

In depth

A look at current financial reporting issues



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The leasing standard

A comprehensive look at the new model and its impact

At a glance

On February 25, 2016, the FASB issued the new standard, *Leases (ASC 842)*. There are elements of the new standard that could impact almost all entities to some extent, although lessees will likely see the most significant changes. Lessees will need to recognize virtually all of their leases on the balance sheet, by recording a right-of-use asset and lease liability.

The IASB issued its new standard, IFRS 16, *Leases*, earlier this year. While there are significant areas of divergence between guidance applicable under US GAAP and that required by IFRS, both Boards have noted that they met their key objectives of recognition of lease-related assets and liabilities and enhanced transparency.

Observations about the significant differences between the new and the current lease accounting standard can be found in paragraph 95.

Background

.1 Leasing is widely used to address a variety of business needs, from short-term asset use to long-term asset financing. Sometimes leasing is the only option available to obtain the use of a physical asset (e.g., one floor of an office building or a single store in a mall). Some have long argued that the current accounting model is inadequate, as it allows lessees to structure lease transactions to achieve off-balance sheet financing.

.2 The FASB and IASB initiated a joint project on leases in 2006 as part of their global convergence effort to address concerns about the current approach. After issuing two exposure drafts, extensive outreach, and re-deliberations to address the concerns raised by stakeholders, the FASB and IASB issued separate lease accounting standards that diverged in significant areas. This *In depth* is focused on the new US GAAP standard.

Key provisions

Definition and scope

.3 According to the new leasing standard, a lease conveys the right to control the use of identified property, plant, or equipment (an identified asset) for a period of time in exchange for consideration. A period of time may be described in relation to the amount of usage (e.g., units produced) of the identified asset.

.4 The leasing standard excludes the following arrangements from its scope (1) leases of intangible assets, including licenses of internal-use software; (2) leases to explore for or use minerals, oil, natural gas, and similar nonregenerative resources; (3) leases of biological assets, including plants and living animals; (4) leases of inventory; and (5) leases of assets under construction (construction in process).

.5 A lessee can, as an accounting policy election by class of the underlying leased asset, elect not to apply the balance sheet recognition requirements under the new guidance to leases with a term less than or equal to twelve months. However, a lease will no longer meet the definition of a short-term lease if circumstances change such that either (a) the lease term changes and the remaining lease term is more than 12 months from the end of the previously determined lease term; or (b) contrary to its earlier determination, the lessee becomes reasonably certain of exercising its purchase option. In either of these cases, the lessee is required to apply the leasing standard from the date of the change in circumstances.

.6 Whether the contract contains a lease is determined at the inception of an arrangement. In many cases, it will be easy to determine if an arrangement contains a lease. However, there will be times when judgment will be required to distinguish between an arrangement to buy or sell goods or services and a lease of an underlying asset. Reassessment of whether a contract is or contains a lease should be carried out only if the terms and conditions of the contract are changed.

Identified asset

.7 To contain a lease, an arrangement must have an explicitly or implicitly identified asset that is physically distinct.

Explicitly identified asset and substitution rights

.8 If an arrangement explicitly identifies the asset to be used, but the supplier has a substantive contractual right to substitute such asset, then the arrangement does not contain an identified asset. A substitution right is substantive if the supplier can (a) practically use another asset to fulfill the arrangement, and (b) it is economically beneficial for the supplier to do so. When evaluating a substitution right, the following should be considered:

- Provisions that allow the supplier to replace an asset under certain circumstances, such as improper operation, would not preclude the arrangement containing an identified asset.
- A provision permitting or requiring a seller to substitute other assets on or after a particular date or a specified event does not preclude the arrangement from containing an identified asset.
- If the asset is at a customer's premises or at a location other than the supplier's premises, it may not be economically beneficial for a supplier to substitute the asset since the substitution costs may be higher than the benefits of substitution.

.9 Future events not likely to occur should not be considered in the evaluation. A customer is required to presume that the supplier does not have a substantive substitution right if the customer is unable to readily make such a determination.

Implicitly identified asset

.10 An arrangement that does not explicitly identify an asset may do so implicitly. This may be the case when only one asset can be used to fulfill the contract, for example, because of economic or legal factors or because the lessor has only one asset available to perform under the contract. When a contract permits substitution, but the asset is on the

customer's site, the asset may be implicitly identified due to the practical challenges of entering the customer's premises and substituting the asset.

Portions of assets

.11 An identified asset must be physically distinct – it is either a single asset or a distinct portion of an asset. For example, a building or a floor within the building (if it can be used independent of the other floors) may be considered physically distinct. However, capacity or a portion of an asset is not an identified asset if (1) the asset is not physically distinct (e.g., the arrangement permits use of a portion of the capacity of a fiber optic cable); and (2) a customer does not have the right to substantially all the economic benefits from the use of the asset (e.g., several customers share a fiber optic cable and no one customer has substantially all of the capacity).

Control

.12 For an arrangement to contain a lease, the customer should have the right to control the use of the identified asset throughout the period of use by possessing the right to (1) obtain substantially all of the economic benefits from the use of such asset and (2) direct the use of the identified asset. If a customer has the right to control the use of an identified asset for only a portion of the term of the contract, the contract contains a lease for that portion of the term.

.13 If the customer in the contract is a joint operation or arrangement, then the control criterion should evaluate if the joint operation or arrangement has the right to control the use of an identified asset throughout the period of use.

Right to obtain substantially all of the economic benefits

.14 According to the new standard, the economic benefits from the use of an identified asset include its primary output and by-products. A customer can obtain economic benefits from the use of an identified asset directly or indirectly, such as by using, holding, or subleasing the asset. Only the economic benefits from use of an identified asset within the defined scope of a customer's rights to use the asset should be considered.

.15 A requirement for the customer to share the cash flows from the use of the identified asset with the supplier does not preclude the customer from deriving substantially all of the economic benefits from the use of an asset. A common example of sharing cash flows is a payment from the customer to the supplier based on a percentage of the sales the customer derives from use of the asset.

Right to direct the use

.16 A customer has the right to direct the use of an identified asset throughout the period of use if:

- the customer has the right to direct how and for what purpose the asset is used during the period of use (e.g., the right to change the type, timing, location, or amount of output produced); or
- the relevant decisions (i.e., those decisions that affect the economic benefits to be derived from the use of the identified asset) about how and for what purpose the asset is used are predetermined (e.g., by design or by contractual restrictions on the asset's use) and one of the following conditions is met:
 - the customer has the right to operate the asset without the supplier having the right to change the operating instructions; or

- the customer designed the asset (or its specific aspects) before the period of use in a way that predetermines the most relevant decisions about how and for what purpose the asset will be used.

.17 Protective rights designed to safeguard the supplier's interest in the identified asset or its personnel or to ensure compliance with laws or regulations will typically not prevent the customer from having the right to direct the use of the asset.

Contract consideration and allocation

.18 A contract may contain both lease and nonlease components. The right to use an underlying asset is a separate lease component if (1) the lessee can benefit from the right of use of the underlying asset either on its own or together with other resources that are readily available (i.e., goods or services that are sold or leased separately or resources that the lessee has already obtained) and (2) the right of use of the underlying asset is neither highly dependent on nor highly interrelated with another right to use of underlying assets (i.e., each right of use does not significantly affect the other).

.19 The right to use land is treated as a separate lease component unless the accounting effect of doing so would be insignificant (e.g., separating land would have no effect on the classification of any lease component or the amount recognized for the land lease component would be insignificant).

.20 Components include only those items or activities that transfer a good or service to the lessee. Provisions related to administrative tasks to initiate the lease and payment of the lessors costs would not be components if they do not transfer a good or service to the lessee separate from the right to use the underlying asset

Lessee

.21 Contract consideration for the lessee includes (a) lease payments, (b) any fixed payments (such as monthly service charges) or in-substance fixed payments, less any incentives paid or payable to the lessee, and (c) any other variable payments that depend on an index or a rate measured using the index or rate at lease commencement date.

.22 A lessee should allocate the contract consideration to the separate lease and nonlease components based on their relative, observable standalone prices. A price is observable if it is the price that either the lessor or similar suppliers charge for similar lease or nonlease components on a standalone basis. If observable standalone prices are not readily available, the lessee should estimate the standalone prices. If an estimate of the standalone price is highly variable or uncertain, then a residual approach can be used.

.23 Initial direct costs should be allocated to the separate lease components based on their relative standalone prices.

.24 A lessee is required to remeasure and reallocate contract consideration upon a remeasurement of the lease liability or upon a lease modification that is not accounted for as a separate contract (see paragraph .67). As a practical expedient, a lessee may make an accounting policy election by class of underlying asset to not separate nonlease components from lease components. This election cannot be used to aggregate different lease components. If an entity elects this practical expedient, it would account for the nonlease and lease component together as a single lease component.

Lessor

.25 A lessor should allocate the contract consideration to the separate lease and nonlease components in accordance with the transaction price allocation guidance in ASC 606, *Revenue from Contracts with Customers*.

.26 The contract consideration for a lessor includes (a) all amounts applicable for lessee consideration as described in paragraph .21, and (b) any other variable payments related specifically to nonlease components that would be included in the transaction price under ASC 606. Measurement of the variable payments in (b) are governed by the revenue recognition guidance. If the variable payments relate specifically or partially to a lease component, such payments are considered variable lease payments and are not estimated or included in the allocation of contract consideration, but are instead recognized in the income statement in the period they are earned).

.27 A lessor should allocate any capitalized costs such as initial direct costs or contract costs to the separate lease and nonlease components to which those costs relate.

.28 A lessor is required to remeasure and reallocate the remaining consideration in the contract when there is a contract modification that is not accounted for as a separate contract. A lessor should allocate changes in contract consideration in accordance with ASC 606-10-32-42 through 32-45.

Lessee accounting model

Classification

.29 A lessee will classify each separate lease component as an operating or finance lease at the lease commencement date and will not reassess the lease classification thereafter unless (a) there is a change in the lessee's assessment of the lease term or exercise of a purchase option or (b) the contract is modified and the modification is not accounted for as a separate lease (see paragraphs .66 and .67).

.30 A lessee will classify a lease as a finance lease when the lease meets any of the following criteria at lease commencement:

- 1) The lease transfers ownership of the underlying asset to the lessee by the end of the lease term.
- 2) The lease grants the lessee an option to purchase the underlying asset that the lessee is reasonably certain to exercise.
- 3) The lease term is for the major part of the remaining economic life of the underlying asset. However, if the commencement date falls at or near the end of the economic life of the underlying asset, this criterion will not be used for lease classification purposes.
- 4) The present value of the sum of lease payments and any residual value guaranteed by the lessee that is not already reflected in lease payments equals or exceeds substantially all of the fair value of the underlying asset. Note that for measurement purposes, lease payments will only include amounts probable of being owed by the lessee under a residual value guarantee.
- 5) The underlying asset is of such a specialized nature that it is expected to have no alternative use to the lessor at the end of the lease term.

.31 If a lease component contains the right to use more than one underlying asset, the lessee should consider the remaining economic life of the predominant asset in the lease component for purposes of applying the third criterion.

Recognition and measurement

.32 The standard requires a lessee to record a right-of-use asset and a lease liability for all leases with a lease term greater than 12 months. Thus, at the lease commencement

date, a lessee is required to measure and record a lease liability equal to the present value of the lease payments. The payments included in lease payments are described in paragraph .58.

.33 The discount rate for the lease is the rate implicit in the lease, unless that rate cannot be readily determined, in which case the lessee should use its incremental borrowing rate. The incremental borrowing rate is determined in a manner similar to how it is described under current lease guidance in ASC 840. Nonpublic entities are permitted to use a risk-free rate for a period comparable to the lease term. Use of a risk-free rate is an accounting policy election, and once elected must be utilized consistently for all leases.

.34 A lessee may determine a single discount rate to apply to a portfolio of leases assuming its application does not create a material difference when compared to individually determined discount rates applied to each of the leases in the portfolio.

.35 The lessee is also required to measure and record a right-of-use asset. The right-of-use asset is equal to the sum of the following:

- Amount of initial measurement of the lease liability
- Payments made by a lessee to the lessor at or before the lease commencement date minus any lease incentives received
- Any initial direct costs incurred by the lessee

.36 The right-of-use asset is subject to impairment testing as a long-lived asset in accordance with ASC 360-10-35.

.37 Although the initial measurement of the right-of-use asset and lease liability is the same for operating and finance leases, the expense recognition and amortization of the right-of-use asset differ significantly.

.38 Operating leases will reflect lease expense on a straight-line basis similar to current operating leases. The straight-line expense will reflect the interest expense on the lease liability (effective interest method) and amortization of the right-of-use asset. The amortization is calculated as the difference between the total straight-line expense and the interest expense on the lease liability for the period. Amortization expense associated with the right-of-use asset will grow as interest expense on the liability declines over the lease term. Lease expense will be presented as a single line item in the operating expense section of the income statement.

.39 Finance leases will reflect a front-loaded expense pattern (i.e., expense per period will decline throughout the lease term) similar to the pattern for current capital leases. The interest expense on the lease liability (effective interest method) and amortization of the right-of-use asset, generally straight line, will be reflected separately on the income statement.

.40 For both operating and finance leases, variable lease payments not included in measuring the lease liability will be recognized in the period in which the obligation for those payments is incurred.

Lessor accounting model

.41 The FASB adopted an approach for lessors that is substantially equivalent to existing US GAAP for sales-type leases, direct financing leases, and operating leases. Leveraged leases have been eliminated, although lessors can continue to account for existing leveraged leases using the current accounting guidance. Other limited changes were

made to the lessor accounting model to align it with changes to the lessee model (e.g., to adopt the same definitions) and the new revenue recognition standard.

Classification

.42 A lessor will classify a lease as either a sales-type, direct financing, or operating lease at the lease commencement date and will not reassess the lease classification thereafter unless the contract is modified and the modification is not accounted for as a separate lease. When a lessee exercises an extension, termination, or purchase option, the lessor will account for the exercise of that option as a contract modification. See paragraph .66 or information about modifications.

.43 A lessor will classify a lease as a sales-type lease if any one of the five criteria specified in paragraph .30 is met. However, in order to derecognize the asset and record revenue (as discussed in paragraph .46) collection of payments due must be probable.

.44 When none of the five criteria in paragraph .30 are met, a lessor will classify the lease as a direct financing lease or an operating lease. A lease is a direct financing lease if the following criteria are met:

- The present value of the sum of lease payments and any residual value guaranteed by the lessee that is not already reflected in lease payments and/or any other third party unrelated to the lessor equals or exceeds substantially all of the fair value of the underlying asset.
- It is probable that the lessor will collect the lease payments plus any amount necessary to satisfy a residual value guarantee.

.45 If a lease is not classified as a sales-type or direct financing lease, it is an operating lease.

Recognition and measurement

Sales-type lease

.46 A lessor will derecognize the underlying asset and recognize (1) the net investment in the lease; (2) selling profit or loss from the lease; and (3) initial direct costs as an expense if, at the commencement date, the fair value of the underlying asset is different from its carrying amount. If the fair value of the underlying asset equals its carrying amount, initial direct costs would be deferred at the commencement date and included in the measurement of the net investment in the lease.

.47 The net investment in the lease is comprised of:

- the lease receivable, which is measured at the present value of:
 - lease payments not yet received by the lessor; and
 - any expected residual value of the underlying asset guaranteed by the lessee or a third party unrelated to the lessor; and
- the present value of the unguaranteed expected residual value of the underlying asset.

.48 Present value is calculated using the rate implicit in the lease. The rate implicit in the lease is the same as that under current leasing guidance in ASC 840 except that deferred initial direct costs will be factored into the determination. The net investment is not

remeasured after the commencement date unless the lease is modified and the modification is not accounted for as a separate lease.

.49 Subsequent to lease commencement, interest income is recorded based on the effective rate of interest on the carrying value of the net investment in the lease. The net investment is subject to impairment testing based on the guidance applicable to receivables under ASC 310-10-35-16 through 35-30.

.50 If collectibility of the lease payments, plus any amount necessary to satisfy a residual value guarantee provided by the lessee, is not probable at the commencement date, the lessor should not derecognize the underlying asset, but should recognize lease payments received (including variable lease payments) as a deposit liability. The lessor should continue to assess collectibility. Once collectibility becomes probable, the lessor should derecognize the underlying asset and the deposit liability, recognize a net investment in the lease based on the remaining lease payments and remaining lease term using the commencement date rate implicit in the lease, and recognize selling profit or selling loss (calculated as lease receivable, plus deposit liability, minus the underlying asset net of the unguaranteed residual).

.51 If before the collectibility becomes probable (a) the contract is terminated, and the lease payments received from the lessee are nonrefundable, or (b) the lessor repossesses the underlying asset with no further obligation to the lessee and the lease payments received from the lessee are nonrefundable, the lessor should derecognize the deposit liability with the corresponding amount recognized as lease income.

.52 If collectibility is probable at the lease commencement date for a sales-type lease or direct financing lease, then a lessor should not reassess whether collectibility is probable. Subsequent changes in lessee's credit risk should be accounted for in accordance with the impairment guidance applicable to the net investment in the lease.

Direct financing lease

.53 Accounting for a direct financing lease is the same as that for a sales-type lease, except that any selling profit (expected to be infrequent) and initial direct costs are deferred and included in the net investment in the lease at lease commencement.

Operating lease

.54 In an operating lease, the leased asset remains on the lessor's balance sheet. Initial direct costs are deferred. Following the commencement date, the lessor will recognize lease payments as income in the income statement over the lease term, generally on a straight-line basis. Initial direct costs are recognized as an expense over the lease term on the same basis as lease income (generally on a straight line basis). Variable lease payments are recognized as income when earned.

.55 If collectibility of the lease payments plus any amounts necessary to satisfy a residual value guarantee (provided by lessee or a third party) is not probable at the commencement date, lease income is limited to the lesser of the income that would be recognized as discussed in paragraph .54 or the lease payments (including variable lease payments) that have been collected from the lessee. If the assessment of collectibility of the lease payments changes after the commencement date, any difference between the lease income that would have been recognized in accordance with paragraph .54 and the lease payments (including variable lease payments) that have been collected from the lessee should be recognized in income at that time.

.56 Similar to a lessee, a lessor may determine a single discount rate to apply to a portfolio of leases assuming its application does not create a material difference when

compared to individually determined discount rates applied to each of the leases in the portfolio.

Lease term

.57 A lessor and a lessee determine the lease term based on the noncancellable period for which a lessee has the right to use an underlying asset. Periods subject to lessee renewal or termination options would not be included in the lease term unless economic factors indicate that continuation of the lease appears to be reasonably certain at lease commencement. The lease term includes periods covered by renewal or early termination options if their exercise is controlled by the lessor.

Lease payments

.58 Lease payments consist of the following payments relating to the use of the underlying asset during the lease term: (1) fixed payments, including in-substance fixed payments, less any lease incentives paid or payable to lessee; (2) variable lease payments that depend on an index or a rate based on the rate at inception; (3) the exercise price of an option to purchase the underlying asset if the lessee is reasonably certain to exercise that option; (4) payments for penalties for terminating the lease, if the lease term reflects the lessee exercising an option to terminate the lease; (5) fees paid by the lessee to the owners of a special-purpose entity for structuring the transaction; (6) for a lessee only, amounts probable of being owed by the lessee under residual value guarantees.

Variable lease payments

.59 Some lease payments vary after the lease commencement date for reasons other than the passage of time. Variability can be due to changes in an external market rate, such as a benchmark interest rate or an index such as CPI. Variability may also be linked to the use of the underlying asset (e.g., payments based on excess mileage in an automobile lease) or performance of the underlying asset (e.g., percentage of sales in a retail store lease).

.60 Variable lease payments that depend on an index or a rate should be included in lease payments based on the index or rate at lease commencement; no increase or decrease to future lease payments during the lease term should be assumed. Variable lease payments other than those that depend on an index or a rate should not be a factor in classifying or measuring the lease unless they are in-substance fixed payments.

In-substance fixed payments

.61 In-substance fixed payments are lease payments that are in form variable but in substance lack genuine variability. Such payments should be treated like fixed lease payments.

Lease incentives

.62 Lease incentives include payments made to or on behalf of the lessee, as well as losses incurred by the lessor as a result of assuming a lessee's preexisting lease with a third party. For example, a lessor may make an up-front cash payment to induce a lessee to sign the lease. These payments should be reflected as a reduction to lease payments used to classify and measure the lease.

Renewal, purchase, and termination option payments

.63 Payments associated with renewal or termination options or the exercise of a purchase option should be included in lease payments if it is reasonably certain that the lessee will exercise such options.

Residual value guarantee

.64 A residual value guarantee is a commitment to compensate the lessor for a shortfall in the value of the underlying asset at the end of the lease term. A lessee-provided residual value guarantee will include the amounts probable of being owed at the end of the lease term as a lease payment when measuring the right-of-use asset and lease liability. A lessor will include not only lessee-provided guarantees, but also those of third parties in the measurement of its lease receivable. For lease classification purposes, the full amount of the lessee's residual value guarantee is used. If residual value guarantees are provided for a portfolio of underlying assets, they are not considered for lease classification purposes since the lessor cannot determine the amount of the residual value guarantee applicable to an individual asset within the portfolio.

Initial direct costs

.65 Initial direct costs are incremental costs that would not have been incurred without entering into the lease. Initial direct costs can include commissions or payments made to existing tenants to incentivize the tenant to terminate its lease. Costs that are not incremental (such as lessee payroll costs that would have been incurred regardless of the lease) or costs that are incremental but that would have been incurred regardless of whether or not the parties execute the lease (such as external legal costs to negotiate a lease) are excluded.

Lease modification

.66 A lessee and lessor may renegotiate the terms of a contract for a variety of reasons. A modification is a change to the contractual terms and conditions of a contract that results in a change in the scope of or the consideration for the lease. Initial direct costs, lease incentives, and any other payments made in connection with a modification are accounted for similar to the accounting for a new lease.

Modification is a separate contract

.67 When a modification provides the lessee with an additional right of use not included in the original lease (such as the right to use an additional asset) and the lease payments increase commensurate with the standalone price for the additional right of use adjusted for the circumstances of the particular contract, the modification is accounted for separate from the original lease. In this case, the accounting for the original lease is not changed and the new lease is accounted for as any other new lease.

Modification is a not separate contract

Lessee

.68 When a modification is not a separate contract, the lessee needs to reassess the classification of the lease and remeasure the lease liability after remeasuring and reallocating the consideration in the contract as of the effective date of the modification. Assumptions used, including the discount rate, fair value, and remaining economic life of the underlying asset are updated as of the modification effective date.

.69 If the modification grants additional rights to the lessee or extends or reduces the term of the existing lease (other than exercise of a contractual option to extend or terminate the lease) or changes contract consideration, the amount of the remeasurement of the liability is recorded with a corresponding adjustment to the right-of-use asset.

.70 For a modification that fully or partially terminates an existing lease, the lessee will be required to decrease the carrying amount of the right-of-use asset proportionate to the impact the full or partial termination of the existing lease has on the lease liability. Any difference between the reduction of the lease liability and the proportionate reduction in

the right-of-use asset would be recognized as a gain or loss at the effective date of the modification.

.71 If a finance lease is modified and the modified lease is classified as an operating lease, any difference between (a) the carrying amount of the right-of-use asset as adjusted per paragraphs .69 and .70, and (b) the carrying amount of the right-of-use asset that would result from applying the operating lease right-of-use asset measurement guidance to the modified lease is accounted for as a rent prepayment or a lease incentive.

Lessor

.72 When a modification is not a separate contract, the lessor will be required to reassess the lease classification as of the effective date of the modification based on circumstances on that date and account for the modified lease prospectively as follows:

- The modification of an operating lease is accounted for as if it were a termination of the existing lease and creation of a new lease that commences on the modification effective date.
 - If the modified lease is classified as an operating lease, any prepaid or accrued lease rentals relating to the original lease (e.g., from the straight lining of rent payments) are added (if prepaid) or subtracted (if accrued) to the sum of the modified lease payments for purposes of calculating the straight-line rental income under the modified lease.
 - If the modified lease is classified as a direct financing or a sales-type lease, the lessor is required to derecognize any deferred rent liability or accrued rent asset and adjust the selling profit or loss accordingly.
- The modification of a direct financing lease is accounted for as follows:
 - If the modified lease is classified as a direct financing lease, the discount rate for the modified lease is recalculated so that the initial net investment in the modified lease equals the carrying amount of the net investment in the original lease immediately before the modification effective date.
 - If the modified lease is classified as a sales-type lease, then guidance applicable to a sales-type lease applies with the commencement date of the modified lease considered as the effective date. Selling profit or loss is calculated based on the underlying asset's fair value at the modification effective date and the carrying amount of the net investment in the original lease immediately before the modification effective date.
 - If the modified lease is classified as an operating lease, the underlying asset is recognized at a carrying amount that equals the net investment in the original lease immediately before the effective date of the modification.
- Modification of a sales-type lease is accounted for as follows:
 - If the modified lease is classified as a sales-type or a direct financing lease, the discount rate for the modified lease is adjusted so that the initial net investment in the modified lease equals the carrying amount of the net investment in the original lease immediately before the effective date of the modification.
 - If the modified lease is classified as an operating lease, the underlying asset is recognized at a carrying amount that equals the net investment in

the original lease immediately prior to the effective date of the modification.

Reassessment

.73 Even when a lease is not modified, there are circumstances when a lessee will be required to remeasure lease payments. Remeasurement of lease payments requires a remeasurement of the lease liability.

.74 When remeasuring the lease liability, the lessee is required to use an updated discount rate, except in specified circumstances.

.75 The remeasurement to the lease liability results in an adjustment to the right-of-use asset. If the carrying amount of the right-of-use asset is reduced to zero, any remaining adjustment is recorded in the income statement.

Lease term and purchase options

.76 A lessee is required to reassess the lease term or its option to purchase the underlying asset if (1) a significant event or a change in circumstances that is within the lessee's control occurs; or (2) an event written in the contract obliges the lessee to exercise (or not exercise) an extension or termination option; or (3) the lessee elects to exercise an option that was previously not reasonably certain of exercise or does not exercise an option that was previously reasonably certain of exercise. When the lease term changes, the lessee must remeasure the lease payments and reassess the lease classification as discussed in paragraphs .73 through .75.

.77 A change in market-based factors, such as market rates relative to renewal or purchase options, should not, in isolation, trigger reassessment. However, events and circumstances that may trigger reassessment include (1) constructing significant leasehold improvements that are expected to have significant economic value for the lessee when the option becomes exercisable; (2) making significant modifications or customizations to the underlying asset; (3) making a business decision that is directly relevant to the lessee's ability to exercise or not to exercise an option (for example, extending the lease of a complementary asset or disposing of an alternative asset); (4) subleasing the underlying asset for a period beyond the exercise date of the option.

.78 A lessor should not reassess the lease term or a lessee option to purchase the asset unless the lease is modified and that modification is not accounted for as a separate lease. When a lessee exercises an option to extend or terminate the lease or purchase the underlying asset, the lessor should account for the option exercise as a contract modification.

Variable rent, residual value guarantee

.79 A lessee should remeasure variable lease payments that depend on an index or a rate when the lessee is otherwise required to remeasure the lease. Such remeasurement will be based on the index or the rate as of the remeasurement date. All subsequent changes to variable payments based on a rate or index are expensed in the period incurred absent a new requirement to remeasure.

.80 A lessee should remeasure lease payments if a contingency associated with a variable lease payment is subsequently resolved such that the variable lease payment now meets the definition of a lease payment.

.81 A lessee should, on an ongoing basis, reassess if there is a change in the amounts expected to be payable under residual value guarantees and remeasure the lease payments to reflect the change.

.82 A lessor should not remeasure lease payments unless the lease is modified and the modification is not accounted for as a separate contract.

Contract combinations

.83 An entity may enter into multiple contracts in contemplation of each other such that the substance is that of a single arrangement that achieves an overall commercial effect. When contracts are entered into at or near the same time with the same counterparty (or its related parties) and at least one of the contracts is or contains a lease, then the contracts should be considered as a single transaction if (1) the contracts are negotiated as a package with the same commercial objective(s); or (2) the amount of consideration to be paid in one contract depends on the price or performance of the other contract; or (3) the rights to use underlying assets conveyed in the contracts (or some of the rights of use conveyed in the contracts) are a single lease component.

Subleases

.84 When a lessee subleases an asset, then the lessee (now a sub-lessor) should account for a head lease and sublease as two separate contracts (unless those contracts meet the contract combinations guidance). The sub-lessor should determine the classification of the sublease based on the underlying asset in the head lease, rather than on the sub-lessor's right-of-use. The accounting by the sub-lessor is based on whether or not the sub-lessor is relieved of primary obligation under the head lease and the classification of both the head lease and the sublease.

Related-party leases

.85 The recognition and measurement requirements for related-party leases are based on their legally enforceable terms and conditions. This is the case even when related-party transactions are not documented and/or the terms and conditions are not at arm's length. Lessors and lessees should disclose lease transactions with related parties in accordance with the related party guidance in ASC 850, *Related Party Disclosures*.

Sale and leaseback transactions

.86 Existing sale and leaseback guidance, including the detailed guidance applicable for sale-leasebacks of real estate, is replaced with a new model applicable to all assets, which will apply equally to both lessees and lessors. A sale-leaseback transaction will qualify as a sale only if all the following conditions are met.

- The transaction meets the sale guidance in the new revenue recognition standard.
- The leaseback is not a finance or a sales-type lease.
- If there is a repurchase option, (a) the exercise price is at the asset's fair value at the time of exercise, and (b) alternative assets that are substantially the same as the transferred asset are readily available in the marketplace.

.87 If the transaction is a sale, the seller-lessee will recognize the sale based on the new revenue recognition standard when control transfers to the buyer-lessor, derecognizing the asset sold and replacing it with a right-to-use asset and lease liability for the leaseback. When the arrangement is a sale, the buyer-lessor will account for its purchase of the asset and classify the lease based on the lessor guidance. A seller-lessee and buyer-lessor should determine if the sale-leaseback transaction is at fair value based on the difference between either (a) the sale price and fair value of the asset, or (b) the present value of lease payments and market rents, whichever is more readily determinable.

.88 If the sale-leaseback transaction is not at fair value, the seller-lessee and the buyer-lessor should adjust the sale price of the asset on the same basis used to determine that the transaction was not at fair value. An increase to the sale price of the asset is accounted for as a prepayment of rent and a reduction of the sale price of the asset as additional financing provided by the buyer-lessor to the seller-lessee.

.89 If the transaction fails sale treatment, the buyer-lessor will reflect the sale-leaseback transaction as a lending. The seller-lessee will not derecognize the transferred asset and will reflect the sale-leaseback transaction as a borrowing.

Build-to-suit transactions

.90 Build-to-suit guidance under the current leasing rules is replaced with a new model under which a lessee is the deemed owner of an asset under construction if the lessee controls such asset during the construction period. A lessee may control the asset under construction in many ways. The following list from ASC 842-40-55 enumerates examples of circumstances when the lessee controls an underlying asset that is under construction. The list is not all inclusive.

- a. The lessee has the right to obtain the partially constructed underlying asset at any point during the construction period (for example, by making a payment to the lessor).
- b. The lessor has an enforceable right to payment for its performance to date, and the asset does not have an alternative use (see paragraph 84210-55-7) to the owner-lessor. In evaluating whether the asset has an alternative use to the owner-lessor, an entity should consider the characteristics of the asset that will ultimately be leased.
- c. The lessee legally owns either:
 1. Both the land and the property improvements (for example, a building) that are under construction
 2. The non-real-estate asset (for example, a ship or an airplane) that is under construction.
- d. The lessee controls the land that property improvements will be constructed upon (this includes where the lessee enters into a transaction to transfer the land to the lessor, but the transfer does not qualify as a sale in accordance with paragraphs 842-40-25-1 through 25-3) and does not enter into a lease of the land before the beginning of construction that, together with renewal options, permits the lessor or another unrelated third party to lease the land for substantially all of the economic life of the property improvements.
- e. The lessee is leasing the land that property improvements will be constructed upon, the term of which, together with lessee renewal options, is for substantially all of the economic life of the property improvements, and does not enter into a sublease of the land before the beginning of construction that, together with renewal options, permits the lessor or another unrelated third party to sublease the land for substantially all of the economic life of the property improvements.

.91 If the lessee controls the asset under construction during the construction period, the lessee and the lessor would be subject to the sale and leaseback model. If the requirements under the sale and leaseback model are not met, the transaction would be accounted for as a financing by the lessee and lessor.

.92 Any payments made by the lessee during the construction period would be accounted for based upon the purpose of those payments. Payments made for the right to use the underlying asset are lease payments irrespective of the timing and nature of such payments. Construction costs incurred by the lessee, where the lessee is not considered the owner of the asset under construction, are considered lease payments unless there is a good or service being provided to the lessee. In the latter case, the payments should be accounted for under other guidance, such as ASC 330, *Inventory*, or ASC 360, *Property, Plant, and Equipment*.

Disclosures

.93 Extensive quantitative and qualitative disclosures, including disclosures about significant judgments made by management, will be required to provide greater insight into both the revenue and expense recognized and expected to be recognized from existing contracts. The level of detail to be disclosed and aggregation or disaggregation of disclosures should satisfy the disclosure objective of enabling users of financial statements to assess the amount, timing, and uncertainty of cash flows arising from leases.

.94 Lessees and lessors, for example, will be required to disclose a general description of leases, the basis on which variable rents are determined, a description of extension and termination options, significant judgments and assumptions made (e.g., with respect to embedded leases and the allocation of consideration between lease and nonlease components), and lease transactions between related parties.

Observations on significant differences with existing guidance

95. The following table summarizes the significant differences between the new and the current lease accounting standard.

Topic	New Guidance	Observations
<i>Definition of a lease</i>	An arrangement contains a lease only when such arrangement conveys the right to “control” the use of an “identified asset.”	Under existing guidance, an arrangement can contain a lease even without control of the use of the asset if the customer takes substantially all of the output over the term of the arrangement. Determining whether an arrangement contains a lease is likely to be more important since virtually all leases will require recognition of an asset and liability. It will also make the allocation of contractual consideration between lease and nonlease components a critical element of the accounting analysis for many companies.
<i>Build-to-suit arrangements</i>	Ownership during construction period based on a control model as described in paragraph .90.	Current guidance is based on a risks and rewards model, but contains several complex prescriptive provisions designed to assess lessee ownership during construction. The new model has eliminated these prescriptive rules and replaced them with a model based on control.

Topic	New Guidance	Observations
<i>Lease classification</i>	<p>Lessees: There are no bright lines and there is one additional criterion regarding the specialized nature of the underlying asset for lease classification.</p> <p>Lessors: Criteria are similar to that for lessees, with an additional requirement to assess collectibility to support classification as a direct financing lease. Also, in order to derecognize the asset and record revenue, collection of payments due must be probable for sales-type leases.</p>	<p>Lessees: The lack of explicit bright lines will increase the level of judgment required when classifying a lease – particularly for certain highly structured transactions. Despite the removal of the bright lines, the basis for conclusions acknowledges that one reasonable approach to determining whether the lease is for a major portion of the assets life and whether payments represent substantially all of the assets value is the 75% and 90% thresholds applicable in today’s guidance.</p> <p>Lessors: Under the current “risks and reward” model, in addition to a collectibility criterion, there is a “reimbursable costs” criterion for sales-type and direct financing lease classification. In addition, to achieve sales-type lease accounting for real estate, title must automatically transfer to the lessee by the end of the lease term. Both of these conditions have been removed from the new guidance.</p> <p>Under the current model, the difference between a sales-type lease and a direct finance lease is the presence of upfront profit. When present, the arrangement is a sales-type lease.</p> <p>Under the new standard, the key distinction is based on control. As a practical matter, this will likely depend on whether the “substantially all” criterion has been met in part due to a third-party residual value guarantee. When this is the case, presuming payments are collectible, the lease is classified as a direct financing lease.</p>
<i>Balance sheet presentation</i>	<p>Lessees: Lessees will recognize a right-of-use asset and a lease liability for virtually all leases.</p> <p>Lessors: Leveraged lease accounting will not be permitted for new transactions or existing transactions modified on or after the effective date.</p>	<p>Lessees: Putting nearly all leases on the balance sheet is the biggest change, and one of the key objectives of the project.</p> <p>Lessors: The lessor model has been carried forward substantially unchanged. Netting of non-recourse debt previously permitted under the leveraged lease model will no longer be available.</p>

Topic	New Guidance	Observations
<i>Income and expense recognition</i>	<p>Lessees: Expense will be recognized on a straight-line basis for an operating lease. This is accomplished by increasing the amortization of the right-of-use asset as interest expense on the liability declines over the lease term. Recognition of expense for a finance lease will be similar to capital leases today.</p> <p>Lessors: To recognize upfront revenue and profit in a sales-type lease, the lessee will need to obtain control over the leased asset.</p>	<p>Lessees: Under current guidance, operating leases are off-balance sheet. With the new balance sheet recognition, the right-of-use asset will now be subject to impairment testing. Further, the mechanics of achieving a straight-line expense for operating leases will backload amortization of the right-of-use asset, potentially increasing the risk of an impairment.</p> <p>Lessors: The shift from a “risks and rewards” model under the current guidance to a “control” model under the new guidance for sales-type leases may have commercial implications for certain transactions (e.g., sale and leaseback transactions).</p>
<i>Inception date versus commencement date</i>	Under the new guidance, the determination of whether or not a contract is a lease or contains a lease is done at the inception date. Lease classification, recognition, and measurement are determined at the lease commencement date.	Under ASC 840, assumptions relevant to classification and measurement are determined at lease inception. Recognition of rent expense or capital lease assets and liabilities begin at the commencement date.
<i>Reassessment - lessee</i>	A lessee is required to reassess the lease term if a triggering event occurs that is under the lessee’s control or an option is exercised/not exercised as planned. A change to the lease term will lead to reclassification of the lease and remeasurement of the right-of-use asset and liability. Assumptions such as the discount rate and variable rents based on a rate or index will be updated as of the remeasurement date.	Current guidance does not require a reassessment unless the lease is modified or an option is exercised. Under the new guidance, a lessee will need to monitor for triggering events on an ongoing basis.

Topic	New Guidance	Observations
<i>Modification</i>	A lease modification is a change to the contractual terms and conditions of a lease that was not part of the original lease and which results in a change in scope or consideration. A modification that grants the lessee an additional right of use priced at market is a separate lease that is then classified at the lease modification date.	The current guidance for lease modification can be very complex and it can be difficult to differentiate between a termination and modification of a lease contract. A renewal or extension is considered a new lease. All other changes are subject to a two-step evaluation of the lease.
<i>Initial direct costs</i>	Under the new guidance, initial direct costs are defined as incremental costs of a lease that would not have been incurred if the lease had not been obtained.	Under current guidance, incremental direct costs can include internal costs as well as external costs such as legal fees, even when the lease has not been obtained. Certain incremental costs previously eligible for capitalization will be expensed.
<i>Sale-leaseback transactions</i>	Under the new standard, a sale-leaseback transaction will qualify as a sale only if (1) it meets the sale guidance in the new revenue recognition standard, (2) the leaseback is not a finance lease, and (3) if there is a repurchase option, (a) the repurchase price is at the asset's fair value at the time of exercise and (b) alternative assets that are substantially the same as the transferred asset are readily available in the marketplace.	<p>Under the current guidance, sale-leaseback accounting is applicable only to lessees. This includes the detailed and specialized guidance applicable to sale-leasebacks involving real estate.</p> <p>Under the new standard, sale-leaseback accounting will apply to lessees and lessors. There will be no specialized guidance for sale-leasebacks of real estate.</p> <p>A “failed” sale is treated as a financing by both the lessee and lessor (i.e., the seller has not sold the asset but has essentially mortgaged it).</p> <p>Sale-leaseback transactions involving equipment frequently have fixed price repurchase options – often at the request of the seller-lessee for commercial reasons. Such transactions will not qualify as a sale under the new standard. However, sale-leaseback accounting applied for transactions executed prior to the effective date will not need to be re-evaluated. Existing “failed” sales will be evaluated under the new standard and may qualify for sale-leaseback accounting on transition.</p>

Topic	New Guidance	Observations
<i>Lease versus nonlease components</i>	<p>A contract may contain lease and nonlease components. Under the new standard, components include only those items or activities that transfer a good or service to the lessee. The right to use land is considered a separate lease component unless the accounting effect of doing so would be immaterial.</p> <p>A lessee may choose not to separate nonlease components from their related lease components. If this election is made, all cash flows associated with the nonlease component would be allocated to the related lease component.</p>	<p>Under current guidance, property taxes and insurance are subject to lease accounting guidance, but are considered executory costs rather than minimum lease payments. Under the new standard, property taxes and insurance are not considered as components of a contract as they are not for a service provided by the lessor to the lessee and are therefore a part of lease payments.</p> <p>Under existing guidance, land is separately classified when the fair value of the land is 25% or more of the combined fair value of the land and building.</p>

What's next

.96 Public business entities are required to adopt the new leasing standard for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2018. For calendar year-end public companies, this means an adoption date of January 1, 2019.

.97 Nonpublic companies (i.e., those not meeting FASB's definition of a public business entity) are required to apply the new leasing standard for fiscal years beginning after December 15, 2019, and interim periods within fiscal years beginning after December 15, 2020. For nonpublic calendar year-end companies, this means an adoption date of January 1, 2020.

.98 Early adoption of the new leasing standard is permitted upon issuance (February 25, 2016).

.99 The new leasing standard requires modified retrospective transition, which requires application of the new guidance at the beginning of the earliest comparative period presented in the year of adoption.

.100 For calendar year public business entities, this means retrospective application to previously issued annual and interim financial statements for 2018 and 2017.

.101 For calendar year nonpublic companies, this means retrospective application to previously issued annual financial statements for 2018 if comparative statements for two preceding years are presented.

.102 An entity can elect the following package of practical expedients for all leases that commenced before the effective date:

- An entity need not reassess whether any expired or existing contracts are or contain embedded leases.
- An entity need not reassess the lease classification for any expired or existing leases (i.e., all existing leases that were classified as operating leases or capital leases under current leasing guidance will be classified as operating leases and finance leases, respectively, under the new leasing guidance).
- An entity need not reassess initial direct costs for any existing leases.

.103 An entity can also elect a practical expedient to use hindsight in determining the lease term when considering lessee options to extend or terminate the lease and to purchase the underlying asset as well as in assessing the impairment of right-of-use assets. This practical expedient can be elected separately or in conjunction with the package of practical expedients above and must be applied consistently to all leases.

.104 Lessors should continue to account for leveraged leases existing at the application date of the leasing standard using the current lease guidance under ASC 840.

Next steps

.105 Beyond the financial reporting impact, the new guidance is likely to require changes to lease systems and related controls. Based on the effective date and the need for retrospective application to prior years, lessees should focus on their ability to gather the required data on existing leases and capture data on new leases, which will be critical to an effective transition. In some cases, new systems, controls, and processes may be warranted, which will take additional time to obtain, develop, implement, and test.

.106 With the issuance of the standard in February 2016, companies will have only three years before they begin reporting under the new guidance. Companies that have not done so already, will want to think through the potential impact, particularly in light of the requirement to retrospectively apply the standard to previously issued financial statements. If they have not done so already, preparers should begin to develop a plan for an orderly and smooth transition.

Questions?

PwC clients who have questions about this *In depth* should contact their engagement partner. Engagement teams who have questions should contact the Financial Instruments team in the National Professional Services Group (1-973-236-7803).

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