ASC 842 LESSEE HANDBOOK

FASB ACCOUNTING STANDARDS CODIFICATION TOPIC 842, *LEASES,* AS AMENDED THROUGH ACCOUNTING STANDARDS UPDATE NO. 2021-09

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BACKGROUND

Sikich LLP has prepared this ASC 842 Lessee Handbook to assist you in obtaining a foundational understanding of the new lease accounting standards in FASB ASC Topic 842, Leases, as it pertains to lessees. Lessor accounting is largely unchanged from the prior standards (FASB ASC Topic 840). This handbook will help you understand the key concepts, terminology, measurement mechanisms and policy elections necessary to implement the new lease accounting standards in most circumstances. **This handbook is not an exhaustive guide to FASB ASC Topic 842.** A glossary of terms is provided in ASC Section 842-10-20. Terms used in this handbook have the same meanings as provided in that guidance.

The FASB began work on the new lease accounting standards in July 2006 in response to concerns over off-balance sheet arrangements, illuminated by the Enron scandal. The FASB, in collaboration with the IASB, issued a preliminary views Discussion Paper in March 2009, followed by the first Exposure Draft in August 2010. Responding to strong feedback on the initial proposal, the FASB and the IASB issued a revised Exposure Draft in May 2013. Ultimately, the FASB and the IASB diverged on certain matters, each issuing separate but similar lease accounting standards. The FASB's Accounting Standards Update No. 2016-02, Leases, (Topic 842) was issued in February 2016. Since then, ASC Topic 842 has been amended by 12 subsequent Accounting Standards Updates (through ASU 2021-09), including deferrals of the effective dates.

Considering that it took nearly 10 years for the FASB to develop and issue Accounting Standards Update 2016-02, which created ASC Topic 842, and that the standards have subsequently been amended and deferred almost six additional years for some entities, you should expect for the new standards to have significant impacts on lease accounting and that implementation will have its challenges.

In addition to this handbook, Sikich LLP has developed the Lessee Ledger, an Excel based lease accounting solution and related user guide, which may meet the ASC 842 compliance needs of many companies. For more information on the Sikich Lessee Ledger, contact your Sikich representative or request a demo on our website: https://www.sikich.com/accounting-tax-audit/new-lease-accounting-standards/.

Throughout this handbook you will note the following highlighted elements:

EXCERPTS FROM FASB GUIDANCE

Selected excerpts from FASB guidance are included throughout this handbook to provide the original text of the guidance. Please refer to each section header for paragraphs extracted from or referencing to the guidance text.

POLICY ELECTION

Implementing ASC Topic 842 requires entities to make several policy elections. These policy elections, presented in their original text, are highlighted throughout this handbook. The various policy elections are also identified and referenced within the table of contents.

PRACTICAL EXPEDIENT

The transition guidance in ASC Topic 842 allows for the use of several practical expedients to reduce the cost and burden of adoption. These practical expedients, presented in their original text, are highlighted throughout this handbook. The various practical expedients are also identified and referenced within the table of contents.

SCOPE AND SCOPE EXCEPTIONS

The guidance in ASC 842 applies to all leases, including subleases. However, the standard specifically excludes the following:

1. Leases of intangible assets.
2. Leases to explore for or use minerals, oil, natural gas and similar nonregenerative resources. This exception applies to the intangible right to explore for and use the related land; it does not apply to equipment used to explore for such resources.
3. Leases of biological assets, including timber.
4. Leases of inventory.
5. Leases of assets under construction.

Notably, leases between related parties are not excluded. Rather, the applicability of the guidance in ASC 842 to leases between related parties is affirmed within the standard.

ASC 842-10-55-12

Leases between related parties should be classified in accordance with the lease classification criteria applicable to all other leases on the basis of 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.

There are two additional opportunities to elect to not apply the guidance in ASC 842 to certain leases: short-term leases and leases below a reasonable recognition threshold.

Short-term leases

Lessees can make an accounting policy election (by class of underlying asset to which the right of use relates) to apply accounting similar to prior operating lease accounting guidance in ASC Topic 840 to leases that meet the definition of a short-term lease. A short-term lease is a lease that, at the commencement date, has a lease term of 12 months or less and does not include an option to purchase the underlying asset that the lessee is reasonably certain to exercise.

POLICY ELECTION – SHORT-TERM LEASES (ASC 842-20-25-2)

As an accounting policy, a lessee may elect not to apply the recognition requirements in this Subtopic to short-term leases. Instead, a lessee may recognize the lease payments in profit or loss on a straight-line basis over the lease term and variable lease payments in the period in which the obligation for those payments is incurred (consistent with paragraphs 842-20-55-1 through 55-2). The accounting policy election for short-term leases shall be made by class of underlying asset to which the right of use relates.

However, if either of the following conditions is met, the lease no longer qualifies for the short-term lease exception:

1. the lease term is changed subsequent to commencement date such that it extends more than 12 months from the end of the previously determined lease term, or
2. it becomes reasonably certain that the lessee will exercise a purchase option.

Under those conditions, the lessee must apply the guidance in ASC 842 as of the date of the change in circumstances as if the lease commenced on that date.

Reasonable recognition threshold

Consistent with other areas of GAAP where entities' application of guidance is not required for items deemed to be immaterial, entities may establish a dollar threshold below which the guidance in ASC 842 will not be applied to lease contracts.

POLICY ELECTION - REASONABLE RECOGNITION THRESHOLD (ASU 2016-02 BC122)

The Board observed that, in addition to accounting for some leases at a portfolio level, entities will likely be able to adopt reasonable capitalization thresholds below which lease assets and lease liabilities are not recognized, which should reduce the costs of applying the guidance. An entity's practice in this regard may be consistent with many entities' accounting policies in other areas of GAAP (for example, in capitalizing purchases of property, plant and equipment).

In addition to considering the capitalization threshold for property, plant and equipment, if applicable, the entity should consider the aggregate impact of a selected threshold. If the exclusion of lease liabilities and ROU assets for all lease contracts under the selected threshold in total would be material to users of the financial statements, the selected threshold would not be appropriate even though the individual contracts are immaterial. Entities should also consider whether the policy can reasonably be based on undiscounted cash flows or the net present value of those cash flows at lease commencement.

The portfolio approach is discussed on pages 10-11 of this handbook.

DEFINITION OF A LEASE

The determination of whether a contract is or contains a lease is made at the contract inception.

ASC 842-10-15-3

A contract is or contains a lease if the contract conveys the right to control the use of identified property, plant or equipment (an identified asset) for a period of time in exchange for consideration. A period of time may be described in terms of the amount of use of an identified asset (for example, the number of production units that an item of equipment will be used to produce).

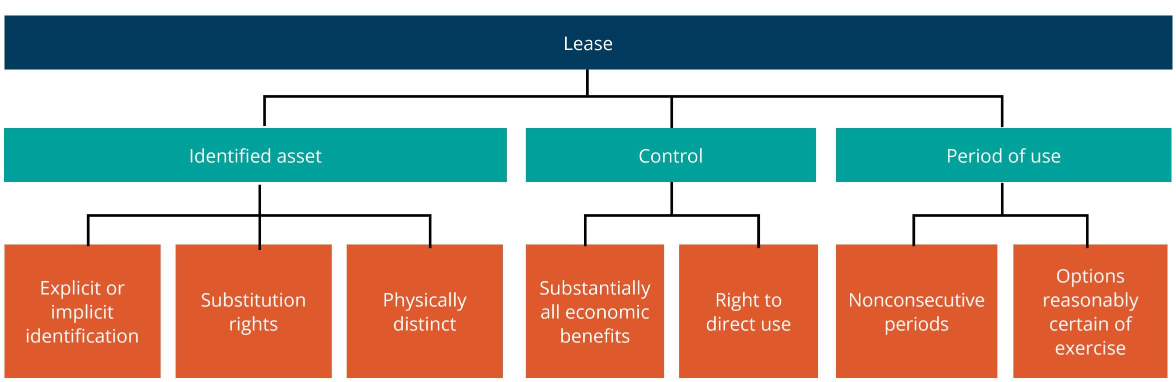
ASC 842-10-15-4

To determine whether a contract conveys the right to control the use of an identified asset for a period of time, an entity shall assess whether, throughout the period of use, the customer has both:

a. The right to obtain substantially all the economic benefits from the use of the identified asset.

b. The right to direct the use of the identified assets.

The key elements of a lease and related concepts can be illustrated as follows:



IDENTIFIED ASSET

Explicit or implicit identification

> **ASC 842-10-15-9**
>
> An asset is typically identified by being explicitly specified in a contract. However, an asset also can be identified by being implicitly specified at the time that the asset is made available for use by the customer.

Leases may be embedded in contracts that are not, by name, considered lease agreements. Examples may include outsourced manufacturing, supply arrangements that bundle services and equipment, use of data centers and more. Entities will need to consider supply arrangements and service contracts to determine if they include an identified asset. If they do, entities then need to determine if they have control of that identified asset through the arrangement.

Substitution rights

> **ASC 842-10-15-10**
>
> Even if an asset is specified, a customer does not have the right to use an identified asset if the supplier has the substantive right to substitute the asset throughout the period of use. A supplier has the substantive right to substitute if both of the following conditions are met:
>
> **a.** 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).
>
> **b.** 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).

The determination of whether a supplier's substitution rights are substantive is made at the inception of the contract and does not consider future events that at contract inception are not likely to occur. In making this determination, the customer should consider a number of factors, such as:

1. Location of the asset (customer premises versus supplier premises).
2. If right or obligation to substitute the asset only after a specified date or occurrence of a specified event.
3. If right to substitute the asset is only for repairs or technical upgrades.

Determining whether a supplier's substitution rights are substantive can be a complex analysis and must be based on the specific rights granted in the contract and only future events that are likely to occur as of the inception of the contract. Establishing that the supplier would benefit economically from exercising substitution rights is intended to be a relatively high threshold and needs to be established with a reasonably high degree of certainty.

Substitution rights that are substantive are expected to be identified more frequently in service contracts and supply arrangements than in real estate leases. Take, for example, a real estate lessor which leases distinct units of a larger complex to multiple tenants. The lease contract may include substitution rights under which the lessor can at any time during the lease term relocate the lessee to a similar unit if the lessor were able to locate another tenant that would pay more for the specified unit. In this scenario, the lessee might determine that the substitution right is not substantive as (1) the future event of locating another tenant to pay more is not likely to occur and (2) it would be difficult at lease inception to determine the lessor would economically benefit from the substitution after considering other costs, such as relocation of the existing tenant and installation of the new tenant.

If the customer is unable to determine if substitution rights are substantive, the customer shall presume they are not substantive.

Physically distinct

An identified asset can be a portion of a larger asset, as long as that portion is physically distinct.

> **ASC 842-10-15-16**
>
> A capacity portion of an asset is an identified asset if it is physically distinct (for example, a floor of a building or a segment of a pipeline that connects a single customer to the larger pipeline). A capacity or other portion of an asset that is not physically distinct (for example, a capacity portion of a fiber optic cable) is not an identified asset, unless it represents substantially all of the capacity of the asset and thereby provides the customer with the right to obtain substantially all of the economic benefits from use of the asset.

Common examples include:

1. a floor in a building,
2. a dedicated production line within a manufacturing facility,
3. a network that connects a single customer to a larger network.

CONTROL

Substantially all of the economic benefits

> **ASC 842-10-15-17**
>
> To control the use of an identified asset, a customer is required to have the right to obtain substantially all of the economic benefits from use of the asset throughout the period of use (for example, by having exclusive use of the asset throughout that period). A customer can obtain economic benefits from use of an asset directly or indirectly in many ways, such as by using, holding, or subleasing the asset. The economic benefits from use of an asset include its primary output and by-products (including potential cash flows derived from these items) and other economic benefits from using the asset that could be realized from a commercial transaction with a third-party.

If the contract includes limitations on the customer's right to use the asset, the assessment of whether the customer has the right to obtain substantially all the economic benefits from the use of the asset should be confined to those limitations. For example, if the contract specifies use up to a predetermined capacity (hours, units, miles, etc.), then only the economic benefits from use up to that capacity should be considered. The standard illustrates this through the consideration of a motor vehicle. If the contract limits the use of the motor vehicle to a particular geographic area during the period of use, the lessee considers the economic benefits of the use of the motor vehicle within that geographic area only. If the contract limits the use of the motor vehicle up to a predetermined number of miles during the period of use, the lessee considers the economic benefits for the permitted mileage only.

Right to direct use

> **ASC 842-10-15-20**
>
> The customer has the right to direct the use of an identified asset throughout the period of use in either of the following situations:
>
> **a.** The customer has the right to direct how and for what purpose the asset is used throughout the period of use (as described in paragraphs 842-10-15-24 through 15-26).
>
> **b.** The relevant decisions about how and for what purpose the asset is used are predetermined (see paragraph 842-10-15-21) and at least one of the following conditions exists:
>
> **1.** The customer has the right to operate the asset (or to direct others to operate the asset in a manner that it determines) throughout the period of use without the supplier having the right to change those operating instructions.
>
> **2.** The customer designed the asset (or specific aspects of the asset) in a way that predetermines how and for what purpose the asset will be used throughout the period of use.

Examples of decision making rights that may indicate the customer has the right to direct how and for what purpose the asset is used include:

1. The right to change the type of output produced by the asset.
2. The right to change when the output is produced.
3. The right to change where the output is produced.
4. The right to change how much output is produced or if any is produced at all.

The relevant decisions about how and for what purpose the asset is used can be predetermined in a number of ways including by the design of the asset (only fit for a particular use) or by contractual restrictions (only certain uses allowed).

The guidance provides several examples to illustrate the right to direct use concept.

RETAIL UNIT – A customer enters into a contract to use physically distinct retail space within a larger retail complex. The contract requires the customer to operate its store within the hours that the larger complex is open. The customer makes all decisions as to how the space is operated within those hours including the mix of products to be sold, pricing of the goods to be sold, staffing, physical access, etc. While the property owner dictates the hours of operation, the customer has the right to direct the use of the retail space during those hours.

TRUCK RENTAL – A customer enters a contract to lease a truck for a period of time to transport cargo between two locations. Only cargo specified in the contract is allowed to be transported in the truck and a mileage limit is established. The customer is able to make all decisions about the details of the trip (including route, speed, stops, driver, etc.). How and for what purpose the truck will be used (specified cargo, specific origination and destination as well as specified timeframe and mileage) are predetermined in the contract. The customer has the right to direct the use of the truck during the period of use as it make all decisions about how to operate the truck within the terms of the contract.

CARGO SHIP – A customer enters into a contract to transport cargo on a specified ship and will occupy substantially all the capacity of the ship. The contract specifies the cargo to be transported and the dates of pickup and delivery. The supplier is responsible for operating and maintaining the ship and ensuring safe transportation of the cargo. The customer does not have the right to direct the use of the ship. How and for what purpose the ship will be used are predetermined in the contract. The customer has no rights to decide how the ship is operated from origination to destination during the period of use.

AIRCRAFT – A customer enters into a contract to use a specified aircraft for a two-year period. There are contractual and legal restrictions on where the aircraft can fly. The contract also stipulates restrictions related to weather and other conditions and well as prohibited cargo. The supplier is responsible for operating the aircraft and providing the crew. The customer is prohibited from hiring a different operator. While the contractual restrictions provide protective rights to the supplier and define the scope of use by the customer, the customer still directs the use of the aircraft during the period of use as it determines when and where the aircraft flies, the passengers and the cargo to be transported (subject to the contractual restrictions).

Additional illustrations and alternative fact patterns are provided in FASB ASC 842-10-55.

PERIOD OF USE

The period of use, or lease term, begins at the date on which the lessor makes the underlying asset available to the lessee and includes any rent-free periods provided by the lessor. The lease term also includes the following:

A lease is not enforceable if both the lessee and lessor have the right to terminate the lease without permission from the other party with no more than an insignificant penalty.

> **ASC 842-10-30-1**
>
> An entity shall determine the lease term as the noncancellable period of the lease, together with all of the following:
>
> **a.** Periods covered by an option to extend the lease if the lessee is reasonably certain to exercise that option.
>
> **b.** Periods covered by an option to terminate the lease if the lessee is reasonably certain not to exercise that option.
>
> **c.** Periods covered by an option to extend (or not to terminate) the lease in which exercise of the option is controlled by the lessor.

Options reasonably certain to be exercised

In determining what is reasonably certain, the entity should consider all relevant factors that create economic incentive to exercise the option. These factors may be contract-based, asset-based, entity-based and/or market based. Examples include renewal rates below future market rates, existence of significant leasehold improvements, cost of obtaining a new lease and possibly relocating and the importance of the underlying asset to the lessee (specialized nature, specific location, etc.).

Nonconsecutive periods

The lease term may be comprised of nonconsecutive periods of use. For example, a contract for the use of an asset for the same six months each year over a period of three years may qualify as a lease under ASC 842 where the lease term consists of three separate six-month periods of use.

SEPARATING COMPONENTS OF A CONTRACT

At inception, the lessee needs to identify the various components of a contract and classify them as lease components and nonlease components. Components, broadly, are those items or activities which transfer a good or service. Lease components are those that convey the right to use an identified asset. Nonlease components are those that are associated with the use of an identified asset but are not integral to the use of the asset. Examples of nonlease components are maintenance, security services, provision of an operator for the asset and supplies or materials consumed in the use of the asset.

Costs within a lease contract that do not transfer a good or service, such as taxes and insurance, are generally costs of securing the asset and do not represent separate components of the contract. The accounting for these costs will depend on whether they are fixed or variable payments. Refer to the guidance on variable payments in the Recognition and Initial Measurement section of this handbook. The following accounting treatments will generally be true:

> If the payments for these costs are fixed or variable based on a rate or index, then they are included in contract consideration and allocated to the identified components for classification and measurement. This would typically occur when the amount for taxes and insurance are fixed dollar amounts stated in the lease contract and paid to the lessor as a reimbursement of its costs.
>
> If the payments for these amounts are variable and not based on a rate or index, then they are not included in contract consideration for classification and measurement. These payments are recognized as variable lease expense as incurred. This would typically occur when the amounts for taxes and insurance are based on actual amounts billed by the third-party, whether they are paid to the lessor or directly to the third-party.

While it may appear that property taxes are variable based on a tax rate, their variability is also dependent on assessed property values and, therefore, not solely variable based on a rate or index.

Lease components should be accounted for separately (i.e., each is recognized and measured separately) when both the following criteria 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 (excluding other components of the contract).
2. The right of use is neither highly dependent on nor highly interrelated with the other rights to use underlying assets in the contract.

If one or both of these criteria are not met, the right to use multiple assets is considered a single lease component. However, in leases involving both land and other assets, the right to use the land should be accounted for as a separate lease component unless the effect of doing so would be insignificant.

ASC 842 does, however, provide for an accounting policy election to not separate nonlease components from lease components. Election not to separate nonlease components from lease components may simplify the accounting process but will increase the lease liabilities and ROU assets reported in the financial statements.

Nonlease components are not within the scope of ASC 842 and other guidance should be applied as appropriate.

POLICY ELECTION – NONLEASE COMPONENTS (ASC 842-10-15-37)

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

Allocation of contract consideration

For contracts including multiple components, the consideration in the contract shall be allocated to each of the components based on their relative standalone prices. The guidance states that the standalone selling price is the price at which an entity would sell a promised good or service separately to a customer. The best evidence of a standalone selling price, according to ASC 842, is the observable price of a good or service when the entity sells that good or service separately in similar circumstances and to similar customers. If not readily determinable, standalone prices may be estimated, maximizing use of observable information.

Suitable methods for estimating the standalone selling price of a good or service include, but are not limited to, the following:

1. **Adjusted market assessment approach** – An entity could evaluate the market in which it sells goods or services and estimate the price that a customer in that market would be willing to pay for those goods or services. This approach may also include referring to prices from the entity's competitors for similar goods or services and adjusting those prices as necessary to reflect the entity's costs and margins.
2. **Expected cost plus a margin approach** – An entity could forecast its expected costs of satisfying a performance obligation and then add an appropriate margin for that good or service.
3. **Residual approach** – An entity may estimate the standalone selling price by reference to the total transaction price less the sum of the observable standalone selling prices of other goods or services promised in the contract. However, an entity may use a residual approach to estimate the standalone selling price of a good or service only if one of the following criteria is met:
   a. The entity sells the same good or service to different customers (at or near the same time) for a broad range of amounts (that is, the selling price is highly variable because a representative standalone selling price is not discernible from past transactions or other observable evidence).
   b. The entity has not yet established a price for that good or service, and the good or service has not previously been sold on a standalone basis (that is, the selling price is uncertain).

A combination of methods may need to be used to estimate the standalone selling prices of the goods or services promised in the contract if two or more of those goods or services have highly variable or uncertain standalone selling prices.

PORTFOLIO APPROACH

Entities may also elect to use a portfolio approach under which lease components do not need to be separately identified and accounted for.

The portfolio approach can be used to bypass the identification of lease components, possibly group contracts with

> **ASU NO. 2016-02 BC120**
>
> …the Board decided to explicitly state that lessees and lessors are permitted to apply the leases guidance at a portfolio level. The Board acknowledged that an entity would need to apply judgment in selecting the size and composition of the portfolio in such a way that the entity reasonably expects that the application of the leases model to the portfolio would not differ materially from the application of the leases model to the individual leases in that portfolio. In the discussion, the Board indicated that it did not intend for an entity to quantitatively evaluate each outcome but, instead, that the entity should be able to take a reasonable approach to determine the portfolios that would be appropriate for its types of leases.

similar terms, determine a single discount rate at the portfolio level and apply other subsequent recognition and measurement guidance to the portfolio as a whole rather than to the individual underlying assets.

The portfolio approach may be appropriately applied to groups of leased assets that have similar characteristics and terms, including start and end dates, renewal options, termination options, purchase options, residual value guarantees, etc. Examples may include office equipment or vehicle fleets.

Entities who chose to use the portfolio approach should consider possible subsequent accounting complications that may arise in contracts that allow renewal, termination or purchase options for individual underlying assets or groups of underlying assets. Changes in assumptions about the likelihood of exercising options to renew, terminate or purchase some but not all assets will require that the lease components be separated at that time for remeasurement.

COMBINATION OF CONTRACTS

> **ASC 842-10-25-19**
>
> An entity shall combine two or more contracts, at least one of which is or contains a lease, entered into at or near the same time with the same counterparty (or related parties) and consider the contracts as a single transaction if any of the following criteria are met:
>
> **a.** The contracts are negotiated as a package with the same commercial objective(s).
>
> **b.** The amount of consideration to be paid in one contract depends on the price or performance of the other contract.
>
> **c.** The rights to use underlying assets conveyed in the contracts (or some of the rights of use conveyed in the contracts) are a single lease component in accordance with paragraph 842-10-15-28.

LEASE CLASSIFICATION

Under ASC Topic 842, lessees will classify leases as either operating or finance. The finance lease terminology replaces the capital lease terminology from prior guidance. The initial determination of the lease liability and ROU asset for both operating and finance leases is the same. The primary difference is the expense recognition on the income statement, as the expense recognition for operating leases results in straight-line expense over the lease term, while expense recognition for finance leases is highest at the beginning and decreases over the lease term. The Subsequent Measurement section of this handbook discusses expense recognition in more detail.

CLASSIFICATION CRITERIA

The classification of a lease is determined at lease commencement. Once determined, entities are not required to reassess the lease classification unless:

1. The contract is modified, and the modification is not accounted for as a separate lease (modifications are discussed on pages 22-23 of this handbook), or
2. There is a change in the lease term or the assessment of whether the lessee is reasonably certain to exercise an option to purchase the underlying asset.

ASC 842-10-25-2

A lessee shall classify a lease as a finance lease and a lessor shall classify a lease as a sales-type lease when the lease meets any of the following criteria at lease commencement:

- **a.** The lease transfers ownership of the underlying asset to the lessee by the end of the lease term.
- **b.** The lease grants the lessee an option to purchase the underlying asset that the lessee is reasonably certain to exercise.
- **c.** 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.
- **d.** 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.
- **e.** 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.

ASC 842-10-25-3

When none of the criteria in paragraph 842-10-25-2 are met:

- **a.** A lessee shall classify the lease as an operating lease.
- **b.** A lessor shall classify the lease as either a direct financing lease or an operating lease. A lessor shall classify the lease as an operating lease unless both of the following criteria are met, in which case the lessor shall 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.

Transfer of ownership

Transfer of ownership occurs through the transfer of title for the underlying asset at the end of the lease term. According to the lease standards, this includes the transfer of ownership of the underlying asset at or shortly after the end of the lease term in exchange for no additional consideration or the payment of a nominal amount (e.g., the minimum fee required by statutory regulation to transfer ownership). If the contract states that ownership is not transferred if the lessee elects not to pay the specified fee (nominal or otherwise), then this provision is a purchase option and not a transfer of title.

Purchase option reasonably certain to be exercised

Leases are classified as finance leases if the lessee is reasonably certain to exercise the purchase option. The term "reasonably certain" is not defined; however, it is considered to be a high threshold.

Major part of the remaining economic life of the underlying asset

Unlike prior lease accounting guidance, ASC Topic 842 does not provide a bright-line threshold for what qualifies as a "major part" of the remaining economic life. However, the implementation guidance provides the following:

POLICY ELECTION – MAJOR PART OF ECONOMIC LIFE (ASC 842-10-55-2)

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:

a. 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.

b. 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.

c. (omitted)

Entities should document their policy for the threshold which represents the "major part" of the remaining economic life as well as a date that falls "at or near the end of the economic life" of the underlying asset. These thresholds should be applied consistently by the entity.

Substantially all of the fair value of the underlying asset

Like the "major part" of the economic life, ASC Topic 842 does not provide a bright-line threshold for what qualifies as "substantially all" of the fair value of the underlying asset. However, the implementation guidance provides the following:

POLICY ELECTION – SUBSTANTIALLY ALL THE FAIR VALUE (ASC 842-10-55-2)

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:

a. (omitted)

b. (omitted)

c. Ninety percent or more of the fair value of the underlying asset amounts to substantially all the fair value of the underlying asset.

Entities should document their policy for the threshold which represents "substantially all" of the fair value of the underlying asset. This threshold should be applied consistently by the entity.

In certain circumstances, it may not be feasible for an entity to determine the fair value of the underlying asset. The guidance states that if a reasonable estimate of fair value cannot be made without undue cost or effort, entities will not consider the present value of lease payments criteria for lease classification.

The present value of lease payments for the purposes of classification is the same calculation as the initial measurement of the lease liability described on page 15 of this handbook with two key differences:

1. All lease payments are used for classification, while only payments not yet paid as of the commencement date are included in the calculation of the lease liability.
2. Lease classification considers the maximum possible amount owed under a residual value guarantee, while lease liability measurement considers only the amount probable of being owed under the residual value guarantee at the end of the lease term.

No alternative use

> **ASC 842-10-55-7**
>
> In assessing whether an underlying asset has an alternative use to the lessor at the end of the lease term in accordance with paragraph 842-10-25-2(e), an entity should consider the effects of contractual restrictions and practical limitations on the lessor's ability to readily direct that asset for another use (for example, 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. A significant economic loss could arise because 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. For example, a lessor may be practically limited from redirecting assets that either have design specifications that are unique to the lessee or that are located in remote areas. The possibility of the contract with the customer being terminated is not a relevant consideration in assessing whether the lessor would be able to readily direct the underlying asset for another use.

RECOGNITION AND INITIAL MEASUREMENT

LEASE LIABILITY

At the commenment date, the lessee will measure the lease liability at the present value of lease payments not yet paid and the ROU asset starting with the lease liability and adjusting for certain items as applicable.

One of the primary differences between the determination of the present value of lease payments for lease classification and the measurement of the lease liability at commencement is that all payments are used for classification, while only payments not yet paid as of the commencement date are included in the calculation of the lease liability. The other primary difference is that lease classification considers the maximum possible amount owed under a residual value guarantee, while lease liability measurement considers only the amount probable of being owed under the residual value guarantee at the end of the lease term.

LEASE PAYMENTS

> **ASC 842-10-30-5**
>
> At the commencement date, the lease payments shall consist of the following payments relating to the use of the underlying asset during the lease term:
>
> **a.** 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).
>
> **b.** 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.
>
> **c.** 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).
>
> **d.** 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.
>
> **e.** 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).
>
> **f.** 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).

In substance fixed payments are payments that may appear to contain variability but are, in effect, unavoidable. Examples from the guidance include:

1. Payments that do not create genuine variability (such as those that result from clauses that do not have economic substance).
2. The lower of payments to be made when the lessee has a choice about which payment(s) it makes, although it must make at least one payment.

Lease incentives

Lease incentives include both:

1. Payments made to or on behalf of the lessee.
2. Losses incurred by the lessor as a result of assuming a lessee's preexisting lease with a third-party.

Leases often involve improvements to the underlying asset. In those cases, a determination should be made as to whether the improvement represents consideration from the lessee or an incentive to the lessee, depending on which party incurs the costs of the improvements.

If the lease does not specifically require the lessee to make an improvement, the improvement should be considered to be an asset of the lessee. The costs of these improvements are excluded from lease payments.

If the lease does require an improvement and the improvement could be utilized by a subsequent tenant, it is likely to be an asset of the lessor. Such improvements would be included in the determination of the fixed lease payments.

In some arrangements, the lessor will reimburse the lessee for the cost of the improvements. If the improvement represents a lessee asset, the amount reimbursed is a lease incentive that should be accounted for as a reduction of fixed lease payments. If the improvement represents a lessor asset, the improvement is not an incentive and should be accounted for as a reimbursement of costs.

Variable lease payments

According to the guidance, variable lease payments are those payments that vary because of changes in facts and circumstances occurring after the commencement date, other than the passage of time. Variable lease payments should be separated into two groupings: those that depend on an index or rate and those that do not (i.e., variability is due to other factors such as asset usage or lessee revenue and amounts that are not known at the lease commencement date, such as real estate taxes and insurance that are reimbursed at actual costs, etc.).

Variable payments that are based on a rate or index, such as the Consumer Price Index (CPI) or a market interest rate, are included in lease payments, using the rate or index as of the commencement date for the measurement of the lease liability. Variable lease payments that are variable due to other factors are not included in lease payments for measurement of the lease liability unless and until the contingency causing in the variability is resolved.

It is important to distinguish between variable payments that are based on a rate or index and those that are based on changes in a rate or index. The intention of the guidance is that future lease payments for measurement purposes are based on information known, not expected, at the commencement date. A future change in a rate or index is not known at the commencement date and therefore only the base payment amount is used for measurement purposes. Essentially, the rate at commencement is 0 as the future change cannot be known. The amount by which the future index or rate adjusted payments exceeds the base payment is treated as variable rent expense.

Consider an example in which a lease agreement requires annual payment escalations based on the higher of the change in a specified index or a fixed percentage. At commencement, the annual changes in the index cannot be known. However, the payments are known to increase by at least the fixed percentage each year. The lease payments at commencement include the fixed percentage increase. If in future periods, the change in the specified index exceeds the fixed percentage, the additional amount will be reported as variable expense.

In the inverse of the above example, in which future payments are based on the lower of the change in the specified index or a fixed rate, lease payments at commencement would not consider any future increase as the future increase are not known (i.e., the change in the specified index could be 0 or negative).

Residual value guarantees

The nature and terms of a residual value guarantee need to be considered to determine if it needs to be included in lease payments at lease commencement. The guidance states that a lease provision requiring the lessee to make up a residual value deficiency based on damage, extraordinary wear and tear, or excessive usage is similar to a variable payment as the amount is not determinable at the commencement date and as such is not considered a lessee guarantee of the residual value. However, if the lessor has the right to require the lessee to purchase the underlying asset by the end of the lease term, the stated purchase price would be included in lease payments at commencement as the lessee would be obligated to pay the amount based on circumstances outside its control.

Costs to return an underlying asset to its original condition, if it has been modified by the lessee, at the end of the lease term are not considered lease payments and generally would be accounted for in accordance with ASC Subtopic 410-20 on asset retirement obligations.

According to the guidance, costs to dismantle or remove the underlying asset at the end of the term that are imposed by the lease agreement generally would be considered lease payments.

DISCOUNT RATE FOR THE LEASE

The discount rate for the lease used to calculate the present value of lease payments at commencement is determined based on information available at the commencement date. There are three methods for determining the discount rate for the lease. The rate implicit in the lease should be used when readily determinable. If not readily determinable, the lessee may use its incremental borrowing rate. Alternatively, a lessee that is not a public business entity may make an accounting policy election to use a risk-free rate for all leases.

Rate implicit in the lease

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

In leases that are not between related parties, all of this information needed to determine the rate implicit in the lease is often not available to the lessee, and the lessee is not required to estimate them.

Incremental borrowing rate

According to the FASB, a lessee's incremental borrowing rate is the rate of interest that a lessee would have incurred to borrow on a collateralized basis over a similar term an amount equal to the lease payments in a similar economic environment.

Risk-free rate

POLICY ELECTION – DISCOUNT RATE (ASC 842-20-30-3)

…A lessee that is not a public business entity is permitted to use a risk-free discount rate for the lease instead of its incremental borrowing rate, determined using a period comparable with that of the lease term, as an accounting policy election made by class of underlying asset.

The standards state that a lessee that is not a public business entity is permitted to make an accounting policy election by class of underlying asset to use the risk-free rate (e.g., the rate of a zero-coupon US Treasury instrument) for the initial and subsequent measurement of lease liabilities. The risk-free rate is determined using a period comparable with the lease term. If a lessee makes this election, the policy must be applied to all leases in the selected asset classes and the notes to the financial statements shall disclose to which asset classes the election applies. However, regardless of whether an entity elects to use a risk-free rate, lessees must use the rate implicit in the lease whenever that rate is readily determinable. This is likely to apply to related-party leases in particular since the lessee is reasonably expected to have access to the same information as the lessor.

Adopting this election may lead to more leases being classified as finance leases, as it would increase the likelihood that the present value of the lease payments and any residual value guaranteed by the lessee would equal or exceed substantially all of the fair value of the leased asset.

RIGHT-OF-USE ASSET

ASC 842-20-30-5

At the commencement date, the cost of the right-of-use asset shall consist of all of the following:

a. The amount of the initial measurement of the lease liability.

b. Any lease payments made to the lessor at or before the commencement date, minus any lease incentives received.

c. Any initial direct costs incurred by the lessee (as described in paragraphs 842-10-30-9 through 30-10).

Initial direct costs

Initial direct costs are defined as incremental costs of a lease that would not have been incurred if the lease had not been obtained. Initial direct costs are considered in the measurement of the ROU asset. Examples of possible initial direct costs include:

1. Commissions paid to a salesperson when a lease agreement is executed.
2. Payments made to existing tenants to incentivize them to terminate a lease.
3. Legal fees related to lease execution.

Generally, all other costs made prior to lease execution are not included in the measurement of the ROU asset, but rather are expensed as incurred. These costs include costs to negotiate or arrange a lease that would have been incurred regardless of whether the lease was obtained. Examples of costs prior to lease execution that are not initial direct costs include:

1. Employee salaries.
2. Fees for general legal and tax advice prior to lease execution, including negotiation of lease terms and conditions.
3. Commissions paid to a salesperson for entering into lease negotiations that are paid even if the lease is not obtained.
4. Planning and engineering costs to determine lease asset requirements and specifications.

Initial direct costs should be allocated to the separate lease components on the same basis as the lease payments.

SUBSEQUENT MEASUREMENT

LEASE LIABILITIES AND ROU ASSETS

Finance leases

For finance leases subsequent to the initial measurement on the commencement date, the lease liability is increased by the amount of interest recognized during the period and reduced by the amount of lease payments made during the period. The ROU asset is maintained at cost less accumulated amortization (or depreciation). Generally, ROU assets should be amortized on a straight-line basis, unless another systematic basis is more representative of the pattern in which the economic benefits from the use of the underlying asset will be consumed.

For leases classified as finance leases due to a transfer of title or purchase option reasonably certain to be exercised, the leased asset should be depreciated over the estimated useful life of the asset, as the transaction is essentially the financed acquisition of the asset.

For leases classified as finance leases due to a major part of the economic life of the underlying asset, substantially all the fair value of the underlying asset or the asset is of a specialized nature, the ROU asset should be amortized over the lease term.

Operating leases

For operating leases subsequent to the initial measurement on the commencement date, the lease liability should be measured as the present value of the lease payments not yet paid using the discount rate established on the commencement date. The ROU asset is measured at the amount of the lease liability on the measurement date, adjusted for (1) prepaid or accrued lease payments, (2) the remaining balance of lease incentives received, (3) unamortized initial direct costs and (4) any impairment of the ROU asset recognized to date.

While the guidance in ASC 842 describes a process to measure the lease liability and ROU asset at each reporting date, utilizing a periodic amortization schedule of the initial measurement balances will yield the same results. In this method, the amortization of the ROU asset is determined by finding the difference between the straight-line lease expense and the periodic accretion of interest on the lease liability.

Impairment

All ROU assets, regardless of lease classification, should be considered for impairment in accordance with ASC Topic 360.

If impairment is recognized on an ROU asset, the lessee should amortize the ROU asset balance from the date of the impairment to the earlier of either the end of the useful life of the ROU asset or the end of the lease term. For both operating and finance leases, the remaining impaired ROU asset carrying value is amortized on a straight-line basis. For finance leases, this results in a new straight-line amortization amount. For operating leases, this results in the lease expense no longer being recognized on a straight-line basis, as the amortization is now straight-line, while liability accretion continues to be determined using the effective interest method.

LEASEHOLD IMPROVEMENTS

According to the standards, leasehold improvements are amortized over the shorter of the useful life of the leasehold improvement or the remaining lease term, unless the lease transfers ownership of the underlying asset to the lessee, or the lessee is reasonably certain to exercise a purchase option to purchase the underlying asset, in which case the leasehold improvement is amortized over its useful life.

EXPENSE RECOGNITION

The primary difference between accounting for operating and finance leases is the expense recognition over the lease term. The expense recognition for operating leases results in a straight-line expense over the lease term, while expense recognition for finance leases is highest at the beginning and decreases over the lease term.

Operating lease expense

The process to determine operating lease expense for an accounting period involves three steps:

1. Calculate the interest expense on the lease liability using the effective interest method.
2. If not determined already, calculate the periodic straight-line lease expense over the lease term.
3. Calculate the amortization of the ROU asset for the period by subtracting interest expense from the periodic straight-line lease expense.

The total lease expense recognized for the period is the sum of the interest expense and the amortization of the ROU, which by definition, results in straight-line expense recognition.

For operating leases, the lease expense is presented as a single line item in operating expenses on the income statement.

Finance lease expense

The process to determine expense for a finance lease involves two steps:

1. Calculate the interest expense on the lease liability using the effective interest method.
2. Determine amortization or depreciation of the lease asset based on the appropriate amortization or depreciation period.

The result is a total periodic expense that declines over the lease term. While the amortization (or depreciation) of the asset is determined on a straight-line basis, the interest portion is calculated based on the declining lease liability.

The interest and amortization (or depreciation) expense portions should generally be presented separately on the income statement.

Variable lease expense

For variable lease payments based on a rate or index, differences between the anticipated payments at lease commencement based on the rate or index at the commencement date and the actual payments based on subsequent changes in the rate or index are reported as variable lease expense in each respective period that the payments are incurred and payable. This treatment is the same for both finance and operating leases. The lease liability and ROU asset are not remeasured as a result of changes to these types of variable payments.

For variable lease payments that are variable due to factors other than a rate or index (e.g., asset usage, gross revenue, etc.), a lessee should recognize costs from variable lease payments (in annual periods as well as interim periods) before the achievement of the specified target that triggers the variable lease payments, provided the achievement of that target is considered probable, per the standards. Variable lease costs recognized based on the expectation that they are probable should be reversed at the time that it becomes probable that the specified target will not be met.

Short-term lease expense

If a lessee makes the accounting policy election to not apply the requirements of ASC Topic 842 to short-term leases as described on page 4 of this handbook, the amount of short-term lease expense shall be disclosed in the notes to the financial statements.

REMEASUREMENTS

After the commencement date, the lease liability and ROU asset may need to be remeasured in certain circumstances that are not the result of a modification of the lease agreement. Modifications are discussed in the next section.

ASC 842-10-35-4

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

a. The lease is modified, and that modification is not accounted for as a separate contract in accordance with paragraph 842-10-25-8.

b. 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. However, a change in a reference index or a rate upon which some or all of the variable lease payments in the contract are based, does not constitute the resolution of a contingency subject to (b) (see paragraph 842-10-35-5 for guidance on the remeasurement of variable lease payments that depend on an index or a rate).

ASC 842-10-35-4, CONT'D

c. There is a change in any of the following:

1. 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.

2. 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.

3. 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.

ASC 842-10-35-1

A lessee shall reassess the lease term or a lessee option to purchase the underlying asset only if and at the point in time that any of the following occurs:

a. 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.

b. 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.

c. The lessee elects to exercise an option even though the entity had previously determined that the lessee was not reasonably certain to do so.

d. The lessee elects not to exercise an option even though the entity had previously determined that the lessee was reasonably certain to do so.

Events that might cause the lessee to reassess the lease term or option to purchase the underlying asset include:

1. Construction of significant leasehold improvements that will have significant economic value beyond the lease term.
2. Significant modifications or customization to the underlying asset.
3. Making business decisions that are directly related to the use of the underlying asset (e.g., extensions/acquisitions or terminations/disposal of related assets, relocation of operations, etc.).
4. Subleasing the underlying asset for a period beyond the initial lease term.

Any adjustment to the lease liability as a result of a remeasurement also results in an equal adjustment to the carrying value of the ROU asset, provided that the ROU asset cannot be adjusted below $0. Any amount of the remeasurement credit adjustment in excess of the ROU asset balance should be recognized as profit in the income statement.

Discount rate in a remeasurement

> **ASC 842-20-35-5**
>
> If there is a remeasurement of the lease liability in accordance with paragraph 842-20-35-4, the lessee shall update the discount rate for the lease at the date of remeasurement on the basis of the remaining lease term and the remaining lease payments, unless the remeasurement of the lease liability is the result of one of the following:
>
> **a.** A change in the lease term or the assessment of whether the lessee will exercise an option to purchase the underlying asset and the discount rate for the lease already reflects that the lessee has an option to extend or terminate the lease or to purchase the underlying asset.
>
> **b.** A change in amounts probable of being owed by the lessee under a residual value guarantee (see paragraph 842-10-35-4(c)(3)).
>
> **c.** A change in the lease payments resulting from the resolution of 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 (see paragraph 842-10-35-4(b)).

Variable payments based on a rate of index upon remeasurement

When one or more of the events described in paragraph 842-10-35-4(a) or (c) occur, or when a contingency unrelated to a change in a reference index or rate under paragraph 842-10-35-4(b) is resolved, variable lease payments that depend on an index or rate shall be remeasured using the index or rate as of the date the remeasurement is required.

MODIFICATIONS

A lease modification is 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, according to ASC 842. Modifications may add or remove contract options, extend or shorten the lease term, change the timing or amount of lease payments, or add or remove an ROU asset. Upon the modification of a lease contract, the lessee must determine if the modified contract is treated as a single modified lease or two separate leases (the original lease and a separate new lease).

> **ASC 842-10-25-8**
>
> An entity shall account for a modification to a contract as a separate contract (that is, separate from the original contract) when both of the following conditions are present:
>
> **a.** The modification grants the lessee an additional right of use not included in the original lease (for example, the right to use an additional asset).
>
> **b.** The lease payments increase commensurate with the standalone price for the additional right of use, adjusted for the circumstances of the particular contract. For example, the standalone price for the lease of one floor of an office building in which the lessee already leases other floors in that building may be different from the standalone price of a similar floor in a different office building, because it was not necessary for a lessor to incur costs that it would have incurred for a new lessee.

Separate new lease

The standards state that lessees account for the separate new lease within the modified contract in the same manner as other new leases.

In determining whether the modification grants an additional right of use, the lessee should consider whether there is an additional identified asset. A change in the lease term only is not considered an additional right of use. The right to use an additional underlying asset (for example, additional square footage of a building or an additional piece of equipment) will generally be a separate lease component, even if the modification granting that additional right of use is not a separate contract.

Single modified lease

If a lease is modified and that modification is not accounted for as a separate contract, the entity shall reassess the classification of the lease and remeasure the lease liability and ROU asset as of the effective date of the modification, according to the guidance. The classification and measurement upon modification follow the same guidance as the initial measurement, using facts and circumstances known as of the effective date of the modification.

Per the standards, an entity shall account for initial direct costs, lease incentives and any other payments made to or by the entity in connection with a modification to a lease in the same manner as those items would be accounted for in connection with a new lease by adjusting the ROU asset.

Remeasurement following a modification

ASC 842-10-25-11

A lessee shall reallocate the remaining consideration in the contract and remeasure the lease liability using a discount rate for the lease determined at the effective date of the modification if a contract modification does any of the following:

a. Grants the lessee an additional right of use not included in the original contract (and that modification is not accounted for as a separate contract in accordance with paragraph 842-10-25-8).

b. Extends or reduces the term of an existing lease (for example, changes the lease term from five to eight years or vice versa), other than through the exercise of a contractual option to extend or terminate the lease (as described in paragraph 842-20-35-5).

c. Fully or partially terminates an existing lease (for example, reduces the assets subject to the lease).

d. Changes the consideration in the contract only.

In the case of a, b or d above, the lessee will recognize the amount of the remeasurement of the lease liability for the modified lease as an adjustment to the corresponding right-of-use asset.

In the case of c above, the lessee will decrease the carrying amount of the right-of-use asset on a basis proportionate to the full or partial termination of the existing lease. Any difference between the reduction in the lease liability and the proportionate reduction in the right-of-use asset will be recognized as a gain or a loss on the effective date of the modification.

If a finance lease is modified and the modified lease is classified as an operating lease, any difference between the carrying amount of the right-of-use asset after recording the adjustment required above and the carrying amount of the right-of-use asset that would result from applying the initial operating right-of-use asset measurement to the modified lease shall be accounted for in the same manner as a rent prepayment or a lease incentive.

TERMINATION

If a lease is terminated before the expiration of the lease term, the lessee should remove the lease liability and ROU asset from its accounts, with profit or loss recognized for the difference.

If the lease is terminated through a purchase of the underlying asset, any difference between the purchase price and the carrying amount of the lease liability immediately prior to the purchase should be recorded as an adjustment to the carry amount of the asset.

PRESENTATION AND DISCLOSURE

PRESENTATION

Statement of financial position

POLICY ELECTION – PRESENTATION (ASC 842-20-45-1)

A lessee shall either present in the statement of financial position or disclose in the notes all of the following:

a. Finance lease right-of-use assets and operating lease right-of-use assets separately from each other and from other assets.

b. Finance lease liabilities and operating lease liabilities separately from each other and from other liabilities.

Right-of-use assets and lease liabilities shall be subject to the same considerations as other nonfinancial assets and financial liabilities in classifying them as current and noncurrent in classified statements of financial position.

The guidance allows lessees to present the required information either on the face of the statement of financial position or within the notes to the financial statements. If the lessee choses to present the information in the notes only, the notes should disclose which line items in the statement of financial position include ROU assets and lease liabilities.

However, in either case, the lessee is prohibited from presenting finance lease and operating lease ROU assets in the same line, as well as finance lease and operating lease liabilities in the same line.

Statement of comprehensive income

ASC 842-20-45-4

In the statement of comprehensive income, a lessee shall present both of the following:

a. For finance leases, the interest expense on the lease liability and amortization of the right-of-use asset are not required to be presented as separate line items and shall be presented in a manner consistent with how the entity presents other interest expense and depreciation or amortization of similar assets, respectively.

b. For operating leases, lease expense shall be included in the lessee's income from continuing operations.

Additionally, lease consideration that is variable and not included in the measurement of the lease liability shall be presented and disclosed as variable lease expense rather than other specific types of expenses. For example, on page 9 of this handbook, the accounting for taxes and insurance that are costs of securing the asset (required by and/or benefit the lessor) is discussed, noting that these amounts may be variable and excluded from contract consideration. These expenses should be reported as "variable lease expense" and not as "taxes" or "insurance" in the financial statements.

Statement of cash flows

> **ASC 842-20-45-5**
>
> In the statement of cash flows, a lessee shall classify all of the following:
>
> **a.** Repayments of the principal portion of the lease liability arising from finance leases within financing activities.
>
> **b.** Interest on the lease liability arising from finance leases in accordance with the requirements relating to interest paid in Topic 230 on cash flows.
>
> **c.** Payments arising from operating leases within operating activities, except to the extent that those payments represent costs to bring another asset to the condition and location necessary for its intended use, which should be classified within investing activities.
>
> **d.** Variable lease payments and short-term lease payments not included in the lease liability within operating activities.

DISCLOSURE

Qualitative disclosures

> **ASC 842-20-50-3**
>
> A lessee shall disclose all of the following:
>
> **a.** 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.
>
> A lessee should identify the information relating to subleases included in the disclosures provided in (1) through (5), as applicable.
>
> **b.** 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.
>
> **c.** Information about significant assumptions and judgments made in applying the requirements of this Topic, which may include the following:
>
> **1.** The determination of whether a contract contains a lease (as described in paragraphs 842-10-15-2 through 15-27).
>
> **2.** The allocation of the consideration in a contract between lease and nonlease components (as described in paragraphs 842-10-15-28 through 15-32).
>
> **3.** The determination of the discount rate for the lease (as described in paragraphs 842-20-30-2 through 30-4).

Additionally, if applicable, the lessee shall disclose accounting policy elections including:

1. Policy election to not apply the requirements of ASC Topic 842 to short-term leases.
2. Policy election to not separate lease and nonlease components and which class or classes of underlying assets to which this election applies.

Quantitative disclosures

ASC 842-20-50-4

For each period presented in the financial statements, a lessee shall disclose the following amounts relating to a lessee's total lease cost, which includes both amounts recognized in profit or loss during the period and any amounts capitalized as part of the cost of another asset in accordance with other Topics, and the cash flows arising from lease transactions:

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

The weighted-average remaining lease term is determined relative to lease liability balances, while the weighted-average discount rate is determined relative to the remaining balance of lease payments. The following table illustrates the calculation of the weighted-average disclosures using three hypothetical operating leases.

LEASE DATA:	(a) Remaining future lease payments	(b) Lease liability at reporting date	(c) Remaining lease term (months)	(d) Discount rate for the lease
Lease 1	24,000	23,324	24	3.0%
Lease 2	12,000	11,930	5	3.5%
Lease 3	159,458	132,661	109	4.0%
	195,458	167,915		

	WEIGHTED-AVERAGE LEASE TERM:	(b) x (c)	WEIGHTED-AVERAGE DISCOUNT RATE:	(a) x (d)
Lease 1		559,776		720.00
Lease 2		59,650		420.00
Lease 3		14,460,049		6,378.32
	∑ ((b) x (c))	15,079,475	∑ ((a) x (d))	7,518.32
	÷ ∑(b)	167,915	÷ ∑(a)	195,458
	Weighted-average months	89.80	Weighted-average	3.85%
	÷	12		
	Weighted-average years	7.48		

In addition to the above, the lessee also needs to provide a maturity analysis of finance and operating lease liabilities separately. The analysis should present undiscounted cash flows on an annual basis for a minimum of each of the next five years and a total of the amounts for the remaining years. These undiscounted cash flows should then be reconciled to the finance and operating lease liabilities recognized in the statement of financial positions or notes to the financial statements.

The standards state that if the short-term lease expense for the period does not accurately reflect the lessee's short-term lease commitments, the lessee shall also disclose the amount of its short-term lease commitments.

Illustrative quantitative disclosure

ASC 842-20-55-53

The following Example illustrates how a lessee may meet the quantitative disclosure requirements in paragraph 842-20-50-4.

	Year ending December 31,	
	20X2	20X1
Lease cost		
Finance lease cost:	$XXX	$XXX
Amortization of right-of-use assets	XXX	XXX
Interest on lease liabilities	XXX	XXX
Operating lease cost	XXX	XXX
Short-term lease cost	XXX	XXX
Variable lease cost	XXX	XXX
Sublease income	(XXX)	(XXX)
Total lease cost	$XXX	$XXX
Other information		
(Gains) and losses on sale and leaseback transactions, net	$(XXX)	$(XXX)
Cash paid for amounts included in the measurement of lease liabilities	XXX	XXX
Operating cash flows from finance leases	XXX	XXX
Operating cash flows from operating leases	XXX	XXX
Financing cash flows from finance leases	XXX	XXX
Right-of-use assets obtained in exchange for new finance lease liabilities	(XXX)	(XXX)
Right-of-use assets obtained in exchange for new operating lease liabilities	$XXX	$XXX
Weighted-average remaining lease term - finance leases	X.X years	X.X years
Weighted-average remaining lease term - operating leases	X.X years	X.X years
Weighted-average discount rate - finance leases	X.X%	X.X%
Weighted-average discount rate - operating leases	X.X%	X.X%

Related party disclosures

Lessees shall disclose lease transactions between related parties in accordance with guidance on related party disclosures in 850-10-50-1 through 50-6.

EFFECTIVE DATE AND TRANSITION

EFFECTIVE DATE

The guidance in ASC Topic 842 is effective as follows:

1. For (a) public business entities, (b) not-for profit entities that have issued or is a conduit debt obligor for securities that are traded, listed or quoted on an exchange or an over-the-counter market (except as noted in 2 below) and (c) employee benefit plans that file or furnish financial statements to the SEC, the guidance is effective for fiscal years beginning after December 15, 2018, and interim periods within those fiscal years.
2. For not-for-profit entities that have issued or is a conduit debt obligor for securities that are traded, listed or quoted on an exchange or an over-the-counter market that has not yet issued financial statements or made financial statements available for issuance as of June 3, 2020, the guidance is effective for fiscal years beginning after December 15, 2019, and interim periods within those fiscal years.
3. **For all other entities, the guidance is effective for fiscal years beginning after December 15, 2021, and interim periods within fiscal years beginning after December 15, 2022. Earlier implementation is permitted.**

TRANSITION

Transition methods

POLICY ELECTION – TRANSITION METHOD (ASC 842-10-65-1(C))

...An entity shall apply the pending content that links to this paragraph using one of the following two methods:

1. Retrospectively to each prior reporting period presented in the financial statements with the cumulative effect of initially applying the pending content that links to this paragraph recognized at the beginning of the earliest comparative period presented, subject to the guidance in (d) through (gg). Under this transition method, the application date shall be the later of the beginning of the earliest period presented in the financial statements and the commencement date of the lease.
2. Retrospectively at the beginning of the period of adoption through a cumulative-effect adjustment, subject to the guidance in (d) through (gg). Under this transition method, the application date shall be the beginning of the reporting period in which the entity first applies the pending content that links to this paragraph.

It is anticipated that most organizations will select the second transition method which applies the guidance starting with only those leases in effect at the beginning of the year of adoption. This transition method forgoes comparative reporting entirely. Under this method, an entity would continue to apply the legacy guidance in ASC Topic 840, including disclosures, in the comparative periods presented in the year it adopts ASC Topic 842.

Transition practical expedients

PRACTICAL EXPEDIENT – "PACKAGE OF THREE" (ASC 842-10-65-1(F))

An entity may elect the following practical expedients, which must be elected as a package and applied consistently by an entity to all of its leases (including those for which the entity is a lessee or a lessor), when applying the pending content that links to this paragraph to leases that commenced before the effective date:

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 (for example, 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.

Previously under ASC 840, the accounting for operating leases and service contracts was similar, and entities may not have determined whether an arrangement contained a lease or was only a contract for services. Entities may need to revisit their assessment of arrangements, as the difference in accounting for service contracts and a lease may be material. The above practical expedient does not grandfather incorrect assessments made under ASC 840 (the practical expedient only applies to arrangements that were appropriately assessed under ASC 840). Using this practical expedient, lessee entities do not need to reassess contacts already identified as leases under ASC Topic 840; however, entities may identify additional contracts that are or contain a lease that had not been accounted for properly under ASC Topic 840.

PRACTICAL EXPEDIENT – HINDSIGHT (ASC 842-10-65-1(G))

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 either one or both of the practical expedients in (f) and (gg) below.

For example, at lease inception, an entity may have not been reasonably certain to exercise a lease extension. However, upon adoption of ASC 842, the entity has determined it is reasonably certain to exercise that option. This practical expedient allows the entity to recognize and measure the lease based on the revised lease term only, rather than first measuring based on the initial term and remeasuring for the revised term.

An entity would consider all facts and circumstances that have changed through the effective date, in applying hindsight. However, an entity would not consider events that occurred after the effective date, but prior to the first time it issues its financial statements reflecting the adoption of ASC 842 (hindsight only extends to the effective date). For example, if an entity adopts ASC 842 on January 1, 2022, only facts and circumstances up to January 1, 2022, would be applicable to apply hindsight, and not any time after January 1, 2022.

PRACTICAL EXPEDIENT – EASEMENTS (ASC 842-10-65-1(GG))

An entity also may elect a practical expedient to not assess whether existing or expired land easements that were not previously accounted for as leases under Topic 840 are or contain a lease under this Topic. For purposes of (gg), a land easement (also commonly referred to as a right of way) refers to a right to use, access, or cross another entity's land for a specified purpose. This practical expedient shall be applied consistently by an entity to all its existing and expired land easements that were not previously accounted for as leases under Topic 840. This practical expedient may be elected separately or in conjunction with either one or both of the practical expedients in (f) and (g). An entity that elects this practical expedient for existing or expired land easements shall apply the pending content that links to this paragraph to land easements entered into (or modified) on or after the date that the entity first applies the pending content that links to this paragraph as described in (a) and (b). An entity that previously accounted for existing or expired land easements as leases under Topic 840 shall not be eligible for this practical expedient for those land easements.

For all land easements that are not subject to the optional practical expedient, an entity will evaluate whether land easements are leases under ASC 842 before applying the intangible assets guidance in ASC 350-30.

Transition recognition and measurement

At the adoption date determined in accordance with ASC 842-10-65-1(c), lease liabilities and ROU assets are recognized and measured based on future lease payments and certain balances existing at the effective date. Entities do not need to retroactively apply the measurement guidance to the entire lease term.

For leases previously classified as operating leases under ASC Topic 840, lease liabilities are measured at the present value of future minimum lease payments (including options reasonably certain to be exercised) and amounts probable of being owed under residual value guarantees. ROU assets are measured starting with the lease liability and adjusted for balances remaining from accounting under ASC Topic 840, including (a) prepaid or accrued lease payments, (b) unamortized lease incentives and (c) unamortized initial direct costs. Entities may also need to consider recognizing ROU asset impairments.

For leases previously classified as capital leases under ASC Topic 840, lease liabilities and ROU assets are recognized at the carrying amount of the capital lease obligations and lease assets in accordance with ASC Topic 840 at the application date. If the "package of three" practical expedient has been used, any unamortized initial direct costs are included in the measurement of the ROU asset.

Transition disclosures

As with all accounting changes and error corrections, entities must provide the applicable transition disclosures required by ASC Topic 250. These, as stated in the guidance, include:

1. The nature of and reason for the change in accounting principle.
2. The method of change, including:
    a. A description of prior period information that has been retrospectively adjusted, if any.
    b. The cumulative effect of the change on retained earnings as of the beginning of the earliest period presented (or as of the beginning of the period of adoption if transition method to forego comparative reporting was selected).
    c. Any effect on the prior periods retrospectively adjusted, including all financial statement subtotals and totals other than income from operations and net income.
3. If indirect effects of the change in accounting principle are recognized:
    a. A description of the indirect effects, including the amounts recognized in the current period and related per-share amounts, if applicable.
    b. Unless impracticable, the amount of the total recognized indirect effects and the related per share amounts, if applicable, that are attributed to each prior period presented.

According to the guidance, entities that issue interim financial statements should provide these disclosures in the financial statements of both the interim period of the change and the annual period of the change.

Additionally, if an entity uses one or more of the three transition practical expedients above, that fact should be disclosed.

FASB ASC TOPIC 842 POLICY ELECTIONS

1. SHORT-TERM LEASES (ASC 842-20-25-2)

______________________ ☐ does ☐ does not make the accounting policy election to not apply the recognition requirements in ASC Topic 842 to short-term leases. Short-term leases are those which have a lease term of 12 months or less, including renewal options likely to be exercised, and do not include options to purchase the underlying asset the lessee is likely to exercise.

2. REASONABLE RECOGNITION THRESHOLD (ASU 2016-02 BC122)

______________________ has established a $______________________ reasonable recognition threshold. The requirements of ASC Topic 842 will not be applied to contracts with total consideration below this threshold. We have determined that the exclusion of contracts below this threshold will not result is misstatements of the financial statements, individually or in the aggregate, that are material to users of the financial statements.

3. SEPARATING LEASE AND NONLEASE COMPONENTS (ASC 842-10-15-37)

______________________ ☐ does ☐ does not make the accounting policy election to not separate nonlease components from lease components.

If the organization does make this accounting policy election, it will account for each separate lease component and the nonlease components associated with it as a single lease component.

If made, this election applies to the following classes of underlying assets:

____

4. MAJOR PART OF THE ECONOMIC LIFE (ASC 842-10-55-2)

______________________has established _____% is an appropriate threshold to determine whether the lease term represents a major part of the economic life of the underlying asset for the purpose of lease classification. This threshold will be applied consistently to all leases.

5. SUBSTANTIALLY ALL OF THE FAIR VALUE (ASC 842-10-55-2)

______________________ has established _____ % is an appropriate threshold to determine whether the present value of the sum of lease payments, and any residual value guaranteed not reflected in lease payments is substantially all of the fair value of the underlying asset for the purpose of lease classification. This threshold will be applied consistently to all leases.

6. RISK-FREE RATE (ASC 842-20-30-3)

______________________ ☐does ☐ does not make the accounting policy election to use a risk-free discount rate for the lease, determined using a period comparable with that of the lease term. This election will be applied consistently to all leases in the following asset classes:

____

7. FINANCIAL STATEMENT PRESENTATION (ASC 842-20-45-1)

________________________ elects to

☐ present in the statement of financial position

☐ disclose in the notes to the financial statements, including disclosure of which line items in the statement of financial position include the following amounts:

1. Finance lease right-of-use assets and operating lease right-of-use assets separately from each other and from other assets.
2. Finance lease liabilities and operating lease liabilities separately from each other and from other liabilities.

8. TRANSITION METHOD (ASC 842-10-65-1(C))

________________________ elects the following transition method:

☐ Retrospectively to each prior period presented.

☐ Retrospectively at the beginning of the period of adoption (foregoes comparative reporting; prior periods presented continue to be reported under ASC Topic 840).

9. PACKAGE OF THREE PRACTICAL EXPEDIENT (ASC 842-10-65-1(F))

________________________ ☐ does ☐ does not elect to use the "package of three" practical expedient. Organization acknowledges that all three must be adopted as a package and applied consistently to all leases.

10. HINDSIGHT PRACTICAL EXPEDIENT (ASC 842-10-65-1(G))

________________________ ☐ does ☐ does not elect to use the practical expedient to use hindsight in determining the lease term and in assessing impairment of ROU assets. This practical expedient will be applied consistently to all leases.

11. EASEMENTS PRACTICAL EXPEDIENT (ASC 842-10-65-1(GG))

☐ Not applicable.

________________________ ☐ does ☐ does not elect to use the practical expedient to not assess whether existing or expired land easements that were not previously accounted for as leases under Topic 840 are or contain a lease under this Topic.