
</thead>
<tbody>
<tr>
<td>Right-of-use asset</td>
<td>$406,213</td>
<td></td>
</tr>
<tr>
<td>Lease liability</td>
<td></td>
<td>$331,213</td>
</tr>
<tr>
<td>Cash</td>
<td></td>
<td>$75,000</td>
</tr>
</tbody>
</table>

The lease has been categorized as an operating lease and the entity has determined that its total fixed rent to be $475,000 ($500,000-35,000+10,000) Therefore, on an annual basis, it will recognize $95,000 of fixed rent expense.

After the first year, the CPI has increased by 2 percent. So the lease payment for year two will be $102,000. The entity's disclosure will reflect variable rents of $2,000 for year two. The lease payments will be reflected as operating cash flows in the entity's statement of cash flows.
That's fairly straightforward, and seems familiar, but what happens with the balance sheet accounts? Here is where the accounting gets tricky. Let's follow the journal entries.

At the end of each year, the entity must accrete the interest at 8 percent on the lease liability, record the rent expense, amortize the right-of-use asset and disburse the cash for year two rent. Note for this example, we will ignore the CPI rent increase.

<table>
<thead>
<tr>
<th>End of year 1 entry</th>
<th>DR</th>
<th>CR</th>
</tr>
</thead>
<tbody>
<tr>
<td>Rent expense</td>
<td>$95,000</td>
<td></td>
</tr>
<tr>
<td>Lease liability (accrue interest)</td>
<td></td>
<td>$26,497</td>
</tr>
<tr>
<td>Right-of-use asset</td>
<td></td>
<td>$68,503</td>
</tr>
<tr>
<td>End of year 1 balances</td>
<td>DR</td>
<td>CR</td>
</tr>
<tr>
<td>Right-of-use asset</td>
<td>$337,710</td>
<td></td>
</tr>
<tr>
<td>Lease liability</td>
<td></td>
<td>$357,710</td>
</tr>
<tr>
<td>Beginning of year 2 entry</td>
<td>DR</td>
<td>CR</td>
</tr>
<tr>
<td>Lease liability</td>
<td>$100,000</td>
<td></td>
</tr>
<tr>
<td>Cash</td>
<td></td>
<td>$100,000</td>
</tr>
<tr>
<td>Beginning of year 2 balances</td>
<td>DR</td>
<td>CR</td>
</tr>
<tr>
<td>Right-of-use asset</td>
<td>$337,710</td>
<td></td>
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<tr>
<td>Lease liability</td>
<td></td>
<td>$257,710</td>
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<tr>
<td>End of year 2 entry</td>
<td>DR</td>
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</tr>
<tr>
<td>Rent expense</td>
<td>$95,000</td>
<td></td>
</tr>
<tr>
<td>Lease liability (accrue interest)</td>
<td></td>
<td>$20,617</td>
</tr>
<tr>
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<td>$74,383</td>
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<tr>
<td>End of year 2 balances</td>
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</tr>
<tr>
<td>Right-of-use asset</td>
<td>$263,326</td>
<td></td>
</tr>
<tr>
<td>Lease liability</td>
<td></td>
<td>$278,326</td>
</tr>
<tr>
<td>Beginning of year 3 entry</td>
<td>DR</td>
<td>CR</td>
</tr>
<tr>
<td>Lease liability</td>
<td>$100,000</td>
<td></td>
</tr>
<tr>
<td>Cash</td>
<td></td>
<td>$100,000</td>
</tr>
<tr>
<td>Beginning of year 3 balances</td>
<td>DR</td>
<td>CR</td>
</tr>
<tr>
<td>Right-of-use asset</td>
<td>$263,326</td>
<td></td>
</tr>
<tr>
<td>Lease liability</td>
<td></td>
<td>$178,326</td>
</tr>
<tr>
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<tr>
<td>-----------------------------------</td>
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<td>-----</td>
</tr>
<tr>
<td><strong>End of year 3 entry</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Rent expense</td>
<td>$95,000</td>
<td></td>
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<tr>
<td>Lease liability (accrete interest)</td>
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<td>$14,266</td>
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<tr>
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<td></td>
<td>$80,734</td>
</tr>
<tr>
<td><strong>End of year 3 balances</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Right-of-use asset</td>
<td>$182,593</td>
<td></td>
</tr>
<tr>
<td>Lease liability</td>
<td></td>
<td>$192,593</td>
</tr>
<tr>
<td><strong>Beginning of year 4 entry</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Lease liability</td>
<td></td>
<td>$100,000</td>
</tr>
<tr>
<td>Cash</td>
<td></td>
<td>$100,000</td>
</tr>
<tr>
<td><strong>Beginning of year 4 balances</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Right-of-use asset</td>
<td>$182,593</td>
<td></td>
</tr>
<tr>
<td>Lease liability</td>
<td></td>
<td>$92,593</td>
</tr>
<tr>
<td><strong>End of year 4 entry</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Rent expense</td>
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<td></td>
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<tr>
<td>Lease liability (accrete interest)</td>
<td></td>
<td>$7,407</td>
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<tr>
<td>Right-of-use asset</td>
<td></td>
<td>$87,593</td>
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<tr>
<td><strong>End of year 4 balances</strong></td>
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<td></td>
</tr>
<tr>
<td>Right-of-use asset</td>
<td>$95,000</td>
<td></td>
</tr>
<tr>
<td>Lease liability</td>
<td></td>
<td>$100,000</td>
</tr>
<tr>
<td><strong>Beginning of year 5 entry</strong></td>
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<td></td>
</tr>
<tr>
<td>Lease liability</td>
<td></td>
<td>$100,000</td>
</tr>
<tr>
<td>Cash</td>
<td></td>
<td>$100,000</td>
</tr>
<tr>
<td><strong>Beginning of year five balances</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Right-of-use asset</td>
<td>$95,000</td>
<td></td>
</tr>
<tr>
<td>Lease liability</td>
<td></td>
<td>$0</td>
</tr>
<tr>
<td><strong>End of year five entry</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Rent expense</td>
<td>$95,000</td>
<td></td>
</tr>
<tr>
<td>Lease liability (accrete interest)</td>
<td></td>
<td>$0</td>
</tr>
<tr>
<td>Right-of-use asset</td>
<td></td>
<td>$95,000</td>
</tr>
<tr>
<td><strong>End of year five balances</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Right-of-use asset</td>
<td>$0</td>
<td></td>
</tr>
<tr>
<td>Lease liability</td>
<td></td>
<td>$0</td>
</tr>
</tbody>
</table>

As illustrated in this example, accounting for leases classified as operating can be quite complex as contrasted with the current model.

Although the rent expense running through the income statement is the same, the need to account for the balance sheet accounts over the term of the lease requires additional calculations and entries to be made each period.
Accounting for changes subsequent to the commencement date of the lease

ASC 842 addresses various scenarios where the initial lease terms or related assumptions about the lease may change and what the related accounting and re-measurements would be. Generally, there are two situations where an entity may need to re-measure the lease liability. These are:

— lease modifications, and
— other changes to the initial measurement due to changes in the original assumptions.

**Lease modifications**
The ASC 842 Glossary describes a lease modification as:

> A change to the terms and conditions of a contract that results in a change in the scope of or the consideration for a lease (for example, a change to the terms and conditions of the contract that adds or terminates the right to use one or more underlying assets or extends or shortens the contractual lease term).

Modifications can be handled in two ways, either as a new contract or as a modification to the initial contract. A modification is treated as a **new contract** when it confers to the lessee an additional right of use.

**Example: Modification grants an additional right of use**

Lessee entered into a ten-year lease for 10,000 square feet of office space. At the beginning of year six, the entity and the landlord agree to modify the lease for the remaining five years by adding an additional 10,000 square feet of space. The increased rent corresponds to the then market rate of rent. Because the entity acquires an additional right of use, it treats the modification as a separate new lease contract, for 10,000 square feet at the stated rent. It continues to account for the original ten-year lease in the same manner, and measures and records a new lease liability and right-of-use asset related to the modification.⁹
Example: Modification does not grant an additional right of use

Lessee enters into a ten-year lease for 10,000 square feet of office space with annual rents of $100,000 paid in arrears. The incremental borrowing rate at lease inception is 6 percent. The lease is classified as an operating lease. After five years, the lessee and landlord agree to a lease modification, adding five years to the initial lease term and changing the rent for the remaining ten years to $110,000. At the date of the modification the lessee’s incremental borrowing rate is 7 percent. At the end of the five years, the lease liability and right-of-use asset is $421,236. (Note since the lease payments are made in arrears and the payments are level throughout the lease term, the balances of the lease liability and the right-of-use asset will be equal).

Since the modification does not provide an additional right of use, the modification is not treated as a separate contract, but is accounted for as a modification of the original lease. The lessee must first reassess the classification by assessing the criteria for classification as a finance lease. The extended term and rent do not change the classification and the lessee continues to classify the lease as operating. Therefore, the lessee calculates the present value level rents of $110,000 for ten years at the new incremental borrowing rate of 7 percent; a total of $772,594. The right-of-use asset is increased by the difference, $351,358. There is no gain or loss as a result of the modification.⁴

Assume the same facts as above, except that instead of office space the right-of-use asset is a piece of equipment, with a remaining economic life of twelve years at the date of modification. Now the additional term of ten years causes the lease to be reclassified to a finance lease, as the remaining term exceeds 75 percent of the remaining economic life. Here, again, the calculation for the additional lease liability and the same adjustment is made to the right-of-use asset. However, going forward the lessee accounts for rent payments in the manner of a finance type lease recognizing interest expense (at 7 percent) and amortization of the right-of-use asset in the income statement. Thus, the income state effect will be to recognize more expense early in the lease and less in the later years, rather than straight line rent expense of $110,000 per year.
Re-measurements as a result of changes in the initial assumptions

ASC 842 requires the lessee to reassess the lease term or lease option to purchase, if any of the following occurs:

— There is a significant event or a significant change in circumstances that is within the control of the lessee that directly affects whether the lessee is reasonably certain to exercise or not to exercise an option to extend or terminate the lease or to purchase the underlying asset.
— There is an event that is written into the contract that obliges the lessee to exercise (or not to exercise) an option to extend or terminate the lease.
— The lessee elects to exercise an option even though the entity had previously determined that the lessee was not reasonably certain to do so.
— The lessee elects not to exercise an option even though the entity had previously determined that the lessee was reasonably certain to do so.\(^5\)

A lessee shall re-measure the lease payments if any of the following occur:

— The lease is modified and that modification is not accounted for as a separate contract in accordance with paragraph 842-10-25-8 (note accounting for this was addressed above).
— A contingency, upon which some or all of the variable lease payments that will be paid over the remainder of the lease term are based, is resolved such that those payments now meet the definition of lease payments. For example, an event occurs that results in variable lease payments that were linked to the performance or use of the underlying asset becoming fixed payments for the remainder of the lease term.
— There is a change in any of the following:
  — The lease term, as described in paragraph 842-10-35-1. A lessee shall determine the revised lease payments on the basis of the revised lease term (note accounting for this event was addressed above).
  — The assessment of whether the lessee is reasonably certain to exercise or not to exercise an option to purchase the underlying asset, as described in paragraph 842-10-35-1. A lessee shall determine the revised lease payments to reflect the change in the assessment of the purchase option.
  — Amounts probable of being owed by the lessee under residual value guarantees. A lessee shall determine the revised lease payments to reflect the change in amounts probable of being owed by the lessee under residual value guarantees.\(^5\)

The following examples illustrate some of the above concepts.
Example: Change in assumptions related to renewal option

Assume an entity enters into a property lease with an initial term of five years with an option to extend the term for an additional three years. The annual rents are $50,000 for the initial term and $55,000 for the extended term. At the inception of the lease the entity was not certain about the success of this expansion to the new space and determined it was probable that it would not take up the option to extend the lease. As such, it accounted for the lease using lease payments of $50,000 for five years, using its incremental borrowing rate of 7 percent. The present value was calculated as $205,010 and recorded as the lease liability with the corresponding right-of-use asset.

During the third year of the lease, the operations at the new location were exceeding all expectations and as a result the lessee made a significant investment in leasehold improvements to enhance the customers’ experience. As a result, the lessee now has a significant economic incentive to exercise the renewal option, in order to realize the full benefit of its investment in the improvements. As a result, the lessee must reassess its initial measurements.

At the time of the re-measurement (at the end of year 3) the lease liability is now $90,401, which is also the balance of the right-of-use asset (the balances are the same because the rent payments are made in arrears). On the re-measurement date the lessee’s incremental borrowing rate is now 7.5 percent. The lessee determines that the lease with the renewal still qualifies as an operating lease. The lessee calculates the net present value of the now 5 remaining lease payments, totaling $265,000 at a 7.5 percent discount rate to yield a new lease liability of $213,546. It records the following entry to adjust the balance sheet:

<table>
<thead>
<tr>
<th></th>
<th>DR</th>
<th>CR</th>
</tr>
</thead>
<tbody>
<tr>
<td>Right-of-use asset</td>
<td>$123,145</td>
<td></td>
</tr>
<tr>
<td>Lease liability</td>
<td></td>
<td>$123,145</td>
</tr>
</tbody>
</table>

The income statement effect would be calculated as follows:

**Annual rent expense**
Undiscounted cash flows $265,000+ (the right-of-use asset-lease liability) = $265,000/5=$53,000.

In this example, since the balance sheet accounts are equal, the annual rent is just the average for the five years. In other situations, such as when the rents are paid in advance or there are incentives or direct leasing costs, the annual rent is more complex to calculate. But the above formula will work.
Example: Change in assumption related to purchase option exercise

Assume an entity enters into a contract to lease some construction machinery. The terms of the lease are annual payments of $50,000 per year for 5 years, with a purchase option of $15,000 (not considered a bargain purchase option). The economic life of the asset is 6 years. At the inception of the lease it was not reasonably certain that the lessee would exercise the purchase option as it was not a bargain.

The lessee determined the lease at inception was a finance lease due to the lease term exceeding 75 percent of the economic life of the asset. Its incremental borrowing rate at inception was 5 percent and it used that rate to calculate the lease liability as $216,474. This amount is recorded also as the right-of-use asset.

After 3 years, the entity realizes the scope of the road building project for which the machine was rented has changed significantly and is likely to extend for an additional 2 years. As a result it determines it would be more economical to exercise the purchase option at the end of the 5 years rather than lease a new machine for an additional 2 years.

The lessee must re-measure its lease liability to reflect this change in assumptions. At the time of the re-measurement the lessee’s incremental borrowing rate is 4 percent. The balance sheet accounts are: Lease liability (at end of three years) $92,971; right-of-use asset (after 3 years of straight line amortization) $86,589.

The entity calculates a new lease liability as the net present value of the remaining lease payment:

$50,000 for 2 years, plus the $15,000 purchase option paid at the end of the fifth year, discounted at 4 percent. The new lease liability is $122,041. The increase in the lease liability is $29,070. The entity records the following journal entry:

<table>
<thead>
<tr>
<th>Right-of-use asset</th>
<th>DR</th>
<th>CR</th>
</tr>
</thead>
<tbody>
<tr>
<td>$29,070</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Lease liability</td>
<td></td>
<td>$29,070</td>
</tr>
</tbody>
</table>

The income statement effect would be:

| Right-of-use asset after adjustment | $115,659 |
| Three years remaining useful life  | 3        |
| Annual amortization through year six | $38,553 |

Annual interest expense related to new lease liability would be:

| Year four     | $4,882 |
| Year five     | $3,077 |
Those are just some basic examples of the reassessment and re-measurement concepts. In each situation, the entity must consider lease classification, changes in expected lease payments, changes in expected lease term, changes in exercise of purchase options and other features. In situations where there were index increases, adjustment to the original lease payment stream may be more complex.

Conclusion

As noted above, although accounting for finance leases will be familiar to entities used to capital lease accounting, the accounting for operating leases is quite complex and will require compound journal entries to properly accrete interest to the lease liability, reduce the right-of-use asset and properly recognize rent expense. In order to do so, many entities may need to use off system spreadsheets, as the legacy enterprise resource planning (ERP) systems may not be able to handle such entries automatically. This will, of course, require attention to internal control over financial reporting (ICFR). Moreover, when encountering the need for re-measurements, entities will need to document all of the assumptions and calculations to support the accounting after modifications.

1 ASC 842-10-55-(226-231)
2 ASC 842-10-55-(226-231)
3 Adapted from ASC 842-10-55-(160-161)
4 Adapted from ASC 842-10-55-(162-165)
5 ASC-842-10-35-1
6 ASC-842-10-35-4
Issues for lessors

Lessors’ accounting for leases is substantially unchanged by the new leases Accounting Standard Update No. 2016-02 (ASC 842). However, there are some relevant changes lessors should take note of.

Definitions

**Lessor:** An entity that enters into a contract to provide the right to use an underlying asset for a period of time in exchange for consideration.

**Underlying asset:** An asset that is subject to the lease for which a right to use has been conveyed to the lessee. The underlying asset could be a physically distinct portion of a single asset.

Lease classification

**There are no substantive changes for lessors with respect to lease classification.** Lessors will still classify leases as operating, sales-type or finance-type leases. The classification criteria is the same as for lessees, as follows:

A lessor shall classify a lease as a sales-type lease if any of the following criteria is met:

- The lease transfers ownership of the underlying asset to the lessee by the end of the lease term.
- The lease grants the lessee an option to purchase the underlying asset that the lessee is reasonably certain to exercise.
- The lease term is for the major part of the remaining economic life of the underlying asset. However, if the commencement date falls at or near the end of the economic life of the underlying asset, this criterion shall not be used for purposes of classifying the lease.
- The present value of the sum of the **lease payments** and any residual value guaranteed by the lessee that is not already reflected in the lease payments in accordance with paragraph 842-10-30-5(f) equals or exceeds substantially all of the **fair value** of the underlying asset.
- The underlying asset is of such a specialized nature that it is expected to have no alternative use to the lessor at the end of the lease term.\(^1\)
If none of these criteria are met, the lessor will classify the lease as an operating lease unless both of the following criteria are met and then the lessor will classify the lease as a direct financing lease:

1. The present value of the sum of the lease payments and any residual value guaranteed by the lessee that is not already reflected in the lease payments in accordance with paragraph 842-10-30-5(f) and/or any other third party unrelated to the lessor equals or exceeds substantially all of the fair value of the underlying asset.
2. It is probable that the lessor will collect the lease payments plus any amount necessary to satisfy a residual value guarantee.

Lease modifications

If an operating lease is modified in a way that does not terminate the initial lease but creates a new lease, the lessor needs to evaluate the terms of the modified lease to determine classification following this guidance:

— If the modified lease is classified as an operating lease, the lessor shall consider any prepaid or accrued lease rentals relating to the original lease as a part of the lease payments for the modified lease.
— If the modified lease is classified as a direct financing lease or a sales-type lease, the lessor shall derecognize any deferred rent liability or accrued rent asset and adjust the selling profit or selling loss accordingly.

If a direct financing lease is modified and not considered a new lease, the lessor should apply the following guidance:

— If the modified lease is classified as a direct financing lease, the lessor shall adjust the discount rate for the modified lease so that the initial net investment in the modified lease equals the carrying amount of the net investment in the original lease immediately before the effective date of the modification.
— If the modified lease is classified as a sales-type lease, the lessor shall account for the modified lease in accordance with the guidance applicable to sales-type leases in Subtopic 842-30, with the commencement date of the modified lease being the effective date of the modification. In calculating the selling profit or selling loss on the lease, the fair value of the underlying asset is its fair value at the effective date of the modification and its carrying amount is the carrying amount of the net investment in the original lease immediately before the effective date of the modification.
— If the modified lease is classified as an operating lease, the carrying amount of the underlying asset equals the net investment in the original lease immediately before the effective date of the modification.

Leveraged leases

For leveraged leases in effect at the effective date of ASC 842, the existing accounting model continues until the end of the lease term. The new standard does not recognize the concept of leveraged leases for any leases entered into after the effective date (see chapter regarding effective dates starting page 32).
Sale leaseback transactions

ASC 842 articulates the guidance for sale leaseback with ASC 606, Revenue from Contracts with Customers. Therefore, if the sale meets the criteria in ASC 606 to be recognized as revenue to the seller, the buyer lessor will account for the lease in accordance with ASC 842.

If the sale does not qualify for recognition in accordance with ASC 606, then the buyer lessor will not recognize the transferred asset and will record any amounts paid to the seller as a receivable in accordance with other topics.

All of the previous specialized guidance with respect to real estate sale leasebacks is not carried over into ASC 842.

Transition requirements for lessors

The objective within ASC 842, with respect to lessors, was basically to not have any significant changes in measurement and accounting models. As such, keep the following points in mind:

Operating leases

— Continue to recognize the carrying amount of the underlying asset and any lease assets or liabilities at the later of the date of initial application and the commencement date as the same amounts recognized by the lessor immediately before that date in accordance with Topic 840.
— Account for previously recognized securitized receivables as secured borrowings in accordance with other Topics.
— Write off, as an adjustment to equity, any unamortized initial direct costs at the later of the beginning of the earliest period presented in the financial statements or the commencement date of the lease that do not meet the definition of initial direct costs in this Topic (unless the lessor elects the practical expedients described in (f)).

5
Sales-type and direct financing leases

— Continue to recognize a net investment in the lease at the later of the beginning of the earliest comparative period presented in the financial statements and the commencement date of the lease, at the carrying amount of the net investment at that date. This would include any unamortized initial direct costs capitalized as part of the lessor’s net investment in the lease in accordance with Topic 840.
— Before the effective date, a lessor shall account for the lease in accordance with Topic 840.
— Beginning on the effective date, a lessor shall account for the lease in accordance with the recognition, subsequent measurement, presentation and disclosure guidance in Subtopic 842-30.
— Beginning on the effective date, if a lessor modifies the lease (and the modification is not accounted for as a separate contract in accordance with paragraph 842-10-25-8), it shall account for the modified lease in accordance with paragraph 842-10-25-16 if the modified lease is classified as a direct financing lease after the modification or paragraph 842-10-25-17 if the modified lease is classified as a sales-type lease after the modification. A lessor shall not re-measure the net investment in the lease on or after the effective date unless the lease is modified (and the modification is not accounted for as a separate contract in accordance with paragraph 842-10-25-8).

ASC 842 also provides guidance on accounting for leveraged leases or sales leasebacks that exist at the transition date. Here again, the goal is for the lessor entity not to encounter any significant change from current accounting.

Disclosure requirements

Disclosure requirements for lessors are extensive and include qualitative, as well as the expected quantitative, information required historically. Some of the qualitative disclosures are:

— Significant assumptions and judgments made in applying the standard, including whether a contract contains a lease, allocations between lease and non-lease components and the amount lessor expects to earn from the underlying asset at the end of the lease term
— Basis for determining variable lease payments

Conclusion

While the transition for lessors will not be as onerous as for lessees, there are considerations that lessor entities should make and these entities should evaluate their processes and controls if they have historically been active in sale leaseback or leveraged leases.

1 ASC 842-10-25-2
2 ASC 842-10-25-3
3 ASC 842-10-25-15
4 ASC 842-10-25-16
5 ASC 842-10-65-1
Effective dates and transition

Adoption of ASC 842 makes accounting much more complex for traditional operating leases. This inherent complexity makes the transition guidance equally complex. To address this complexity, the Financial Accounting Standards Board (FASB) has provided several practical expedients entities may use for the transition.

Effective dates

- Public business entities, not for profit entities with conduit debt and certain employee benefit plans that file with the Securities and Exchange Commission: Apply ASC 842 for fiscal years beginning after Dec. 15, 2018 and the interim periods within that year.
- For all other entities: Apply ASC 842 for fiscal years beginning after Dec. 15, 2019 and interim periods for years beginning after Dec. 15, 2020.
- Early application is permitted for both groups of entities.

Transition provisions

The basic provisions are:

- Entities shall apply the provisions of ASC 842 in one of two ways at transition:
  - To the earliest comparative period presented in the financial statements of the year of adoption with a cumulative effect change to retained earnings or comparable account.
  - Retrospectively at the beginning of the period of adoption with a cumulative effect adjustment to retained earnings or comparable account. (See update starting on page 41 for additional information.)
- The entity will adjust disclosures to reflect the adoption for the period(s) presented in the financial statements of the year of adoption.
Measurement requirements

Leases previously classified as operating leases

— For each lease, an entity must calculate a lease liability and a related right to use asset as of the beginning of the earliest period of adoption presented in the financial statements or as of the inception of the lease.

— The lease liability shall be measured as the present value, using a discount rate for the lease\textsuperscript{1}, of the sum of the remaining lease payments and any residual value guarantees that are probable of being paid.

— For leases classified as an operating lease in accordance with ASC 842\textsuperscript{2}, the right to use asset is measured as the amount of the lease liability plus or minus, any prepaid or accrued lease payments, remaining balance of unamortized lease incentives, unamortized direct initial lease cost; and the amount of any recognized liability related to exit or disposal cost obligations recorded in accordance with ASC 420.

— For leases classified as a finance lease in accordance with ASC 842\textsuperscript{3}, a lessee shall measure the right of use asset, as the applicable portion of the lease liability determined by the remaining lease term relative to the initial total lease term, plus or minus any prepaid or accrued lease payments and the amount of any recognized liability related to exit or disposal cost obligations recorded in accordance with ASC 420.

— Any unamortized initial direct costs that do not meet the definition in ASC 842\textsuperscript{4} shall be written off as a direct charge to equity.

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Example: Transition for an operating lease\textsuperscript{5}

The effective date for this entity to adopt ASC 842 is Jan. 1, 2019. The entity entered into a 5 year lease for an asset on Jan. 1, 2016 requiring annual payments at the end of the year; the entity incurred $500 in initial direct costs to be amortized over the lease term.

At Jan. 1, 2017, the entity had recognized $1,200 of accrued rent and 4 remaining lease payments; 1 of $31,000 and 3 of $33,000. The unamortized direct costs balance was $400.

As of Jan. 1, 2017, the earliest comparative period, the entity calculates a lease liability, using its incremental borrowing rate of 6 percent, as the present value of the above remaining lease payments, $112,462.

The corresponding right of use asset is calculated as $111,662 ($112,462 – $1,200 + $400). For subsequent measurements through the transition periods, 2017 and 2018, the entity will measure its lease liability and right of use asset in accordance with ASC 842 and, as it is an operating lease, will recognize rent expense.
Leases previously classified as capital leases

— For leases classified as a finance lease in accordance with ASC 842, an entity shall⁶:
  — Recognize a right to use asset and a lease liability at the beginning of the earliest period presented or
    the commencement date of the lease in accordance with extant GAAP in ASC 840.
  — Include any unamortized initial direct costs that meet the definition in ASC 842 in the right to use asset.
  — Write off as a direct charge to equity any unamortized initial direct costs that do not meet the definition
    in ASC 842.

— For leases classified as operating leases in accordance with ASC 842, an entity shall⁷:
  — Derecognize the carrying amount of any capital lease asset and liability as of the earlier of the
    beginning of the earliest period presented or the inception of the lease. Any difference shall be
    accounted for in the same manner as prepaid or accrued rent.
  — Recognize a right of use asset and lease liability in the manner required by ASC 842, at the earlier of the
    beginning of the comparative period or the commencement date of the lease.
  — Write off as a direct charge to equity any unamortized initial direct costs that do not meet the
    definition in ASC 842.

Example: Transition for a capital lease⁸

The effective date for the entity to adopt ASC 842 is Jan. 1, 2019. The lessee had entered into a
seven year lease on Jan. 1, 2016 requiring annual payments of $25,000 at the end of each year.
The lease included a residual value guarantee of $8,190. At the inception of the lease the entity
determined it should be classified as a capital lease, and using its incremental borrowing rate
at the time of 6 percent, calculated a capital lease obligation and recorded a capital lease asset.
Additionally, the lessee capitalized direct costs of $2,800.

At the transition date, the earliest period presented is Jan. 1, 2017. As of that date, the entity
has a lease liability of $128,707, a lease asset of $124,434 and unamortized direct costs of
$2,400. Therefore, at transition the entity continues to recognize a lease liability in the amount
of $128,707 and recognizes a right of use asset of $126,834, which is the asset balance plus the
unamortized direct costs.

For subsequent measurements through the transition periods, 2017 and 2018, the entity will
measure its lease liability and right of use asset in accordance with ASC 842 and continue to
recognize in the statement of comprehensive income, interest expense and amortization of the
right to use asset in a manner similar to what was previously recognized under extant GAAP.
Subsequent measurement

For both transition examples, the subsequent measurement will be in accordance with ASC 842 as applied to operating leases or finance type leases.

Practical expedients

While the transition requirements are fairly complex, the FASB fortunately has provided some practical expedients for transition. The practical expedients apply to all leases in place at the time of transition. However, the practical expedients must be applied altogether as a package.

The practical expedients are:

1. An entity need not reassess whether any expired or existing contracts are or contain leases.
2. An entity need not reassess the lease classification for any expired or existing leases (that is, all existing leases that were classified as operating leases in accordance with Topic 840 will be classified as operating leases, and all existing leases that were classified as capital leases in accordance with Topic 840 will be classified as finance leases).
3. An entity need not reassess initial direct costs for any existing leases.9

In addition, the standard provides this practical expedient which may be elected separately from the above:

An entity also may elect a practical expedient, which must be applied consistently by an entity to all of its leases (including those for which the entity is a lessee or a lessor) to use hindsight in determining the lease term (that is, when considering lessee options to extend or terminate the lease and to purchase the underlying asset) and in assessing impairment of the entity’s right-of-use assets. This practical expedient may be elected separately or in conjunction with the practical expedients in (f).10
Conclusion

For entities that rely extensively on leases for operating assets, the transition is likely to be labor intensive even when applying the practical expedients. All lease contracts will need to be inventoried and an analysis of each will need to be undertaken to determine relevant information to calculate the beginning lease liability and the related right of use asset. It may be possible for some companies to apply a portfolio approach if they have groups of similar assets entered into at the same time with similar lease terms. Although the portfolio approach is permitted, the entity will need to support the assertion that applying such an approach is not materially different from analyzing each contract individually.

Entities will need to provide supporting documentation for their auditors to demonstrate the transition process was adequately controlled and the risk of material misstatement was appropriately managed.

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1 This is the rate implicit in the lease, or if not determinable the lessees incremental borrowing rate. Non-public entities may substitute the risk free rate for the comparable period. The rate is established as the earlier of the beginning of the comparative period or the inception date of the lease, as in the first bullet.
2 See practical expedients discussion
3 See practical expedients discussion
4 Per the Glossary: Incremental costs of a lease that would not have been incurred if the lease had not been obtained.
5 ASC 842-10-55-249-254
6 See practical expedients discussion
7 See practical expedients discussion
8 ASC 842-10-55-244-247
9 ASC 842-10-65-1 (f)
10 ASC 842-10-65-1 (g)
Presentation and disclosures

The adoption of Accounting Standards Codification (ASC) 842, Leases, makes accounting much more complex for traditional operating leases. Not surprisingly, the disclosure requirements are quite extensive. Additionally, the new leases standard has specific requirements as to how leasing activity is to be presented in the basic financial statements.

Presentation matters

Statement of financial position

ASC 842 requires each type of lease, operating or finance type, to be displayed in the statement of financial position. The related right to use asset must be presented separately from other assets, as well as from each other. The corresponding lease liabilities also must be presented separately from other liabilities and from each other.

— The classification of the assets and liabilities as current or noncurrent will be subject to the same considerations as other assets and liabilities.
— If an entity chooses not to provide the display noted above, the entity may disclose which line items in the statement of financial position contain the related assets and liabilities for operating leases and finance type leases, and the relevant balances.
— An entity is prohibited from combining the assets and liabilities of the different types of leases in the same line item.

Statement of comprehensive income

There are no substantive changes from current practice related to display in this statement. For finance type leases, the related interest expense need not be separately stated and the amortization of the right to use asset may be combined with other amortization expense.

The rent expense from operating leases needs to be included in the income from continuing operations.

Statement of cash flows

Repayments of the principle portion of finance leases are classified as financing activities and related interest expense is classified in the same manner as interest paid as required in Topic 230. Operating lease payments are classified within operating activities, except for expenditures to make the asset ready for use — such as moving and related set up costs, which should be classified as investing activities. Related variable lease payments and payments related to short term leases will be classified in operating activities.
Disclosure

The overall objective of the disclosure requirements is to enable users of the financial statements to understand the “...amount, timing and uncertainty of cash flows arising from leases.” A lessee will need to disclose quantitative and qualitative information about its leases, the related significant judgments made in measuring leases and the amounts recognized in the financial statements. An entity needs to consider the required level of detail to meet this objective, including the extent of aggregation or disaggregation used in the disclosures.

Required disclosures

Although ASC 842 is considered to be a principle-based standard, specific required disclosures are as follows:

1. Information about the nature of its leases, including:
   1. A general description of those leases
   2. The basis and terms and conditions on which variable lease payments are determined
   3. The existence and terms and conditions of options to extend or terminate the lease
      • A lessee should provide narrative disclosure about the options that are recognized as part of its right-of-use assets and lease liabilities and those that are not
   4. The existence and terms and conditions of residual value guarantees provided by the lessee
   5. The restrictions or covenants imposed by leases (for example, those relating to dividends or incurring additional financial obligations)
2. A lessee should identify the information relating to subleases included in the disclosures provided in (a.1) through (a.5), as applicable
3. Information about leases that have not yet commenced but that create significant rights and obligations for the lessee, including the nature of any involvement with the construction or design of the underlying asset
4. Information about significant assumptions and judgments made in applying the requirements of this Topic, which may include the following:
   — The determination of whether a contract contains a lease (as described in paragraphs 842-10-15-2 through 15-27)
   — The allocation of the consideration in a contract between lease and nonlease components (as described in paragraphs 842-10-15-28 through 15-32)
   — The determination of the discount rate for the lease (as described in paragraphs 842-20-30-2 through 30-4)

Total lease cost

An entity shall also disclose information related to its total lease cost, including amounts recognized in the income statement and costs capitalized related to leases and the related cash flows. This is accomplished by providing the following disclosures:

— Finance lease cost, segregated between the amortization of the right-of-use assets and interest on the lease liabilities
— Operating lease cost determined in accordance with paragraphs 842-20-25-6(a) and 842-20-25-7
— Short-term lease cost, excluding expenses relating to leases with a lease term of one month or less, determined in accordance with paragraph 842-20-25-2
— Variable lease cost determined in accordance with paragraphs 842-20-25-5(b) and 842-20-25-6(b)
— Sublease income, disclosed on a gross basis, separate from the finance or operating lease expense
— Net gain or loss recognized from sale and leaseback transactions in accordance with paragraph 842-40-25-4
— Amounts segregated between those for finance and operating leases for the following items:
  — Cash paid for amounts included in the measurement of lease liabilities, segregated between operating and financing cash flows
  — Supplemental noncash information on lease liabilities arising from obtaining right-of-use assets
  — Weighted-average remaining lease term
  — Weighted-average discount rate³

**Future lease payment requirements**

A lessee must also disclose the future lease payment requirements, undiscounted, for the first five years and the total for the remaining lease term. This requirement, of course, is a requirement of the current lease standard.

**Related parties**

If relevant, a lessee will separately disclose its lease transactions with related parties and information related to its short term leases commitments. If an entity elects the practical expedient for not separately accounting for nonlease components in a lease contract, this policy and information for which classes of assets the election has been made must be disclosed.

**Conclusion**

The new disclosure requirements will potentially require new process and controls, especially related to the accounting for operating leases. ASC 842 provides an example of how the quantitative disclosure could be displayed in Example 6, ASC 842-20-55-4. Examples of related qualitative disclosures are not provided. Entities will need to consider how and in what format the required information should be provided, possibly using its current lease footnote as a starting point and building from there. The disclosures are subject to audit and, for issuers, will be in scope for management’s report on internal controls.

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1 ASC 842-20-5-1
2 ASC 842-20-50-3
3 ASC 842-20-5-4
Addendum:
Recent developments

As the adoption date for Accounting Standards Codification 842: Leases (ASC 842), rapidly approaches, the Financial Accounting Standards Board (FASB) has issued, or plans to issue, some additional guidance related to the transition. This guidance is a result of FASB stakeholders requesting relief in narrow areas where applying the extant guidance is burdensome and generally does not provide the users of the financial statements with highly relevant information. These include a practical expedient for accounting for land easements (ASU 2018-01), and a proposed ASU regarding targeted transition improvements.

ASU 2018-01, Leases (Topic 842) Land Easement Practical Expedient for Transition to Topic 842

In this accounting standards update (ASU), the FASB addressed concerns of stakeholders with respect to the accounting for land easements. Land easements are defined as “...the right to use, access, or cross another entity’s land for a specified purpose.”

Prior to the issuance of ASC 842, the accounting for these land easements was somewhat diverse. Entities accounted for them by applying ASC Topic 840, Leases; Topic 350, Intangibles-Goodwill and Other; or Topic 360, Property, Plant and Equipment. Additionally, many of these easements were very old and in some industries (such as gas pipelines) exceedingly numerous. The stakeholders also pointed out that in many cases, the easements were prepaid and therefore already reflected on the balance sheet as an asset.

In response, the FASB has provided an optional practical expedient for land easements existing at the transition date to ASC 842. Entities may elect to not evaluate these easements in accordance with ASC 842, and to continue the existing accounting treatment. The basic requirements, if the practical expedient is elected, are:

- An entity must not have accounted for land easements as leases in accordance with ASC 840, Leases
- An entity must apply this practical expedient consistently to all current or expired land easements
- An entity should continue you to apply its current accounting policy (under ASC 350 or ASC 360) for existing land easements at transition
- Topic ASC 842, should be applied prospectively to all new land easement contracts, to determine whether the contract contains a lease
- If the entity elects this practical expedient, it should disclose this along with other practical expedients
- If an entity determines not to apply this practical expedient it should apply transition guidance provided for applying ASC 842, to all its easements
ASU 2018-11, Leases (Topic 842) Targeted Improvements

In this ASU, the FASB provides some technical improvements to the standard, which will provide some relief to the adoption with two practical expedients as follows:

**Comparative reporting at transition**

In response to concerns voiced by many constituents as to the difficulty of retrospectively applying the new lease standard to the earliest period presented, the FASB has provided an alternative. Entities may now elect to adopt the new lease standard for the first time in the year of adoption. Entities may now present the right to use asset and related lease liability as of the beginning of the adoption year, with any difference being recorded as a cumulative effect adjustment to retained earnings. This does not change how the requirements of the standards apply.

**Separating components of a contract**

The standard requires that lease and nonlease components (such as maintenance services or other activities) be separated and nonlease components should be accounted for in accordance with other standards such as ASC 606, Revenue from Contracts with Customers. The consideration in the contract is to be allocated to each component based on relative standalone prices basis. The standard does provide a practical expedient for lessees which permits accounting for the lease and nonlease components together as a single lease component. Certain disclosures are required if the lessee adopts this practical expedient.

The standard did not permit this practical expedient to be used by lessors. After hearing from lessee constituents about the difficulty of applying this requirement, the FASB has extended the practical expedient to lessors as well. However, the timing and pattern of revenue recognition must be the same for the nonlease components and related lease components; and the combined single lease component would be classified as an operating lease.

The issuance of these ASUs related to ASC 842 is welcome news and is likely to significantly reduce the degree of difficulty in initially applying the new lease standard.
About the author

Philip Santarelli, CPA, is a partner emeritus at Baker Tilly. His experience includes leadership within the audit and accounting practice, risk management, quality assurance and technical resources and capabilities – including ASC 606 and ASC 842.

As past chair of the American Institute of Certified Public Accountants’ private companies section technical issues committee, he interfaced with accounting and auditing standard setters and provided comments and perspectives on the impact of accounting standards for private companies.

Industry involvement

- American Institute of Certified Public Accountants (AICPA)
- AICPA Financial Reporting Executive Committee (FinRec)
- AICPA Private Companies Practice Section, Technical Issues Committee (TIC), past chair
- AICPA Auditing Standards Board, Special Considerations - Audits of Group Financial Statements (including the Work of Component Auditors) (AU-C 600) task force
- Center for Audit Quality, Professional Practice Executive Committee and Smaller Firm Task Force, chair
- Public Company Accounting Oversight Board, Standing Advisory Group
- Financial Accounting Standards Board
- FASB Private Company Financial Reporting Resource Group
- FASB NFP Financial Reporting Resource Group
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