

ASC Topic 842: Lease Accounting

The FASB's New Guidelines and
Their Effects on Leasing Arrangements



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Overview

In February 2016, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) 2016-02, *Leases*, which provides new guidelines that change the accounting for leasing arrangements.

The new guidelines are contained in Accounting Standards Codification (ASC) Topic 842, *Leases*. Conforming changes were made throughout the Codification as applicable. The current guidance in ASC Topic 840 will be discontinued.

Compared with legacy lease accounting, ASC Topic 842 primarily changes the accounting for lessees, requiring lessees to record assets and liabilities on the balance sheet for almost every lease. This significantly differs from legacy accounting for operating leases, under which they were viewed as executory contracts not recognized for accounting purposes—in other words, they were off balance sheet.

In this guide, we focus on how the new standard applies to lessees. (For an overview of its impact on lessors, see *How Will ASC Topic 842 Affect Lessors?*, page 08.)

INSIGHT

ASC Topic 842 is the culmination of a decade-long, joint project with the FASB's international counterpart, the International Accounting Standards Board (IASB). The IASB released its standard on lease accounting, IFRS 16, *Leases*, on January 12, 2016.

The IASB and FASB agreed on many aspects of lease accounting but reached different decisions in one fundamental area: the lessee accounting model. IFRS 16 applies a single lessee accounting model, which requires all leases to be accounted for in a manner similar to a finance lease under ASC Topic 842.

IFRS also provides an exemption for leases of low-value assets. In its basis for conclusions, the IASB indicated it didn't intend to require lessees to apply the full finance lease accounting to leased assets with a value of \$5,000 or less at lease commencement.

IFRS 16 and ASC Topic 842 also differ in terms of the treatment of subleases, sale-leaseback transactions, and variable lease payments. Last, IFRS 16 contains different disclosure, effective date, and transition provisions.

EXAMPLES

Before we get into the details, let's consider two relatively simple examples of how a lessee applies ASC Topic 842.

The first example looks at the accounting for a finance lease, the new term introduced in ASC Topic 842 to describe what are often classified as capital leases today. The second example shows the accounting for an operating lease (see Lease Classification, page 18.)

Both examples use the same lease payment schedule and an assumed lease term of three years. For simplicity, all lease payments are made in arrears—specifically \$100,000 at the end of Year 1, \$110,000 at the end of Year 2, and \$125,000 at the end of Year 3. The appropriate discount rate for both examples is 5.51%, meaning the present value for both sets of lease payments is \$300,000. (See page 28 for more on discount rates.) Finally, the lessee expects to benefit from the right to use the leased asset evenly over the lease term.

FINANCE LEASE

Similar to legacy accounting for capital leases, a lessee in a finance lease initially records an asset and liability for the present value of the lease payments (see Lease Payments, page 26). Under ASC Topic 842, the asset is referred to as a right-of-use (ROU) asset. It represents the lessee's right to use an asset over the term of the lease.

The ROU asset and lease liability are recognized at lease commencement, the date on which the lessor makes an underlying asset available for use by the lessee. Using the figures set out at the beginning of the example, the lessee records the following journal entry:

During year one, the lessee recognizes entries, first, to accrete interest on the lease liability; second, to amortize the ROU asset evenly over the three-year lease term; and third, to reflect the scheduled lease payment.

LEASE COMMENCEMENT

ROU asset	\$300,000
Lease liability	\$300,000

YEAR ONE ENTRY

Interest expense	\$16,535 ¹
Lease liability	\$16,535
Amortization expense	\$100,000 ²
ROU asset	\$100,000
Lease liability	\$100,000
Cash	\$100,000

YEAR TWO ENTRY

Interest expense	\$11,935 ³
Lease liability	\$11,935
Amortization expense	\$100,000
ROU asset	\$100,000
Lease liability	\$110,000
Cash	\$110,000

YEAR THREE ENTRY

Interest expense	\$6,530 ⁴
Lease liability	\$6,530
Amortization expense	\$100,000
ROU asset	\$100,000
Lease liability	\$125,000
Cash	\$125,000

¹ \$300,000 lease liability × 5.51%

² \$300,000 ROU asset ÷ 3-year lease term

³ (\$300,000 initial lease liability – \$100,000 payment in Year 1 + \$16,535 accretion in Year 1) × 5.51%

⁴ (\$300,000 initial lease liability – \$100,000 payment in Year 1 – \$100,000 payment in Year 2 + \$16,535 accretion in Year 1 + \$11,935 accretion in Year 2) × 5.51%

INSIGHT

At the request of financial statement users, companies may disclose a non-GAAP financial measure called EBITDA, or earnings before interest, taxes, depreciation, and amortization. For a finance lease, the entire expense shown in the finance lease table is excluded from EBITDA, because it's recorded separately—as components of interest and amortization expense—on the income statement.



Over the three-year lease term, the lessee reports the following expenses and cash flows:

	Year One	Year Two	Year Three	TOTAL
Interest expense	\$16,535	\$11,935	\$6,530	\$35,000
Amortization expense	\$100,000	\$100,000	\$100,000	\$300,000
Total expense	\$116,535	\$111,935	\$106,530	\$335,000
Operating cash flows ⁵	\$16,535	\$11,935	\$6,530	\$35,000
Financing cash flows ⁶	\$83,465	\$98,065	\$118,470	\$300,000
Total cash flows	\$100,000	\$110,000	\$125,000	\$335,000

The lessee's balance sheet at the end of each year of the three-year lease term includes the following assets and liabilities:

	Year One	Year Two	Year Three
ROU asset	\$200,000	\$100,000	—
Lease liability	\$216,535	\$118,470	—

⁵ ASC Topic 842 requires the "interest component" of the cash lease payments to be presented as operating.

⁶ ASC Topic 842 requires the noninterest component of the cash lease payments to be presented as financing.

OPERATING LEASE

Unlike the lessee's accounting for finance leases, the accounting for operating leases is quite different under the new lease accounting standard. In contrast to legacy accounting requirements, ASC Topic 842 requires lessees to recognize an ROU asset and lease liability for operating leases.

At lease commencement, the lessee records exactly the same initial journal entry recorded under a finance lease.

Interestingly, the income statement and cash flow statement presentation for operating leases remains exactly the same under ASC Topic 842 compared to legacy GAAP. In particular, an entity recognizes a single lease expense from the operating lease on a straight-line basis over the lease term in its income statement.

In our example, the lessee agrees to make total payments of \$335,000 over a three-year period (\$100,000 in year one, \$110,000 in year two, and \$125,000 in year three). This means the lessee should recognize \$111,667 in operating lease expense each year ($\$335,000 \div 3$).

Again, under the new guidance, lessees report a single lease expense rather than the separate interest and amortization associated with a finance lease. However, some find it easier to think of this single lease expense as having two components:

INTEREST COMPONENT ⁷

The accretion of interest on the outstanding lease liability (the same as in a finance lease). This amount decreases over the lease term.

AMORTIZATION COMPONENT ⁷

The amortization of the ROU asset, recognized not as a constant amount each reporting period but rather as a balancing figure that keeps the total operating lease expense constant over the lease term. This amount increases over the lease term.

To demonstrate using our previous case facts, the interest component of the year one single lease expense is \$16,535 ($5.51\% \times \$300,000$). The amortization component of the single lease expense is \$95,132 (the \$111,667 annual lease expense less the interest component) to ensure the total single lease expense for year one is \$111,667. Recognizing an annual expense of \$111,667 over three years totals \$335,000, exactly equal to the total lease payments during the lease term.

LEASE COMMENCEMENT

ROU asset	\$300,000
Lease liability	\$300,000

YEAR ONE ENTRY

Lease expense	\$111,667 ⁹
Lease liability	\$83,465 ¹⁰
ROU asset	\$95,132
Cash	\$100,000

YEAR TWO ENTRY

Lease expense	\$111,667
Lease liability	\$98,065
ROU asset	\$99,732
Cash	\$110,000

YEAR THREE ENTRY

Lease expense	\$111,667
Lease liability	\$118,470
ROU asset	\$105,137
Cash	\$125,000

INSIGHT

The most significant change in a lessee's accounting for operating leases under ASC Topic 842 relates to the recognition of ROU assets and lease liabilities on the balance sheet throughout the lease term.

The income statement and cash flow statement presentation for operating leases is largely the same as under legacy lease accounting. However, lessees need to employ new processes—such as creating interest-amortization schedules and calculating the balancing figure reduction of the ROU asset—to account for and properly disclose operating leases under ASC Topic 842.

Companies should modify or update their processes and accounting systems to address the new operational requirements of ASC Topic 842 as early as possible. The timing is especially important because companies will likely be adopting the new revenue guidance in ASC Topic 606 as well.

Over the three-year lease term, the lessee reports the following expenses and cash flows:

	Year One	Year Two	Year Three	TOTAL
Interest component	\$16,535	\$11,935	\$6,530	\$35,000
Amortization component	\$95,132	\$99,732	\$105,137	\$300,000
Total single lease expense	\$111,667	\$111,667	\$111,667	\$335,000
Operating cash flows	\$100,000	\$110,000	\$125,000	\$335,000

In the above table, note that the amortization component of the lease expense increases over the lease term. This is necessary to ensure the total single lease expense remains constant during the lease term, but it implies the ROU asset is consumed more in later years than in earlier periods. The FASB acknowledged this idiosyncrasy but ultimately decided this unusual outcome is acceptable given its decisions around the overall accounting for operating leases and the strong desire to maintain a constant lease expense as opposed to a front-loaded expense such as that of a finance lease.

Unlike with a finance lease, the entire lease expense shown in the above table is included in EBITDA. This is because ASC Topic 842 requires the lease expense from an operating lease to be presented in a single line item in the operating section of the income statement (even if you do find it easier to think of an operating lease as having both an interest component and an amortization component). ASC Topic 842 further prescribes that all lease payments made under an operating lease be presented as operating cash flows.

In conclusion, the lessee reports the following assets and liabilities under the operating lease throughout the lease term:

	Year One	Year Two	Year Three
ROU asset	\$204,868	\$105,137	—
Lease liability	\$216,535	\$118,470	—

Note: Under the legacy guidelines in ASC Topic 840, the lessee's balance sheet would have reflected a deferred lease liability of \$11,667 at the end of year one and \$13,333 at the end of year two. These amounts are equal to the net of the ROU asset and the lease liability reflected under ASC Topic 842.

- 7 These two terms—interest component and amortization component—aren't used in the Codification and shouldn't be interpreted as such.
- 8 Discount rate percentages have been rounded to the nearest hundredth.
- 9 Includes the interest component, \$16,535, and the amortization component, \$95,132.
- 10 \$100,000 year one payment – \$16,535 Year 1 interest component
- 11 $(\$300,000 \text{ initial lease liability} - \$100,000 \text{ payment in year one} + \$16,535 \text{ accretion in year one}) \times 5.51\%$
- 12 Includes the interest component of \$11,935 and the amortization component of \$99,732.
- 13 \$110,000 year two payment – \$11,935 year two interest component
- 14 Includes the interest component, \$6,530, and the amortization component, \$105,137.
- 15 \$125,000 year three payment – \$6,530 year three interest component
- 16 \$300,000 – year one amortization component, \$95,132.
- 17 \$204,868 (year one ending balance) – \$99,732 (year two amortization component, rounded)

HOW WILL ASC TOPIC 842 AFFECT LESSORS?

The FASB originally undertook the lease accounting project to address criticism from SEC staff and others regarding lessee accounting for operating leases. A main objective of ASC Topic 842 is to ensure lessee financial statements provide comparability and transparency by recognizing assets and liabilities for the vast majority of lease arrangements.

During project deliberations, the FASB considered also making changes to the lessor accounting model but ultimately concluded legacy accounting guidelines were generally appropriate. Therefore, ASC Topic 842 makes relatively few amendments to legacy lessor accounting rules. The handful of targeted changes focus on aligning lessor accounting with concepts in ASC Topic 606, *Revenue from Contracts with Customers*.

Under ASC Topic 842, lessors continue to classify leases as operating, direct financing, or sales-type. Lessors are no longer able to classify arrangements as leveraged leases, but leveraged leases existing as of the transition date will be grandfathered.

Sales-Type Leases

For a sales-type lease, the lessor must transfer control of the underlying asset to the lessee. In other words, a lessor couldn't recognize revenue and selling profit unless the lease arrangement meets the revenue recognition conditions in the new ASC Topic 606. (For more on ASC Topic 606, see our revenue recognition report at mossadams.com/revrec.)

Under legacy US generally accepted accounting principles (GAAP), a sales-type lease occurs when, among other conditions, the fair value of the leased property at lease inception differs from its carrying amount. It's no longer necessary to classify this condition as a sales-type lease under ASC Topic 842. Instead, a sales-type lease results when a lease meets one of five criteria. These same criteria, if all met, require a lessee to classify an arrangement as a finance lease (see Lease Classification, page 18).

Finally, ASC Topic 842 changes what qualifies as an initial direct cost (IDC) of entering into a lease. In short, only incremental costs are eligible for deferral under ASC Topic 842. This means that internal costs—even if associated with specified lease-origination activities—can't be deferred as IDCs under the new lease accounting guidelines. This is different from the treatment of loan origination costs under ASC Subtopic 310-20. Financial institutions that enter into both loan and lease transactions may need to establish new processes to differentiate IDCs under ASC Topic 842 from direct loan origination costs under ASC Subtopic 310-20.



Definition of a Lease

ASC Topic 842 defines a lease as:

“a contract, or part of a contract, that conveys the right to control the use of an identified asset for a period of time in exchange for consideration.”

A contract is (or contains) a lease if the following two conditions are met:

IDENTIFIED ASSET

The contract explicitly or implicitly specifies the use of identified property, plant, or equipment.



CUSTOMER CONTROL

The customer controls the use of the identified asset for a period of time.



IDENTIFIED ASSET

A lease must explicitly or implicitly identify a specific asset that is the subject of the contract. Therefore, if the supplier has a substantive substitution right, the contract isn't a lease.

SUBSTANTIVE SUBSTITUTION RIGHTS

Supplier has the practical ability to substitute the identified asset ✓

Supplier can benefit from exercising that right of substitution ✓

Both conditions met = supplier has the substantive right to substitute an asset ✓

In some situations, judgment is necessary to determine if a contract specifies an identified asset.

For example, transportation contracts may explicitly or implicitly specify the exact vessel, rail car, or truck to be used. If no other practical alternatives can be used to fulfill the transportation services, the contract may be (or contain) a lease, depending on whether the customer can control the use of the transportation vehicle.

EXAMPLE



ABC CO

To demonstrate, assume ABC Co. enters into a contract to receive up to 50 terabytes of server space to house entity-specific applications and store data. The vendor owns hundreds of servers and has the right to select which server (or portion of a server) will host ABC's software and data. For instance, the vendor can easily shift ABC's data to another server in less than one hour if a new customer requires the entire capacity of a particular server.

This contract doesn't contain a lease of server equipment, because no one specific asset is the subject of the contract. The vendor's substitution rights are substantive because it has the practical ability to substitute servers and can benefit from that right by using the servers for other business opportunities.

EXAMPLE



ZYX CORP.

In contrast, assume ZYX Corp. is a logistics company that rents its forklifts from Lift Co. Its contract with Lift Co. specifies the make, model, and serial number of each forklift provided to ZYX Corp. for a specified period of time. The contract doesn't allow for a right of substitution, except if a forklift breaks down, the supplier must provide a like-kind replacement within two business days.

Unlike in the prior scenario, the substitution right isn't substantive, because it doesn't provide the supplier with an economic benefit. The supplier incurs expense in trailering the replacement equipment to and from the ZYX Corp.'s facility and is unable to use the substitute forklift for other lease arrangements. Therefore, this contract is a lease, assuming the customer can control the use of the identified assets (in this case, the forklifts).

CUSTOMER CONTROL

Under ASC Topic 842, a contract conveys the right to control the use of an identified asset if, throughout the period of use, the customer has the right to both:

CUSTOMER CONTROL CRITERIA

Direct the use of the identified asset	✓
--	---

Obtain substantially all of the economic benefits from the use of the identified asset	✓
--	---

Both conditions met = Customer has right to control the asset	✓
--	----------

The right to direct the use of an identified asset means the lessee has the right to direct how the asset is used and for what purpose. This includes the right to change how the asset is used throughout the contract term. ASC Topic 842 further indicates a supplier's protective rights over the identified asset don't necessarily prevent the customer from having the right to direct its use.

EXAMPLE

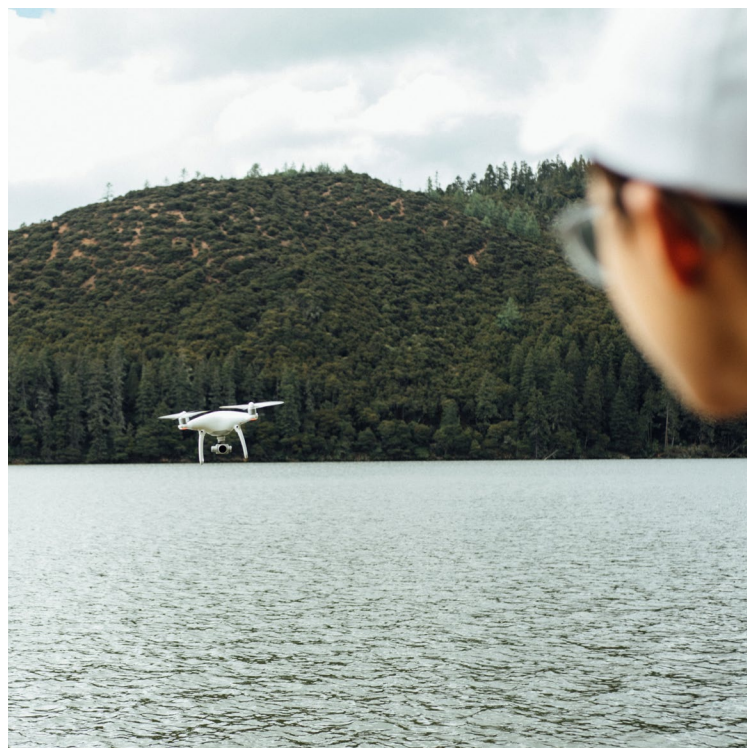


FDR INC.

For example, assume FDR Inc. contracts a fleet of cars for its sales force. The contract specifies that the cars must be driven less than 15,000 miles per year and can't be driven recklessly or taken outside the continental United States.

Despite these protective rights, FDR likely has the ability to direct the use of the automobiles. FDR determines which member of the sales force should be provided a car and defines the job responsibilities of those individuals (including how the car is used to fulfill those duties).

FDR also can change how and for what purpose the cars are used. For instance, FDR may decide the cars should be provided to senior executives and plant managers rather than distributed to the sales force. Therefore, FDR has the right to direct the use of the cars specified by the contractual arrangement, and the restrictions in the contract are simply protective rights.





INSIGHT

The definition of a lease in ASC Topic 842 is different from legacy GAAP in ASC Topic 840.

Accordingly, some contracts considered leases under ASC Topic 840 may no longer meet the definition of a lease in ASC Topic 842 and vice versa. For example, legacy GAAP¹⁸ indicates an arrangement is or contains a lease if the purchaser “has the ability or right to control physical access to the underlying property, plant, or equipment while obtaining or controlling more than a minor amount of the output or other utility of the property, plant, or equipment.”

CUSTOMER-CONTROLLED EQUIPMENT

Some companies enter into solar agreements whereby a supplier installs equipment on the roof of the customer's facility. That equipment generates electricity, which is substantially consumed by the customer. This arrangement likely represents a lease under legacy GAAP because the equipment is located on the customer's property; therefore, the customer controls access to the equipment. Moreover, much or all the output from the solar equipment is consumed by the customer.

Under ASC Topic 842, determining whether the solar agreement contains a lease requires further analysis. For instance, if the supplier has substantive rights to substitute the solar equipment, the arrangement doesn't represent a lease (even in part) under ASC Topic 842. Similarly, if the customer can't direct the use of the equipment—changing how and for what purpose it's used—then it also doesn't contain a lease.

PURCHASE POWER AGREEMENTS

Companies may participate in power purchase agreements (PPAs), which means they receive substantially all the output from power-producing equipment and pay a fee that's neither contractually fixed per unit of output nor equal to the current market price per unit of output as of the time of delivery. This arrangement generally contains a lease under legacy GAAP; however, this same type of agreement may not be a lease under ASC Topic 842. If the supplier of the power equipment can direct the equipment's use (control how it's operated without any direction from the customer), it may not be a lease under ASC Topic 842.

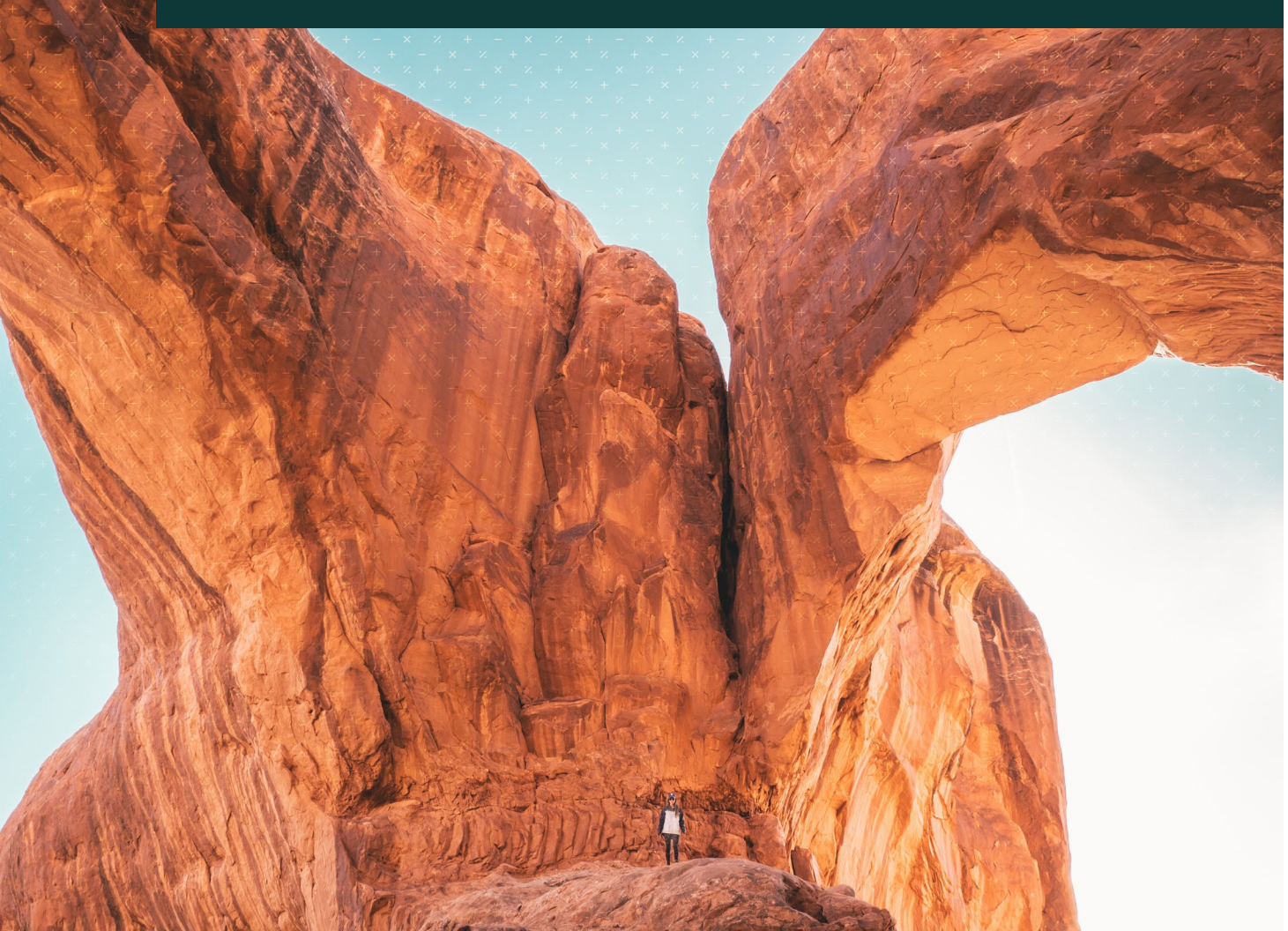
FIBER-OPTIC CABLE & NETWORK SERVICES

Entities that enter into arrangements to use fiber-optic cable or network services or various types of transportation agreements must carefully evaluate those arrangements to see whether they contain leases under the new lease accounting standard.

STRUCTURED ARRANGEMENTS

Some parties may attempt to structure arrangements—including small-ticket equipment leases—to intentionally fail the conditions that require lease accounting in ASC Topic 842 so they're instead accounted for as service contracts. Doing so purportedly allows the arrangement to be accounted for off the balance sheet, with no ROU asset or lease liability recognized by the customer. Carefully evaluate the substance of these arrangements. In many cases (and despite supplier assurances to the contrary), these structured arrangements may still meet the definition of a lease, meaning they need to be accounted for within the scope of ASC Topic 842.

18 See ASC 840-10-15-6 (derived from Emerging Issues Task Force Issue No. 01-8, *Determining Whether an Arrangement Contains a Lease*).



SCOPE EXCEPTIONS TO ASC TOPIC 842

The new leasing guidelines don't apply to the following:

Intangible assets	ASC Topic 350
Leases to explore for or use minerals, oil, natural gas, and similar nonregenerative resources	ASC Topics 930 and 932
Biological assets, including timber	ASC Topic 905
Inventory	ASC Topic 330
Assets under construction	ASC Topic 360

SHORT-TERM LEASES

In addition, lessees can elect not to recognize short-term leases on their balance sheet under ASC Topic 842 and instead account for them as executory contracts, which is similar to the accounting for operating leases under legacy GAAP. The accounting policy election for short-term leases must be made by class of underlying asset.

A short-term lease is one with a maximum lease term of 12 months or fewer that doesn't include an option to purchase the underlying asset that the lessee is reasonably certain to exercise.

Careful consideration is required when evaluating whether a lease has a maximum term of 12 months or fewer. For example, a month-to-month lease (whether for equipment or facilities) may not qualify as a short-term lease if the lessee is economically compelled to renew the lease beyond the next 12 months. This could occur for the following reasons:

- The leased asset is of a specialized nature and difficult to replace.
- The leased asset is necessary to fulfill customer orders under a long-term contract, so it's commercially disruptive to exit the lease.

SMALL-TICKET ITEMS

There are no scope exceptions for small-ticket items such as automobiles, computers, or even copiers. These must be accounted for using an asset and liability approach under ASC Topic 842, provided the lease term is more than 12 months. However, lessees are allowed to account for leases on a portfolio basis. For example, a lessee may group together copier lease contracts entered into around the same time and under similar lease terms. Similarly, leases for a bundle of laptops or even for a fleet of cars may qualify for the portfolio accommodation.

EXAMPLE



Assume DGH leases its headquarters building and warehouse from a related-party entity on a month-to-month basis. Although the lease agreement is between related parties and is for nonunique facilities, the lease may still not qualify as short-term if it's commercially disruptive or expensive for DGH to relocate.

In other words, if DGH is economically compelled to extend the lease for more than 12 months, the arrangement doesn't qualify for the short-term lease policy election under ASC Topic 842.

Other examples could include significant lessee investments in leasehold improvements, a high degree of integration of the leased asset, or regulatory certification or approval of systems that incorporate the leased asset.

INSIGHT

Determining whether separate leases can be grouped and accounted for on a portfolio basis involves judgment. To safely qualify for the portfolio accommodation, the group of leases should be for similar assets, have relatively similar lease terms (that is, no more than a 12-month difference between the shortest and longest lease), and commence within a few months of each other. Accounting for leases on a portfolio basis requires management to calculate the weighted-average lease term for the portfolio of leases as well as develop an appropriate weighted-average discount rate.

Leases are often characterized commercially as net or gross leases.

NET LEASE

The monthly, quarterly, or annual lease payment covers solely the consideration for renting a lessor's asset. Ancillary costs, such as property taxes, insurance, and maintenance on the leased asset are paid separately and directly by the lessee.

OR

GROSS LEASE

The lessee's payments cover not only the cost of renting an asset, but also other ancillary costs paid directly by the lessor. This may include payments to cover maintenance or repair of the leased asset, property tax, insurance, etc.

Therefore, in a gross lease, there may be lease and nonlease components.

Nonlease Components

A nonlease component includes goods and services provided to the lessee separate from the right to use the leased asset. Examples of nonlease components could be two years of scheduled maintenance on a leased automobile or security or janitorial services for a leased property when these services are included in the lease. However, payments to compensate a lessor for administrative tasks in setting up a lease contract or to reimburse the lessor for the costs of owning an asset (such as property taxes) don't represent nonlease components.

ASC Topic 842 indicates a lessee should separately account for nonlease components, though a lessee may optionally elect a policy to account for nonlease components as being related to lease components. Specifically, the lessee should allocate the total consideration in the contract to the lease and nonlease components using a relative stand-alone price basis. When observable, stand-alone prices aren't available, lessees should estimate the stand-alone price for lease and nonlease components based on the best available information.

EXAMPLE**SHK INDUSTRIES**

To demonstrate, assume SHK Industries leases equipment for two years and determines the arrangement should be classified as a finance lease. The monthly payment is fixed at \$3,000 per month, payable in advance, for the entire term of the lease. SHK separately pays for insurance and taxes on the leased equipment. Under the lease contract, the lessor agrees to remain on call 24 hours a day, seven days a week, in the event the equipment unexpectedly stops working. The lessor also agrees to repair or replace the nonfunctioning equipment within one business day.

This embedded support agreement represents a nonlease component. This is because the support agreement provides a service to SHK, which SHK would have to pay for separately if not otherwise included in the contract. However, SHK's payments for insurance and taxes don't represent separate components of the contract because they're solely a reimbursement for the lessor's costs of owning the asset. Accordingly, SHK bifurcates the monthly payments into a lease component (the right to use the equipment) and a nonlease component (the service contract) based on relative stand-alone prices. Assuming the insurance and tax rates aren't fixed, these payments are treated as variable lease payments and excluded from the measurement of the ROU asset and lease liability.

SHK determines it could enter into a maintenance contract with a third party that provides similar scheduled and on-call services for a cost of \$7,500 per year. SHK can't find observable stand-alone prices for the lease component of the arrangement from the specific supplier, but it can estimate—based on observable data from competing leasing companies—that net leases for comparable equipment run \$2,500 per month. Accordingly, the stand-alone prices of the contract's components are:

- A two-year service contract at \$15,000 (\$7,500 per year for two years)
- The lease of equipment at \$60,000 (\$2,500 per month for 24 months)

On a relative stand-alone price basis, 20% of the contract amount should be allocated to the service contract (nonlease component), and 80% to the lease component. These percentages come from dividing each component's stand-alone price by their sum. When applying those same percentages to the \$3,000 monthly lease payment, the result

is a monthly allocation of \$2,400 to the lease component and \$600 to the nonlease component.

As discussed earlier, ASC Topic 842 requires lessees to initially recognize an ROU asset and lease liability at lease commencement. In the case of SHK Industries, the ROU asset and lease liability are based solely on the payment allocated to the lease component of the arrangement, or \$2,400 per month. Assuming a discount rate of 6.83%, SHK initially records an ROU asset and lease liability of \$54,000¹⁹ at lease commencement.

Each month, under the finance lease, SHK amortizes the ROU asset and recognizes interest on the lease liability. SHK does the following with the \$3,000 monthly payment:

- Applies \$2,400 against the accrued interest and lease liability
- Accounts for the remaining \$600 as a period expense, a prepaid asset (or liability, if more services have been consumed than paid), or a combination of the two, depending on the pattern in which nonlease services are provided under the contract

Because this accounting can get complex, lessees may make an accounting policy election by class of underlying asset to not separate lease from nonlease components. Instead, lessees can elect to account for lease and nonlease components together, as a single combined lease component. Had SHK elected to account for the lease and nonlease components on a combined basis, the initial ROU asset and lease liability would have been approximately \$67,500²⁰ as opposed to the \$54,000 figure calculated earlier.

Each month thereafter, SHK amortizes the ROU asset, recognizes interest on the lease liability, and applies the entire \$3,000 monthly payment against the lease liability.

INSIGHT

The accounting policy election to jointly account for payments attributable to nonlease components must be made by class of underlying asset. For example, lessees need to make separate policies elections for leases of copiers, heavy machinery, automobiles, and real estate.

¹⁹ Reflects the present value of an annuity of \$2,400 per month, for 23 periods, discounted at an annual rate of 6.83%, plus the initial up-front payment of \$2,400.

²⁰ Reflects the present value of an annuity of \$3,000 per month, for 23 periods, discounted at an annual rate of 6.83%, plus the initial up-front payment of \$3,000.



Lease Classification

Lessees should classify leases as either finance or operating.

An arrangement is a finance lease if it effectively represents an installment purchase by the lessee. More specifically, an arrangement is a finance lease if any of the following conditions exist, as determined at lease commencement:

FINANCE LEASE CRITERIA

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

The lease provides the lessee an option to purchase the underlying asset, and that option is reasonably certain to be exercised (see Factors in Classification, page 20). ✓

The lease term is for the **major part** of the remaining economic life of the underlying asset, even if title isn't transferred. ✓

Note: This criterion doesn't need to be considered if the lease commencement date falls at or near the end of the economic life of the underlying asset.²¹

The present value of the lease payments (see Lease Payments, page 26)—plus any residual value guaranteed by the lessee that isn't already reflected in the lease payments—equals or exceeds **substantially all** the fair value of the underlying asset. ✓

The underlying asset is of such a **specialized nature** that only the lessee can use it without major modifications. In other words, the lessor expects to have no alternative use for the leased asset at the end of the lease. ✓

ANY condition exists = finance lease ✓

The first four conditions of lease classification are fairly similar to legacy GAAP, except that there are no longer any bright lines or specific numerical values that automatically trigger finance lease classification.

Under ASC Topic 842, companies can't simply default to the percentages in legacy GAAP when evaluating whether the lease term is for a major part of the economic life of the leased asset, or whether the present value of the minimum lease payments equals or exceeds substantially all the fair value of the underlying asset. Instead, lessees should examine their own business practices and use judgment in determining whether a lease meets either of these conditions.

Having said this, the new leasing guidance does state that "one reasonable approach" to assessing the aforementioned criteria is to conclude that a finance lease results if either of the following conditions are met:

The lease term is equal to **75%** or more of the remaining economic life of the leased asset. ✓

The present value of lease payments (plus any residual value guarantee) equals or exceeds **90%** of the fair value of the leased asset. ✓

EITHER condition met = finance lease ✓

If the classification of a particular lease is unclear, lessees should return to the underlying distinction in ASC Topic 842. The arrangement should be classified as a finance lease if the lease effectively represents an installment purchase in which the lessee essentially acquires substantially all of the economic benefits of an asset and pays for this acquisition over time.

This is true even if the lease term is for less than 75% of the asset's remaining economic life, or the present value of the lease payments is for less than 90% of the leased asset's fair value.

ASC Topic 842 introduces a new fifth criteria to evaluate whether an arrangement should be classified as a finance lease. The FASB concluded if a leased asset is of a specialized nature, a lessor can't easily re-lease or even sell the asset to other parties. Accordingly, the lessor would demand, and the lessee would likely accept, that substantially all the leased asset's economic utility is transferred to or consumed by the lessee via the lease arrangement in exchange for commensurate payments over time.

That means the lease of a specialized asset is effectively an installment sale. It should be classified as a finance lease because no remaining benefits inherent in the specialized underlying asset revert to the lessor at the end of the lease.

²¹ While the standard stresses there are no bright lines in lease classification assessments, implementation guidance (ASC 842-10-55-2) states one reasonable approach would be to conclude that a lease commencing in the final 25% of an asset's economic life would be considered at or near the end of its economic life.

DETERMINING LEASE CLASSIFICATION

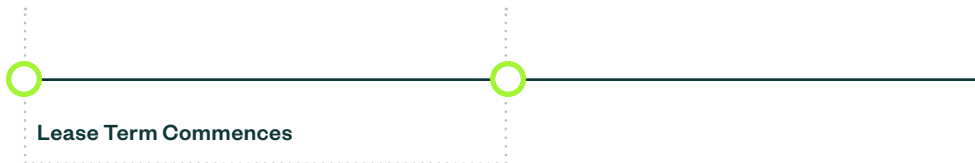
When evaluating the classification of a lease, the assessment is made at lease commencement and not lease inception as required by legacy lease accounting. The difference between lease commencement and lease inception is shown in the following graphic.

LEASE INCEPTION DATE

Date the principal terms of the lease are agreed to.

LEASE COMMENCEMENT DATE

Date the lessor makes an underlying asset available for use by the lessee.



Consider other GAAP to determine how to account for and disclose the existence of other rights or obligations created between the lease inception date and the commencement date.

Date at which a lessee should initially classify, recognize, and measure lease-related assets and liabilities—except if applying the short-term lease exemption.

FACTORS IN CLASSIFICATION

In making this determination, consider contract-, asset-, market-, and entity-based factors described in ASC 842-10-55-26. For example, is the option price expected to be lower than the asset's fair value at the time of exercise? Is the leased asset difficult for the lessee to replace? If the lessee is economically compelled to exercise the option, the arrangement should be classified as a finance lease.

See Lease Term, page 22 for more on this topic.



Applying ASC Topic 842

This section discusses the following six specific areas of focus when applying ASC Topic 842:

1

Lease Term

Determining the lease term, considering extension, renewal, and early termination clauses

2

Purchase Options

Evaluating purchase options, term-extension options, and early termination clauses

3

Lease Payments

Determining the six key components lease payments comprise under ASC Topic 842

4

Discount Rate

Discerning the discount rate used to calculate the present value of the future lease payments

5

Initial Direct Costs (IDCs)

Defining lessee IDC regulations after entering into a lease under ASC Topic 842

6

Financial Statement Presentation

Calculating balance sheet, income statement, and statement of cash flows

LEASE TERM

Identifying the lease term is critical in accounting for leases and is determined at the lease commencement date. When identifying the lease term, the lessee must consider the extension, renewal, and early-termination clauses.

The lessee uses the lease term to evaluate whether a lease should be classified as operating or finance, to calculate the initial measurement of the ROU asset and lease liability, and in subsequent accounting for the lease.

ASC Topic 842 states that the lease term includes the following:

Noncancellable period for which a lessee has the right to use an underlying asset



Any periods covered by an option to:

EXTEND THE LEASE

If the lessee is reasonably certain to exercise that option

TERMINATE THE LEASE

If the lessee is reasonably certain they will not exercise that option

EXTEND THE LEASE (OR NOT TERMINATE)

If the lessor controls the ability to exercise that option



REASONABLY CERTAIN THRESHOLD

Reasonably certain is intended to be a high threshold consistent with the *reasonably assured* threshold in previous lease guidance (ASC Topic 840). It reflects an even greater likelihood of occurrence than the term *probable*, which is used elsewhere in GAAP.²² Therefore, to reflect an option in the lease term, a lessee must be very confident an option to extend will be exercised, or an option to terminate won't be exercised, assuming the lessee has control of the option

Judgment is necessary in evaluating whether a lessee is reasonably certain to exercise an option to extend (or not terminate) a lease. In making this judgment, a lessee should consider all relevant factors that create an economic incentive for the lessee to exercise such options.

ASSET-BASED FACTORS

If the leased asset is difficult to procure, the lessee may have a significant economic incentive to exercise any renewal or extension options or forgo any early termination options, particularly if the asset is critical to the lessee's operating activities.

CONTRACT-BASED FACTORS

If the contract contains a substantial penalty for failure to renew or extend the lease, it could lead the lessee to conclude it has a significant economic incentive to extend the lease beyond the base rental period.

MARKET-BASED FACTORS

The contractual renewal rate may be well below expected market rates for similar assets at the date the option is exercisable. Therefore, there may be an expectation at lease commencement that a significant economic incentive will exist for the lessee to take advantage of the below-market renewal pricing and extend the lease.

ENTITY-BASED FACTORS

If the lessee plans to invest significant time and money installing or integrating the leased asset into its operations, dismantling the leased asset and replacing it will be disruptive and costly. Accordingly, these entity-based factors may cause the lessee to conclude it has a significant economic incentive to renew or extend the lease.

EXAMPLE

For example, say a lessee enters into a property lease with a noncancelable term of six years and an option to extend for another three years. The lessee plans to invest a significant amount in leasehold improvements that won't be readily saleable, and those improvements will easily have an economic life of nine years or more. Accordingly, the lessee may have a significant economic incentive to exercise the three-year option, which would maximize its investment in the leasehold improvements.

²² Although *probable* isn't defined in US GAAP, most believe it connotes a likelihood of occurrence of 75% or more. To support this assertion, ASC 815-20-25-16(e) states: "The term *probable* requires a significantly greater likelihood of occurrence than the phrase *more likely than not*." In turn, ASC 740-10-25-6 states in part: "The term *more likely than not* means a likelihood of more than 50 percent."

REASSESSING THE LEASE TERM

Once the lease term has been established, it should be reassessed only at certain points in time, such as the following:

- A significant event or a significant change in circumstances within the lessee's control directly affects whether the lessee is reasonably certain to exercise, or not to exercise, an option to extend.
- The lessee elects to exercise an option even though the lessee previously determined it wasn't reasonably certain to do so.
- The lessee elects not to exercise an option, even though the lessee previously determined it was reasonably certain to do so.
- An event written into the contract obliges the lessee to exercise (or not to exercise) an option to extend or terminate the lease. For instance, the lease may require the lessee to extend the lease term if the leased asset is used for less than 1,000 hours during an initial lease term. If this condition is met, the lessee would reassess the previously determined lease term.

Note that the lease term shouldn't be reassessed simply because market rental rates start to increase following lease commencement. While commercially this would likely cause the lessee to reconsider exercising an option to extend, the increase in market rental rates isn't within the lessee's control.

On the other hand, if the lessee decides to exit a significant line of business in which the leased asset is used, the lessee should reevaluate the lease term, especially if it has the contractual ability to terminate the lease early—such as upon disposal of the business or if the lessee previously determined it was reasonably certain to exercise a renewal option.





PURCHASE OPTIONS

Under ASC Topic 842, purchase options included in lease agreements—assuming they aren't embedded derivatives, as defined in ASC 815-15-25-1—should be evaluated in exactly the same way as term-extension options or early termination clauses.

In particular, a lessee should evaluate whether it's reasonably certain to exercise a purchase option based on all relevant factors (see Lease Term, page 22). If exercise of the purchase option is reasonably certain, the lessee should do the following:

- Calculate the lease term as being through the date of the earliest purchase option that's reasonably certain to be exercised
- Include the amount to be paid upon exercise of the purchase option as a lease payment for purposes of calculating the initial ROU asset and lease liability

INSIGHT

If the exercise of a purchase option is reasonably certain, the lessee will likely classify the arrangement as a finance lease, either because:

The option price is expected to be sufficiently lower than the fair value of the leased asset at the date the option becomes exercisable (see the second criteria under Lease Classification, page 18).

The present value of the lease payments—including the option purchase price—equals or exceeds substantially all the underlying asset's fair value (see the fourth criteria under Lease Classification, page 18).

LEASE PAYMENTS

Under ASC Topic 842, lease payments comprise the following six components:

Fixed Payments

Fixed payments, including in-substance fixed payments²³, less any lease incentives paid or payable to the lessee
(see *Lease Incentives*, page 38)

Transaction Fees

Fees paid by the lessee to the owners of a special-purpose entity for structuring the transaction²⁴

Purchase Option

The exercise price of an option to purchase the underlying asset, if the lessee is reasonably certain to exercise that option
(see *Lease Term*, page 22)

Penalty Payments

Penalty payments for terminating the lease, when the lease term reflects the lessee exercising an option to terminate the lease

Amounts Owed

Amounts it's probable the lessee will owe under residual-value guarantees

Variable Lease Payments

Variable lease payments that depend on an index or a rate

²³ In-substance fixed payments are payments that may appear to contain variability but are, in effect, unavoidable. They're to be included in the lease payments used to determine the lease liability and ROU asset. In-substance fixed payments may result from terms that appear to contain variability but lack economic substance. An example of in-substance fixed payments is when a lessee has a choice among multiple payment options but must choose one; in such instances, the lower of the payment options should be included in the lease payments.

²⁴ These amounts aren't included in lease payments for purposes of evaluating lease classification in ASC 842-10-25-2.

ACCOUNTING FOR VARIABLE LEASE PAYMENTS

Sometimes, a lessee agrees to make rental payments that aren't fixed at lease commencement. Two common examples of variable lease payments are:

- Rents that increase each year based on the change in an index, such as the consumer price index (CPI)
- Payments contingent on achieving specified sales or net income figures
(For example, some retailers pay a portion of their storefront rent based on a percentage of sales, such as 4% of monthly sales in excess of \$500,000.)

Under ASC Topic 842, the accounting for variable lease payments is similar to how such payments were treated under ASC Topic 840. That is, most variable lease payments are ignored at lease commencement, other than those that depend on an index or rate, and accounted for as period expenses.

Exception

Changes in variable lease payments due to movements in an index or rate are generally excluded from the remeasurement of the lease liability and ROU asset. However, there's one exception to this principle. The ROU asset and lease liability should be remeasured using current rates or indices if the lease liability is remeasured for any other reason—for instance, following the reassessment of the lease term (see Lease Term, page 22).

Retail enterprises that lease storefronts often agree to make variable lease payments based on sales or other operating metrics—for example, EBITDA—from that location. These variable lease payments are accounted for in the exact same manner described in this example. Such variable payments aren't considered to be for separate nonlease components under ASC Topic 842 because they don't relate to goods or services separate from the right to use the asset.

EXAMPLE



CVNJ CO.

To demonstrate, assume CVNJ Co. enters into a 10-year building lease with an initial rent of \$100,000 per year, payable in advance. In subsequent years, the annual rent increases by the change in the CPI. CVNJ determines the arrangement is an operating lease.

In this scenario, CVNJ excludes potential rent increases due to changes in the CPI when determining lease classification and calculating the initial ROU asset or lease liability. Although variable lease payments that depend on an index or a rate are included in the initial measurement of ROU assets and lease liabilities per ASC Topic 842, those payments are measured using the index or rate at lease commencement.

This means that, throughout the term of the lease, the basis for CVNJ calculating the change in the lease payments is always the same CPI index that exists at lease commencement. Because the initial CPI index at lease commencement is used throughout the lease term, there are no additional lease payments to include when subsequently remeasuring the lease liability or related ROU asset.

In this example, the initial ROU asset and lease liability are \$700,000²⁵, assuming an appropriate discount rate of 8.98%. Because CVNJ determined the lease is an operating lease, CVNJ recognizes \$100,000²⁶ of lease expense in year one.

After the first year, assume the annual rental payment increases to \$105,000 based on the change in the CPI. CVNJ doesn't remeasure the consideration in the contract simply because of the change in the index or future rental payments; instead, CVNJ recognizes \$105,000 of operating lease expense in year two:

- \$49,742²⁷ of reduction of the lease liability
- \$50,258²⁸ of ROU asset reduction necessary to recognize lease expense on a straight-line basis
- \$5,000 of variable rent expense incurred in year two due to the change in CPI

25 Reflects the present value of an annuity of \$100,000 per annum, paid for nine years, discounted at an annual rate of 8.98%, plus the initial up-front payment of \$100,000.

26 Includes \$53,883 reduction of the lease liability [$8.98\% \times (\$700,000 \text{ initial lease liability} - \$100,000 \text{ initial payment in advance})$] and a balancing figure of \$46,117 reduction of the ROU asset.

27 $(\$700,000 \text{ initial lease liability} - \$100,000 \text{ payment in beginning of year one} + \$53,883 \text{ accretion in year one} - \$100,000 \text{ payment in beginning of year two}) \times 8.89\%$

28 $\$100,000 \text{ straight-line rent expense} - \text{year two accretion of the lease liability } (\$49,742).$

DISCOUNT RATE

Determining the discount rate used to calculate the present value of future lease payments

Implicit Rate

In calculating the ROU asset and lease liability, future lease payments should be discounted at the rate implicit in the lease, if known. This rate is sometimes disclosed in the lease documentation, particularly in small-ticket equipment leases such as for copiers, computers, and vehicles. The rate implicit in the lease can be calculated if the fair value of the leased asset, the periodic payments due under the lease, and the lessor's expected residual value for the leased asset are all known to the lessee at lease commencement.

Incremental Borrowing Rate

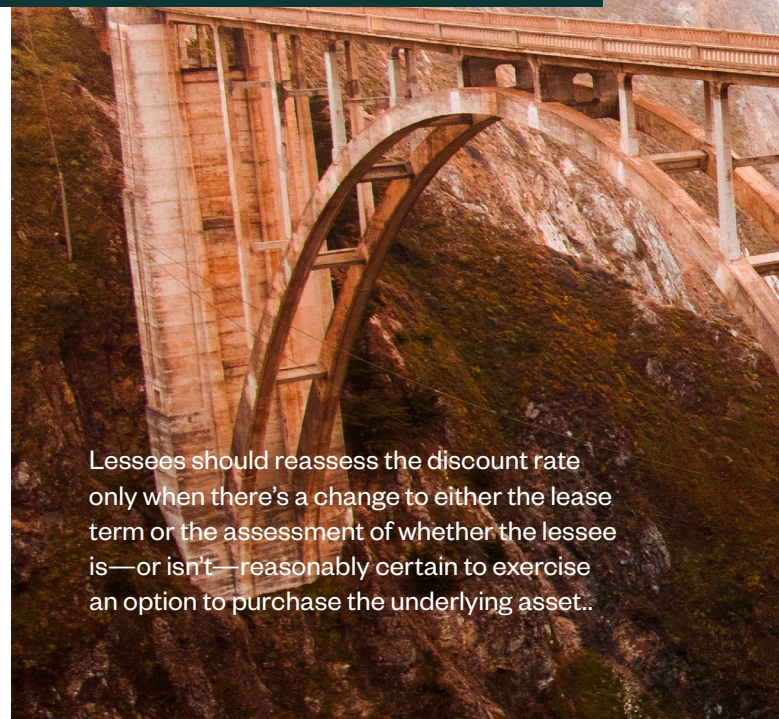
If the rate implicit in the lease isn't known or calculable, the lessee should use its incremental borrowing rate at lease commencement.

ASC Topic 842 defines the incremental borrowing rate as, "the rate of interest that a lessee would have to pay to borrow on a collateralized basis over a similar [lease] term an amount equal to the lease payments in a similar economic environment."

Judgment is necessary in estimating the incremental borrowing rate. Companies should support their estimates of incremental borrowing rates by using all available evidence, including but not limited to:

- Rates charged to the lessee by third-party creditors in recent borrowings, if applicable
- Observable risk-free interest rates and credit spreads for similar-tenor commercial debt—credit spreads should correlate to the lessee's own creditworthiness
- Quotes from third-party lending institutions of the borrowing rate that would be charged if the lessee elected to purchase the asset on installment over the same term as the lease

When determining the incremental borrowing rate, the lessee should assume the debt would be collateralized by the underlying leased asset, or an asset of similar value.



Lessees should reassess the discount rate only when there's a change to either the lease term or the assessment of whether the lessee is—or isn't—reasonably certain to exercise an option to purchase the underlying asset..

Risk-Free Rate

ASC Topic 842 permits nonpublic business entities to elect an accounting policy to use the risk-free rate in lieu of determining an incremental borrowing rate for all leases.

NOMINAL INTEREST RATES FOR TREASURY CONSTANT MATURITIES

One source of risk-free rates is the Federal Reserve website, where you can review the Treasury constant maturities nominal yields, as of the lease commencement date, for a lease term of similar length.

	2018 Apr 26	2018 Apr 27	2018 Apr 30	2018 May 1	2018 May 2
Treasury constant maturities					
Nominal \$					
1-month	1.02	1.02	1.02	1.02	1.02
3-month	1.02	1.02	1.02	1.02	1.02
6-month	2.02	2.02	2.04	2.05	2.05
1-year	2.25	2.24	2.24	2.26	2.24
2-year	2.49	2.49	2.49	2.50	2.49
3-year	2.93	2.92	2.92	2.96	2.94
5-year	2.92	2.90	2.79	2.92	2.90
7-year	2.95	2.92	2.91	2.93	2.92
10-year	3.00	2.96	2.90	2.97	2.97
20-year	3.08	3.03	3.01	3.03	3.04
30-year	3.16	3.13	3.11	3.13	3.14

Source: "Selected Interest Rates (Daily)—H.15," www.federalreserve.gov/releases/h15/data.htm



INITIAL DIRECT COSTS

Like the legacy accounting rules under ASC Topic 840, lessees are permitted to defer IDC of entering into a lease under ASC Topic 842.

Lessees should include IDCs in the initial measurement of the ROU asset rather than reporting them as a separate deferred charge on the balance sheet. IDCs are also included in the subsequent measurement of ROU assets for both operating and finance leases.

Qualification Requirements

ASC Topic 842 arguably narrows what sort of payments qualify as IDCs compared to previous accounting rules (ASC Topic 840). Under ASC Topic 842, IDCs include only incremental costs that wouldn't have been incurred if the lease wasn't obtained.

EXAMPLE



GBIV INC.

To demonstrate, assume GBIV Inc. hires an attorney to negotiate a lease and review multiple drafts of the lease agreement. GBIV also makes a commission payment to a real estate broker, due only upon successfully executing a lease contract.

The commission payment is considered an IDC because the payment wouldn't have been required had GBIV not executed the lease agreement. However, the legal fees aren't considered IDCs because they would be incurred regardless of whether a lease is ultimately obtained and they aren't a direct consequence of the lease agreement being executed. Therefore, the legal fees aren't recorded as part of the ROU asset; instead, they're expensed as incurred.

FINANCIAL STATEMENT PRESENTATION

ASC Topic 842 prescribes how leases should be presented on the balance sheet, income statement, and statement of flows.

BALANCE SHEET

The ROU assets and lease liabilities must be presented by lease classification (operating versus finance) on a gross basis and on separate line items from one another. This means that, unless immaterial, each of the following must be recorded by the lessee in separate balance sheet line items:

Finance lease—ROU assets

Operating lease—ROU assets

Finance lease—liabilities

Operating lease—liabilities

If a lessee doesn't actually present these as separate line items on the face of the balance sheet, it must disclose in the footnotes each balance sheet line item that includes these amounts.

ROU Assets

While not specifically discussed in ASC Topic 842, lessees are generally required to present all ROU assets as long-term assets. The change in the ROU asset expected in the next 12 months shouldn't be classified as a current asset. This is consistent with how other wasting assets—such as intangible assets and property and equipment—are presented on a classified balance sheet under the guidance in ASC Subtopic 210-10.

Lease Liabilities

Lease liabilities, on the other hand, should be apportioned into current and noncurrent components. This presentation requirement could result in lower liquidity measures, including the current ratio. Companies with certain covenants in debt or other agreements should evaluate the impact these presentation requirements have on their compliance with those covenants before implementing the new lease accounting guidance.

The basis for conclusions to the new lease accounting standard discusses the decision to intentionally characterize operating lease liabilities as operating liabilities rather than debt or debt-like. This is because, from an economic perspective, they're significantly different from finance lease liabilities. This economic dissimilarity is a factor considered by the FASB for prohibiting operating lease and finance lease liabilities from comingling and for viewing operating lease ROU assets as economically dissimilar from finance lease ROU assets.

While operating lease liabilities aren't technically considered debt under US GAAP, some creditors may view them that way. Accordingly, carefully review the provisions of existing agreements, including debt covenants, to ensure recognizing operating lease liabilities following adoption of ASC Topic 842 won't cause the failure of debt covenants or have other unanticipated consequences.

INCOME STATEMENT

Finance Lease

Under ASC Topic 842, interest on finance leases generally is presented below the line—that is, in the nonoperating section of the income statement, consistent with other items of interest expense.²⁹ Amortization of the finance lease ROU asset is presented above the line, as a component of operating income (loss) and in a manner consistent with other similar items of depreciation or amortization. Nonetheless, both amounts generally would be added back to earnings when calculating EBITDA, a non-GAAP measure.

Operating Lease

For operating leases, a single lease expense continues to be presented as a component of income (loss) from continuing operations. Operating lease expense isn't added back to earnings when determining EBITDA because there's no amortization or interest to add back to GAAP net income.

²⁹ Like other interest costs, finance lease interest would be eligible for capitalization for qualifying assets in accordance with ASC 835-20-15-5.

STATEMENT OF CASH FLOWS

Cash payments for the principal portion of the lease liability arising from finance leases are shown as cash outflows from financing activities. Lessees should present all other lease-related cash payments, or receipts from subleases, within cash flows from operating activities, regardless of whether they're associated with finance or operating leases. Cash flows associated with bringing an asset to the condition and location necessary for its intended use should continue to be classified as an investing activity.

To prepare a cash flow statement using the indirect method, lessees likely need to develop new processes to adjust their net income for noncash lease expenses recognized in the income statement.

EXAMPLE

Returning to the examples on pages four through seven, assume that in year one:

- The lessee recognized \$116,535 of expense for the finance lease.
- The lessee recognized \$111,667 of expense for the operating lease.
- For both leases, the actual cash outflow was \$100,000.

In this example, the lessee would have to record net adjustments of \$16,535 and \$11,667, respectively, to reconcile the expense recognized in the income statement with the \$100,000 of actual cash outflow.

Specifically, in the example of the finance lease, the cash flow statement includes the following:

- A financing cash outflow of \$83,465 (the \$100,000 cash payment less the \$16,535 interest portion).
- A \$100,000 add-back to net income for ROU asset amortization is included with other depreciation and amortization charges within the noncash operating activities section of the cash flow statement. Note that because the total expense recognized in the income statement was \$116,535, interest expense of \$16,535 remains unadjusted and flows directly from the income statement into a component of cash flows from operations.

The combination of the financing (\$83,465) and the remaining operating cash outflows (\$16,535) equals the \$100,000 in cash paid by the lessee. This cash flow treatment is effectively the same as would be recorded for a capital lease under legacy lease accounting rules.

Additional Considerations in Applying ASC Topic 842

LEASE MODIFICATIONS

Lease agreements are sometimes amended subsequent to their origination date. ASC Topic 842 contains detailed guidelines on evaluating the accounting for various types of amendments.

ASC Topic 842 defines a lease modification as “a change to the terms and conditions of a contract that results in a change in the scope of or the consideration for a lease.”

Either extending or shortening the lease term subsequent to lease commencement results in a change in scope; increasing or reducing remaining future payments due under a lease signifies a change in the consideration for a lease.

ASC Topic 842 indicates a modification should be accounted for as an entirely new contract, completely separate from the original lease agreement, when both of the following criteria exist:

SEPARATE CONTRACT CRITERIA

The modification grants the lessee an additional right of use not included in the original lease. ✓

The lease payments increase commensurate with the stand-alone price for the additional right of use, in the context of the particular contract. ✓

Both conditions met = separate contract ✓

EXAMPLE



SAE
LABORATORIES

For example, assume SAE Laboratories is currently leasing two centrifuges. After the lease commencement date, SAE Industries and the lessor amend the existing contract to add a third centrifuge. The new, all-in lease cost represents market rates of rent for similar contracts in which three centrifuges are leased.

This amendment would be accounted for as a separate contract because:

- It introduces a new right of use (access to a third centrifuge not part of the original contract).
- The total lease payments increase commensurate with adding the additional right of use.

Note that to meet the second criteria the incremental lease payments don't necessarily have to equal the rental rate to lease one stand-alone piece of equipment. Instead, in evaluating this condition, consider whether market participants would provide a discounted rate for renting multiple centrifuges in the context of the lease contract being analyzed.

It's important to note a modification that merely extends the lease term doesn't introduce an additional right of use. It simply modifies the lessee's existing right of use by extending it for a longer period of time. Therefore, a modification that merely extends or shortens an existing lease would never be accounted for as a separate contract.

REASSESSING LEASE CLASSIFICATION

When a lease modification fails to meet the separate contract criteria and isn't accounted for as a separate contract, ASU Topic 842 requires the lessee to:

Reassess the classification of the lease.	
Remeasure the lease liability using a discount rate determined at the effective date of the modification.	
Consider the following:	
For modifications that increase the existing right, or rights of use, change the consideration in the lease, or extend or reduce the term of the lease	The lessee should make a corresponding adjustment to the ROU asset. Note the right or rights of use may increase if the lease is modified to insert a term extension option not included in the original contract or add additional equipment at prices not commensurate with market rates.
For modifications that fully or partially terminate an existing lease	The lessee should decrease the carrying amount of the ROU asset on a proportional basis and recognize a gain or a loss for the difference between the reduction in the ROU asset and lease liability at the effective date of the modification. This is done to reflect the partial or full termination of the lease.
For modifications that change the lease classification	ASC Topic 842 provides additional guidance. For example, ASC 842-10-25-4 describes the accounting for a modification that changes the classification of what was previously a finance lease to an operating lease.



LEASE TERMINATIONS

The new lease accounting guidelines amended ASC Subtopic 420-10, *Exit or Disposal Cost Obligations*. Prior to ASU 2016-02, terminations of operating leases were accounted for under ASC 420-10-25-12.³⁰ All lease modifications, including partial or complete terminations, are governed by ASC Topic 842 upon adoption.

As noted, when a lease is fully or partially terminated, ASC Topic 842 requires a gain or loss to be recognized at the effective date of the modification.

EXAMPLE



MJKS LTD.

To demonstrate, assume MJKS Ltd. is leasing two trucks under a 10-year lease classified as an operating lease. At the end of the second year, MJKS and the lessor agree to modify the lease to eliminate one of the trucks. The remaining truck continues to be rented subject to the original lease terms.

Under ASC Topic 842, MJKS remeasures the lease liability, using an appropriate discount rate as of the modification date, and adjusts the ROU asset proportionally. For example, assume the carrying values of the ROU asset and lease liability are \$48,000 and \$56,000, respectively, as of the modification date. The remeasured lease liability, considering eight more years of lease payments at a current discount rate, is \$24,000. MJKS records the following journal entry for the lease modification:

Lease liability	\$32,000 ³¹
ROU asset	\$27,428 ³²
Gain on modification	\$4,572 ³³

³⁰ ASC 420-10-25-12 states: "A liability for costs to terminate a contract before the end of its term shall be recognized when the entity terminates the contract in accordance with the contract terms (for example, when the entity gives written notice to the counterparty within the notification period specified by the contract or has otherwise negotiated a termination with the counterparty)."

³¹ Reflects the \$56,000 carrying value of lease liability minus the \$24,000 remeasured value of the lease liability, using current discount rates.

³² The lease liability was reduced by 57.1% [(\$56,000 – 24,000) ÷ \$56,000], and the ROU asset should be proportionally reduced by that same percentage. The adjustment would be \$27,428 [57.1% × \$48,000 carrying value immediately prior to the lease modification].

³³ The gain is calculated as the differential between the adjustments to the ROU asset and the lease liability.

SALE-LEASEBACK TRANSACTIONS

ASC Topic 842 fundamentally changes the accounting for sale-leaseback arrangements.

Before the issuance of ASC Topic 842, US GAAP contained very prescriptive and detailed rules around sale-leaseback accounting (ASC SubTopic 840-40 and ASC 360-20-40). In most cases, these rules precluded the immediate recognition of a gain on the sale of assets subject to a sale-leaseback arrangement. In many other situations, particularly those involving real estate, US GAAP required the seller-lessee to treat the transaction as a financing rather than sale transaction with a related operating lease.



The new leasing guidance indicates the presence of the leaseback doesn't, in isolation, preclude the seller-lessee from concluding it sold the underlying asset to the buyer-lessor. Instead, a seller-lessee can recognize a gain on sale at the time of the sale-leaseback arrangement, provided the sale meets the conditions in ASC Topic 606, *Revenue from Contracts with Customers*.

If a sale has occurred based on the guidelines in ASC Topic 606, the seller-lessee should account for the leaseback in the same manner as any other lease.

(Visit mossadams.com/revrec for more on ASC Topic 606.)

The guidance in ASC Topic 842 will increase the frequency of gain recognition from a sale-leaseback arrangement at the transaction date.

Presently, ASC SubTopic 840-40 significantly restricts the types of arrangements that qualify for sale-leaseback accounting, and even if a transaction meets the exacting conditions in ASC SubTopic 840-40, the gain from selling the equipment or property is often deferred and amortized over the life of the leaseback. Even then it may be limited to the amount of gain in excess of the present value of the minimum lease payments to be made by the seller-lessee over the term of the leaseback.

Because ASC Topic 842 arguably makes it easier for transactions to qualify for sale-leaseback accounting—including immediate recognition of the gain on sale—companies may want to revisit whether to pursue these sorts of transactions when financing needs arise.

In particular, sale-leaseback arrangements may make sense both economically and from a financial reporting perspective for companies that own substantially depreciated property that nonetheless has significant market value. For instance, a sale-leaseback might be appealing for companies that own buildings, commercial warehouses, or land with a fair value that significantly exceeds its carrying value.

EXAMPLE**MPW ASSOCIATES**

To demonstrate, assume MPW Associates owns an office building that originally cost \$2 million but is now fully depreciated. MPW also owns the underlying land, which has a cost basis of \$3 million. MPW agrees to sell the land and building to a financial buyer for \$15 million and to lease back the real estate for three years for payments of \$6,000 per month (paid in advance). MPW's annualized incremental borrowing rate to purchase similar property rights via a three-year loan is determined to be 8.66%. That means the present value of the future lease payments is \$191,000. MPW has provided the buyer-lessor with first lien rights against its other tangible and intangible assets to protect the buyer-lessor against risk of default by MPW on the lease obligations.

Under the legacy guidelines of ASC Topic 840, the fact that MPW provided the buyer-lessor with collateral other than the property subject to the sale-leaseback arrangement would be a "prohibited form of continuing involvement" that would preclude sale-leaseback accounting. However, there are no similar restrictions precluding sale-leaseback accounting under ASC Topic 842. Presuming the transaction would qualify as a sale under ASC Topic 606 and an effective sale-leaseback under ASC Topic 842, MPW would record the following journal entries at the transaction date to reflect the sale and to record the ROU asset and lease liability resulting from the leaseback:

Cash	\$15,000,000
Accumulated depreciation	\$2,000,000
Land	\$3,000,000
Building	\$2,000,000
Gain on sale of land and building	\$12,000,000
ROU asset	\$191,000
Lease liability	\$191,000

EXAMPLE**XRC DEVELOPERS**

Let's consider another example. Assume XRC Developers enters into a sale-leaseback transaction for one of its pieces of heavy equipment. The equipment was originally purchased for \$3 million and currently has a net carrying value, after accumulated depreciation, of \$750,000. Assume this carrying amount approximates the equipment's fair value, and a buyer agrees to purchase the equipment for \$750,000. XRC agrees to lease back the equipment for payments of \$14,000 per month (in advance) for the next five years, for a total of \$840,000 in lease payments. The annual implicit rate in the lease, 7.69%, is explicitly stated in the agreement. Therefore, the present value of the future lease payments is \$700,000.

In this scenario, XRC hasn't truly transferred control of the leased asset to the buyer-lessor because the present value of the lease payments, \$700,000, is for substantially all of the fair value of the underlying asset, \$750,000, at the transaction date. Therefore, the transaction doesn't qualify as a sale under ASC Topic 606.³⁴

XRC accounts for the sale-leaseback as a financing transaction, recording the following journal entry:

Cash	\$750,000
Financing from sale-leaseback agreement	\$750,000

The equipment remains on XRC's books and continues to be depreciated over its remaining useful life. Over the term of the leaseback, a portion of each monthly lease payment is recognized as interest expense, with the balance reducing the financing obligation established at the transaction's inception.

³⁴ In the basis for conclusions to the ASU promulgating ASC Topic 842, the FASB concluded that, "in a finance/sales-type lease, the lessee, in effect, obtains the ability to direct the use of, and obtain substantially all the remaining benefits from, the underlying asset. Consequently, if a transaction in which the leaseback would be classified as a finance/sales-type lease were determined to be a sale and a leaseback, one would effectively conclude that the seller-lessee transferred control of the asset to the buyer-lessor and immediately re-obtained control of the asset. The FASB decided that no sale should occur in that scenario because it would be inappropriate for a seller-lessee to account for a concurrent (similar in nature to a 'round trip') sale and, in effect, repurchase of the same asset."

SUBLEASES

When lessees no longer need full use of a leased asset, they may enter into a sublease with another party to help defray the cost of the original lease.

Under ASC Topic 842, the original lease, referred to as a *head lease*, and any subleases are almost always treated as separate contracts, each of which should be separately analyzed to determine its proper classification. Note the head lease may be classified as a finance lease while the sublease is classified as an operating lease.

An entity generally shouldn't offset lease expense related to a head lease with lease income related to a sublease in the income statement. Similarly, assets and liabilities from the head lease and sublease shouldn't be combined on the balance sheet.

INSIGHT

While not explicitly stated in ASC Topic 842, we recommend presenting cash flows from the head lease and sublease separately, on a gross basis, in the statement of cash flows.

LEASE INCENTIVES

Lessees often receive incentives from a lessor, typically in the form of rent-free periods called **rent holidays**, or **cash allowances** to help fund tenant improvements.

RENT HOLIDAYS

Rent holidays are simply captured as part of the initial and subsequent measurements of the lease liability and ROU asset. In other words, a five-year lease that requires monthly rent of \$5,000 results in total lease payments of \$300,000, while an identical lease with a three-month rent holiday results in total lease payments of only \$285,000. Discounting both total lease payments at the lease's implicit rate results in the initial ROU asset and lease liability being smaller for the lease with the three-month rent holiday. In addition, the lease containing the incentive results in lower overall expense flowing through the income statement.

TENANT ALLOWANCES

Tenant improvement allowances and similar cash incentive payments to, or on behalf of, a lessee should be credited directly against the ROU asset upon receipt. This effectively results in reduced overall expense from the lease over the lease term compared to what would have been recorded had the incentive not been provided, due to the smaller initial ROU asset. The cash incentive is reflected in the lessee's initial measurement of the lease liability through the reduction of the lease payments for any lease incentive "paid or payable to the lessee" (see Lease Payments, page 26).



IN-SUBSTANCE OWNERSHIP DURING CONSTRUCTION

Under ASC Topic 840, special accounting considerations exist when a lessor agrees to construct a property to a lessee's specifications. These arrangements are often called build-to-suit leases.

On the surface, the lessor appears to have substantial risk in these arrangements: A lessor could construct an asset to the lessee's specifications only to have the lessee back out of the deal. The lessor may then find it difficult to lease or sell the property, because it was built to the lessee's specifications.

Understandably, lessors often request that lessees provide guarantees or share in construction costs for build-to-suit leases. Doing so provides some level of protection to the lessor, but it can cause the lessee, for accounting purposes, to be deemed the in-substance owner of the property during construction. Even though the lessee doesn't have legal ownership of the facility, it records construction in process and a corresponding liability as though it did.

At lease commencement, the lessee would consider whether sale-leaseback accounting is appropriate. Frequently the lessee doesn't qualify for sale-leaseback accounting, meaning the assets and liabilities recorded during the construction period remain on the lessee's books, and the leaseback is treated as a financing arrangement.

ASC Topic 842 removes this prior guidance on build-to-suit leases and in-substance ownership during the construction period. For many build-to-suit transactions, there's no recognition of the arrangement on the lessee's books during the period from lease inception to lease commencement. However, lessees should consider whether other GAAP applies to the transaction, including but not limited to ASC Topic 460, *Guarantees*, and ASC Topic 440, *Commitments*. At minimum, such guidance may require disclosures regarding the build-to-suit arrangement prior to and during construction.

RELATED-PARTY LEASES

ASC Topic 842 requires that lessees and lessors account for related-party leases on the basis of the legally enforceable terms and conditions of the lease.

EXAMPLE

HDG LLC & KLM LLC

Assume that HDG LLC is a single-member LLC owned by Mr. Crowley. HDG leases its manufacturing facility from KLM LLC, a special-purpose leasing entity that is also owned 100% by Mr. Crowley. KLM financed a portion of the building using a 20-year mortgage with a commercial bank, which Mr. Crowley also personally guarantees. The stated lease term in the lease agreement is month to month; however, HDG is reasonably certain to renew or extend the lease for a period that exceeds 12 months because:

- The lease provides the necessary cash flows for KLM to service its mortgage debt. If KLM defaults on this mortgage, Mr. Crowley is personally liable as the guarantor.
- It's economically disruptive and commercially unrealistic for HDG to relocate to another facility at least annually, which would make it eligible for the short-term lease exception to recording an ROU asset and lease liability.

Even if the monthly lease payments are below market, HDG should still recognize an ROU asset and lease liability based on the stated enforceable terms of the agreement between HDG and the KLM, except the stated lease term is ignored because it was determined reasonably certain the lease would be renewed or extended. Judgment is necessary in determining the lease term to use in calculating the initial ROU asset and lease liability under ASC Topic 842. HDG should consider asset-specific, contractual, market, and entity-specific factors in making such determination (see Discount Rate, page 28).

EXAMPLE

As another example, assume a lessee and an affiliated lessor enter into a sale-leaseback arrangement with off-market terms. Specifically, the sales price is significantly higher than what a third party would pay for the property. Nonetheless, ASC Topic 842 indicates the transaction should be accounted for based on the legally enforceable stated terms. The seller-lessee shouldn't adjust the transaction price to market rates when determining the proper accounting for the transaction, but the details of the related-party transaction would need to be disclosed under ASC Topic 850, *Related Party Disclosures*.

DISCLOSURES

ASC Topic 842 introduces some new footnote requirements for lessees while retaining many previously required disclosures.

The following is an overview of the qualitative disclosures required by ASC Topic 842 for lessees:

1	Information about the nature of leases (and subleases)
	General description of leases
	Basis, terms and conditions, on which variable lease payments are determined
	Existence, terms and conditions of options to extend or terminate the lease
	Existence, terms and conditions of lessee residual value guarantees
2	Restrictions or covenants imposed by leases
	Information about leases that haven't yet commenced, but that create significant rights and obligations for lessees
	Information about significant judgments and assumptions made in accounting for leases
	Determination of whether a contract contains a lease
	Allocation of the consideration in a contract between lease and nonlease components
3	Determination of the discount rate
	Main terms and conditions of any sale-leaseback transactions
	Whether an accounting policy election was made for the short-term lease exemption. If so, lessees should disclose if the short-term lease expense doesn't reflect amounts attributable to the lessee's short-term lease commitments and the amount of its short-term lease commitments

INSIGHT

Don't underestimate the effort required to comply with the disclosure requirements in ASC Topic 842. Reporting entities should evaluate the information tracked by their existing lease accounting systems and processes to identify any gaps in what's currently being collected compared to the disclosures mandated by ASC Topic 842. If gaps are identified, entities need to change or upgrade their systems—or possibly even request additional data from their lessor.

The following example demonstrates the quantitative disclosures required by ASC Topic 842 for lessees. Note that lessees aren't required to present these disclosures in a tabular format.

For the years ended December 31, 20X8 and 20X7 (in thousands)

LEASE EXPENSE		20X8	20X7
1	Finance lease expense		
	Amortization of ROU assets	\$ 600	\$ 525
	Interest on lease liabilities	150	110
2	Operating lease expense	1,000	900
3	Short-term lease expense	50	40
4	Variable lease expense	75	60
5	Sublease income	(10)	(8)
Total		\$1,865	\$1,627
OTHER INFORMATION		20X8	20X7
6	(Gains) losses on sale-leaseback transactions, net	\$ (8)	\$ 5
7	Cash paid for amounts included in the measurement of lease liabilities for finance leases		
	Operating cash flows	\$1,400	\$1,300
	Financing cash flows	\$ 200	\$ 170
	Cash paid for amounts included in the measurement of lease liabilities for operating leases		
	Operating cash flows	\$ 800	\$ 635
8	ROU assets obtained in exchange for lease liabilities		
	Finance leases	\$ 275	\$ 375
	Operating leases	\$ 200	\$ 140
9	Weighted-average remaining lease term (in years)		
	Finance leases	5.2	5.9
	Operating leases	9.2	8.4
10	Weighted-average discount rate		
	Finance leases	6.1%	6.3%
	Operating leases	7.2%	7.3%
11	Maturity Analysis	Finance	Operating
	20X9	\$ 1,700	\$ 1,000
	20Y0	1,900	1,100
	20Y1	2,050	1,200
	20Y2	1,500	1,300
	20Y3	1,200	1,400
	Thereafter	1,550	3,300
	Total	\$9,900	\$9,300
	Less: Present value discount	(3,456)	(4,302)
	Lease liability	\$ 6,444	\$ 4,998

1. For finance leases, amortization of ROU assets and interest on lease liabilities, including capitalized interest*
2. Operating lease expense (including capitalized costs)*
3. Short-term lease expense, when term > 30 days*
4. Variable lease expense*
5. Sublease income
6. Gains and losses on sale-leaseback transactions
7. Cash paid for amounts included in measurement of lease liabilities, segregated by finance and operating leases and between operating and financing cash flows
8. Supplemental noncash information on ROU assets obtained in exchange for new lease liabilities, separately for finance and operating leases
9. Weighted-average remaining lease term, presented separately by finance and operating leases
10. Weighted-average discount rate for operating and finance leases as of the balance sheet date
11. Maturity analysis of lease liabilities for each of the first five years after balance sheet date and in total thereafter, including reconciliation of undiscounted cash flows to lease liabilities on the balance sheet

* The disclosed expense items should include any amounts capitalized as part of the cost of another asset, such as inventory, software development costs, and equipment.

Effective Dates & Transition



EFFECTIVE DATES

In fiscal years beginning after **December 15, 2018**, including interim periods within those fiscal years.

- Public business entities
- Not-for-profit entities that have issued, or are a conduit bond obligator for, securities that are traded, listed, or quoted on an exchange or an over-the-counter market
- Employee benefit plans that file financial statements with the US Securities and Exchange Commission (SEC)

In fiscal years beginning after **December 15, 2019**, and interim periods in fiscal years beginning after **December 15, 2020**.

- All other entities

Note: Early adoption is permitted at any time for all entities.

TRANSITION

Lessees must adopt ASC Topic 842 using a modified retrospective transition approach. There are two options for determining the date of initial application.

EFFECTIVE DATE OPTION

An entity can elect to apply the new lease standard at the effective date and recognize a cumulative effect adjustment to the opening balance of equity in the period of adoption.

If an entity elects this option, the reporting for comparative periods presented in the financial statements will continue to be in accordance with legacy GAAP.

OR

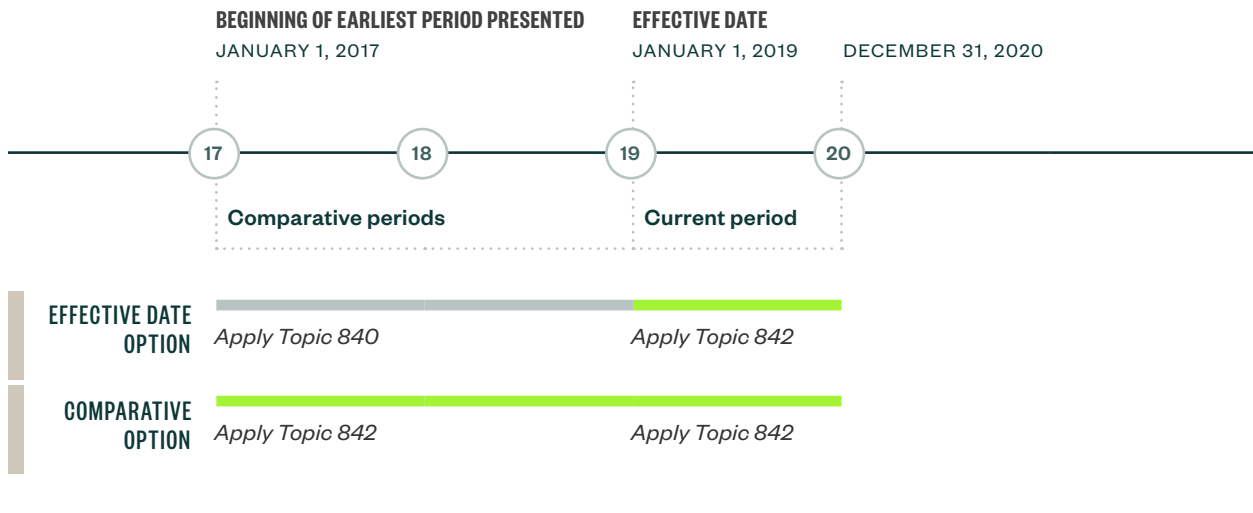
COMPARATIVE OPTION

An entity can elect to apply the new lease standard at the beginning of the earliest period presented, and recognize a cumulative effect adjustment to the opening balance of equity in that period.

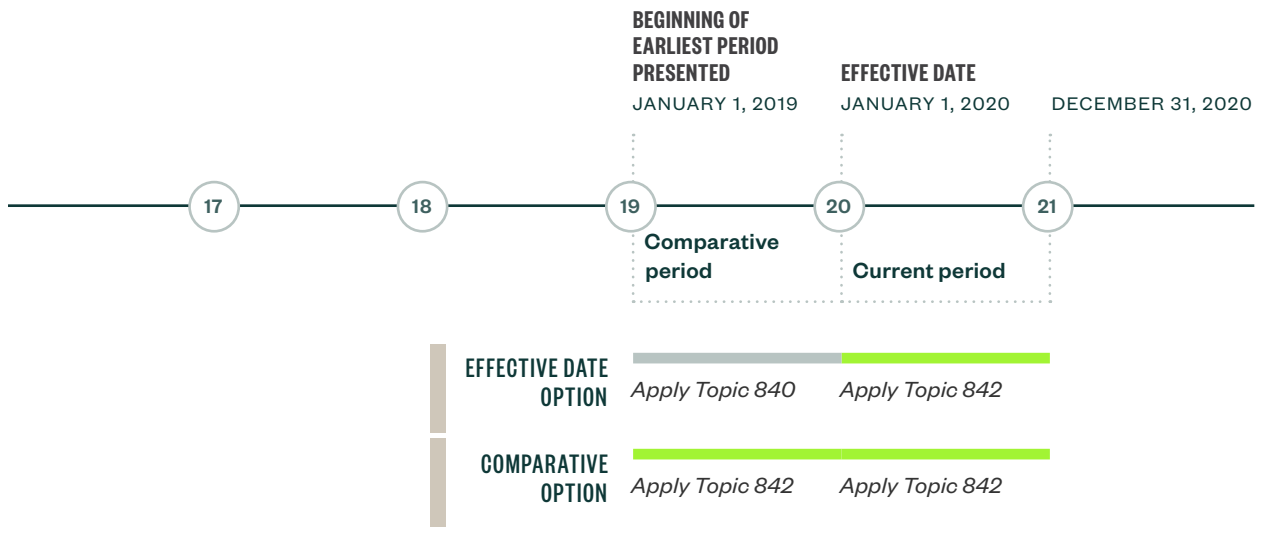
This approach will result in any leases existing at, or entered into after, the beginning of the earliest period presented being reported in accordance with ASC Topic 842.

Neither of these approaches require transition accounting for leases that expired before the date of initial application or before the period of adoption.

Calendar Year-End Public Companies



Calendar Year-End Nonpublic Companies



TRANSITION RELIEFS

Optional Accommodations

Lessees may apply certain optional accommodations. These must be elected as a package and applied to all leases. In other words, they can't be elected on a lease-by-lease or accommodation-by-accommodation basis. Specifically, lessees can elect to forgo assessing:

- Whether any expired or existing contracts are or contain leases
- The lease classification for any existing or expired leases
- IDCs for any existing leases, whether or not those costs would have qualified for capitalization under the new lease standard

Lease Renewals & Purchase Options

ASC Topic 842 also allows entities to use hindsight with respect to lease renewals and purchase options when determining the lease term and assessing impairment of the ROU asset in accounting for existing leases at transition. This relief can be elected independently of the package above, but it must be applied consistently to all an entity's leases—regardless of whether the entity is the lessee or lessor.

Land Easements

Optional Transition Practical Expedient

Entities that have land easements—which are the right to use, access, or cross another entity's land for a specified purpose—have an additional available option when transitioning to ASC Topic 842.

This practical expedient allows entities to opt out of evaluating existing or expired land easements not previously accounted for as a lease upon adoption of ASC Topic 842. It must be elected and applied to all of its existing or expired land easements not currently accounted for as a lease under ASC Topic 840.

Entities will still be required to evaluate any new or modified land easements after adoption of Topic 842. If this practical expedient isn't adopted, entities must assess all existing or expired land easements to determine whether or not the easements meet the definition of a lease upon adoption of Topic 842.





CAPITAL LEASES

Upon transition, capital leases will generally be classified as finance leases. Under the modified retrospective transition approach, lessees don't have to recompute an initial finance lease ROU asset and lease liability for existing capital leases. Instead, the initial ROU asset and lease liability generally equal the carrying amounts of existing capital lease assets and liabilities under ASC Topic 840 (see paragraphs 2-16 of ASC 840-40-55) at the date of initial application.

From the date of initial application onward, the finance lease ROU asset and lease liability are subsequently measured using the guidelines in ASC Topic 842.

For operating leases, a lessee should initially recognize an ROU asset and lease liability at whichever is later: the date of initial application or lease commencement. The lease liability should initially be measured as the present value of the sum of the following:

- The remaining minimum rental payments, as defined under ASC Topic 840
- Any amounts the lessee expects to pay to satisfy a residual-value guarantee

DISCOUNT RATE

The discount rate should be determined in accordance with ASC Topic 842 (see Discount Rate, page 28).

The initial ROU asset for operating leases should equal the lease liability, adjusted for any prepaid or accrued rent, lease incentives, impairments (if applicable), or unamortized initial direct costs that would have qualified for capitalization under ASC Topic 842.

The difference between the initial lease liability and ROU asset recognized should be adjusted against opening equity along with any write-offs of previously reported assets and liabilities—for example, unamortized initial direct costs that don't qualify for capitalization under the new leasing standards.

INITIAL DIRECT COSTS

If an entity has any unamortized IDCs that don't meet the narrowed definition of an IDC under ASC Topic 842, those costs should be written off as adjustments to equity if incurred before the beginning of the earliest period presented in the financial statements.

If the IDCs were incurred on or after the beginning of the earliest period presented, the costs should be written off through earnings in the period incurred. An entity wouldn't be required to assess IDCs upon adoption if certain practical expedients are adopted (see Appendix, Accounting Policy Elections Upon Adoption of ASC Topic 842, page 48).

Appendix

ACCOUNTING POLICY ELECTIONS UPON ADOPTION OF ASC TOPIC 842

FORMAL ELECTIONS REQUIRED

TOPIC	Policy Election
Nonlease components <i>page 16</i>	Lessees are permitted, as an accounting policy election by class of underlying asset, to not separate lease and nonlease components. Instead, a lessee can elect to account for lease and nonlease components as a single combined lease component.
Short-term lease <i>page 15</i>	Lessees can elect to not recognize ROU assets and lease liabilities for short-term leases under ASC Topic 842 and instead record them in a manner similar to operating leases under legacy leasing guidelines. A short-term lease is one with a maximum lease term of 12 months or fewer and does not include a purchase option the lessee is reasonably certain to exercise.
Discount rate <i>page 28</i>	Nonpublic business entities can make an accounting policy election to use the risk-free rate in lieu of determining an incremental borrowing rate when determining the present value of the lease payments for purposes of calculating the ROU asset and lease liability. While not expressly stated in ASC Topic 842, nonpublic business entities should also apply a consistent accounting policy when determining the classification of a lease.
Presentation of ROU assets and lease liabilities <i>page 30</i>	A lessee can either: • Present separate line items on the balance sheet for finance and operating lease liabilities and ROU assets • Disclose in the footnotes the balance sheet line items where each type of asset and liability has been recognized Comingling of ROU assets for operating and finance leases, or lease liabilities for operating and finance leases, is prohibited.
MODIFIED RETROSPECTIVE TRANSITION OPTIONS	
Effective date option <i>page 46</i>	An entity can elect to apply the new lease standard at the effective date and recognize a cumulative effect adjustment to the opening balance of equity in the period of adoption. If an entity elects this option, the reporting for comparative periods presented in the financial statements will continue to be in accordance with legacy GAAP.
Comparative option <i>page 46</i>	An entity can elect to apply the new lease standard at the beginning of the earliest period presented, and recognize a cumulative effect adjustment to the opening balance of equity in that period. This approach will result in any leases existing at, or entered into after, the beginning of the earliest period presented being reported in accordance with ASC Topic 842.

Transition reliefs

page 46

Optional Accommodations

Lessees may apply certain optional accommodations. These must be elected as a package and applied to all leases. In other words, they can't be elected on a lease-by-lease or accommodation-by-accommodation basis. Specifically, lessees can elect to forgo assessing:

- Whether any expired or existing contracts are or contain leases
- The lease classification for any existing or expired leases
- IDCs for any existing leases, whether or not those costs would have qualified for capitalization under the new lease standard

Lease Renewals & Purchase Options

ASC Topic 842 also allows entities to use hindsight with respect to lease renewals and purchase options when determining the lease term and assessing impairment of the ROU asset in accounting for existing leases at transition. This relief can be elected independently of the package above, but it must be applied consistently to all an entity's leases—regardless of whether the entity is the lessee or lessor.

Land Easements

Entities that have land easements—which are the right to use, access, or cross another entity's land for a specified purpose—have an additional available option when transitioning to ASC Topic 842.

This practical expedient allows entities to opt out of evaluating existing or expired land easements not previously accounted for as a lease upon adoption of ASC Topic 842. It must be elected and applied to all of its existing or expired land easements not currently accounted for as a lease under ASC Topic 840.

Entities will still be required to evaluate any new or modified land easements after adoption of Topic 842. If this practical expedient isn't adopted, entities must assess all existing or expired land easements to determine whether or not the easements meet the definition of a lease upon adoption of Topic 842.

INFORMAL POLICY ELECTIONS, JUDGMENTS, AND INTERNAL CONTROL PROCESSES TO CONSIDER

TOPIC	Policy Election
Major part page 19	Consider establishing an accounting policy, by class of asset, to determine what constitutes a major part of the economic life of the underlying asset. Entities need this when evaluating whether the lease term is for a <i>major part</i> of the leased asset's economic life for purposes of lease classification.
Substantially all page 19	Consider establishing an accounting policy, by class of asset, to determine what constitutes <i>substantially all</i> . Entities need this when evaluating whether the present value of the lease payments amounts to at least substantially all of the fair value of the underlying asset for purposes of lease classification.
Specialized nature page 19	Consider establishing an accounting policy to define which types of assets are considered of a <i>specialized nature</i> for purposes of assessing lease classification. This accounting policy is also applied in evaluating the reasonably certain principle in determining the lease term and assessing the effects of purchase options.
Reasonably certain page 23	Consider developing guidelines to evaluate whether it's <i>reasonably certain</i> that a renewal option, termination option, or purchase option will be exercised. The guidelines should consider all relevant factors that create an economic incentive for the lessee to exercise the options, including market-, asset-, entity-, and contract-based factors.
Incremental borrowing rate page 28	If the rate implicit in the lease isn't known or calculable, the lessee should discount future lease payments using its <i>incremental borrowing rate</i>. ASC Topic 842 defines incremental borrowing rate as "the rate of interest that a lessee would have to pay to borrow over a similar [lease] term, and with a similar security, the funds necessary to obtain an asset of a similar value . . . in a similar economic environment." Lessees should consider whether they need to modify existing processes to estimate incremental borrowing rates by class of asset.



We're Here to Help

The goal of this guide is to describe some—but certainly not all—of the potential changes that will result from ASC Topic 842. It also highlights some of the implications of the new guidelines that may apply at your organization.

If you have questions on how the new lease accounting standard could affect your organization, contact your Moss Adams professional.

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Updated through ASU 2018-11

ADDITIONAL RESOURCES

Learn more about the FASB's new guidelines and their potential effects on you and your business.

[The Financial Accounting Standards Board Issues Improvements to New Lease Accounting Standard](#)

[FASB Proposes Targeted Improvements to Lease Standard](#)

[The Financial Accounting Standards Board Adds Lease Accounting Transition Option and Practical Expedient for Lessors](#)

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