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Frequently Asked Questions About the FASB's New Leases Standard

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Introduction

It's been over a year since the FASB issued [ASU 2016-02](#),¹ its new standard on accounting for leases (codified in ASC 842).² Although the standard will not be effective until 2019,³ entities have already begun raising implementation issues.⁴ In addition, many questions have arisen about the standard's fundamental concepts, including the definition of a lease, lease payments, and presentation and disclosure.

In this *Heads Up*, we share our perspectives on such topics and address FAQs about the standard. We have also included several Driving Discussions to highlight certain key issues related to the new guidance, some of which remain unresolved as of the issuance date of this publication.

For a comprehensive overview of ASU 2016-02, see Deloitte's March 1, 2016, [Heads Up](#).

¹ For full titles of standards, regulations, and other literature, see [Appendix A](#). For definitions of abbreviations, see [Appendix B](#).

² ASU 2016-02 was issued on February 25, 2016. IFRS 16, the IASB's new leases standard, was issued on January 13, 2016.

³ For public business entities, certain not-for-profit entities, and certain employee benefit plans, ASU 2016-02 is effective for annual periods beginning after December 15, 2018, and interim periods therein. For all other entities, the ASU is effective for annual periods beginning after December 15, 2019, and interim periods within annual periods beginning after December 15, 2020. Early adoption is permitted.

⁴ On November 30, 2016, for the first time since issuing ASU 2016-02, the FASB discussed implementation issues related to the new leases standard. The Board indicated that it would address implementation issues raised by stakeholders in future FASB meetings instead of forming a transition resource group (TRG) similar to the TRGs created to address transition issues related to the new revenue recognition and credit losses guidance.

Join us on May 8 at 2:00 p.m. EDT for a *Dbriefs* webcast on FAQs about the FASB's new leases standard.

Scope

Q&A 1 Capitalization Policy Considerations

Many entities have accounting policies that establish a materiality threshold for capitalizing fixed assets (i.e., property, plant, and equipment (PP&E)). Under such policies, expenditures below the established threshold are expensed in the period incurred, as opposed to being capitalized on the balance sheet and depreciated over the life of the asset.

Because ASC 842 requires entities to recognize a right-of-use (ROU) asset and lease liability for all leases (other than short-term leases) and does not contain a “small-ticket item” exception similar to that in IFRS 16,⁵ many entities have asked whether a similar capitalization threshold may be established for lease assets and lease liabilities under ASU 2016-02.

Question

Can a lessee use an appropriate capitalization threshold when evaluating the requirement to recognize, on the balance sheet, leases that otherwise require recognition under the ASU?

Answer

Yes. Paragraph BC122 of [ASU 2016-02](#) states, in part:

[E]ntities will likely be able to adopt reasonable capitalization thresholds below which lease assets and lease liabilities are not recognized, which should reduce the costs of applying the guidance. An entity's practice in this regard may be consistent with many entities' accounting policies in other areas of GAAP (for example, in capitalizing purchases of property, plant, and equipment).

While the new leases standard does not provide for a specific exemption, an entity is not required to apply U.S. GAAP to immaterial items; therefore, materiality is always a consideration in the preparation of financial statements. However, an entity should not simply default to its existing capitalization threshold for PP&E for the following reasons:

- The existing capitalization threshold for PP&E is unlikely to include the effect of the additional asset base introduced by the ASU. That is, the addition of another set of assets not recognized on an entity's balance sheet may require a refreshed analysis of the entity's capitalization thresholds to ensure that the aggregated amounts will not become material.
- The existing capitalization threshold for PP&E does not affect the liability side of the balance sheet. Under the new standard, if an entity wishes to establish a threshold that will be used to avoid accounting for both ROU assets and lease liabilities on the balance sheet, it must consider materiality, in the aggregate, of all of its ROU assets and related lease liabilities that would be excluded as a result of its adoption of such a threshold.

One reasonable approach to developing a capitalization threshold for leases is to use the **lesser** of the following:

- A capitalization threshold for PP&E, including ROU assets (i.e., the threshold takes into account the effect of leased assets determined in accordance with ASU 2016-02).
- A recognition threshold for liabilities that takes into account the effect of lease liabilities determined in accordance with the ASU.

Another reasonable approach to developing a capitalization threshold for leases is to record all lease liabilities but subject the related ROU assets to such a threshold. Under this approach, if an ROU asset is below the established capitalization threshold, it would immediately be recognized as an expense. In subsequent periods, entities would amortize

⁵ Under IFRS 16, an entity may exclude leases for which the underlying asset is of low value from its ROU assets and lease liabilities. See paragraphs B3 through B8 in IFRS 16 for information about how to assess whether an asset is of low value.

the lease liability by using the effective interest method, under which a portion of the periodic lease payments would reduce the liability and the remainder would be recognized as interest expense.

In addition, when evaluating and applying a capitalization threshold for leases determined in accordance with the ASU, entities should consider the following:

- *The gross balance of each side of the lease entry* — It would be inappropriate for an entity to consider only the net balance sheet effect of the lease entry (which is often zero) when assessing materiality.
- *Disclosure requirements* — We expect that entities will often want to omit disclosures about leases that they have determined do not require balance sheet recognition on the basis of their use of capitalization thresholds as discussed above. We believe that while it may be appropriate to omit such disclosures, an entity will need to consider the impact of the omitted disclosures when performing a materiality assessment to establish the thresholds.
- *Internal control over financial reporting (ICFR) implications* — As entities revisit and change (or create new) capitalization thresholds for financial reporting purposes, they should be cognizant of the related ICFR implications. In addition, the Form 10-K and Form 10-Q disclosure requirements under SEC Regulation S-K, Item 308(c), related to material changes in ICFR should be considered.
- *SAB Topic 1.M (SAB 99)* — Entities may find the guidance on materiality in SAB Topic 1.M helpful when identifying an appropriate capitalization threshold for leases.

Example

A lessee enters into a five-year lease of a machine to use in its operations. The lessee determines that its ROU asset and lease liability are measured at \$3,260 at lease commencement.

To identify an appropriate capitalization threshold for its ROU assets and lease liabilities, the lessee considers the following:

- The gross balances (rather than the net balance) of its ROU assets and lease liabilities.
- The disclosures that would be omitted if certain ROU assets and lease liabilities were not recognized.
- The appropriate internal controls needed for the lessee to apply and monitor the capitalization threshold.
- Overall materiality considerations in SAB Topic 1.M.

After considering these factors, the lessee determines that (1) an appropriate capitalization threshold for PP&E, including ROU assets, is \$3,500 and (2) an appropriate recognition threshold for lease liabilities is \$3,000. The lessee should apply the lower of the two thresholds when determining whether to record the lease on its balance sheet. Given that the initial measurement of the lessee's ROU asset and lease liability exceeds the \$3,000 threshold established for lease liabilities (i.e., the lower of the two thresholds), the lessee should recognize the ROU asset and lease liability on its balance sheet at lease commencement.

Alternatively, the lessee may choose to recognize the lease liability of \$3,260 but not the ROU asset on the basis of the established \$3,500 threshold for PP&E, including ROU assets (i.e., the lessee may choose to expense the cost of the ROU asset at lease commencement).

Definition of a Lease

Q&A 2 Assets With a Significant Service Component

Background

An entity may enter into a service arrangement that involves PP&E necessary to meet the contract's performance obligations. The importance of the PP&E to the overall delivery of the service may vary depending on the type of arrangement.

For example, a customer contracting for transportation services to ship a package from Munich to Milwaukee cares little about the PP&E used to perform the services. In contrast, a customer contracting a vessel and crew for a specified period to transport its goods where and when it chooses is likely to be more concerned with the PP&E used in the arrangement. Both arrangements, however, involve a significant service component provided by the supplier to operate the PP&E used to fulfill its transportation obligations.

Often, the assessment of whether a contract is or contains a lease will be straightforward. However, the evaluation will be more complicated when a service arrangement involves a specified physical asset or when both the customer and the supplier make decisions about the use of the underlying asset. Examples of these more ambiguous and complex arrangements include arrangements that involve cloud computing services (i.e., if there is a lease of the supporting equipment, such as mainframes and servers) and cable television services (i.e., if the cable box provided to the customer is a leased asset).

Question

Does an entity need to evaluate a service arrangement that involves the use of PP&E to determine whether the arrangement contains a lease?

Answer

Yes. In accordance with ASC 842-10-15-2, an entity is required at contract inception to identify whether a contract contains a lease. Not all leases will be labeled as such, and leases may be embedded in larger arrangements. For example, supply agreements, power purchase agreements, and oil and gas drilling contracts may contain leases (i.e., there may be an embedded lease of a manufacturing facility, generating asset, or drill rig, respectively). If PP&E are identified in an arrangement (either explicitly or implicitly), the customer and supplier must both determine whether the customer controls the use of the PP&E throughout the period of use.

Under ASC 842, the determination of whether an arrangement is or contains a lease is critical. A lessee's failure to identify leases, including those embedded in service arrangements, is likely to lead to a financial statement error given the requirement in ASC 842 that all leases, other than short-term leases, be reflected on the balance sheet. On the other hand, if a customer concludes that a contract is a service arrangement and does not contain an embedded lease, the customer is not required to reflect the contract on its balance sheet (unless required by other U.S. GAAP). The assessment of the arrangement may be more critical under ASC 842 than under the current guidance on leases since under ASC 840, the balance sheet and income statement treatment of operating leases is often the same as that of service arrangements.

Q&A 3 Economic Benefits and Tax Attributes

Background

ASC 842-10-15-3 states that a “contract is or contains a lease if the contract conveys the right to control the use of identified property, plant, or equipment (an identified asset) for a period of time in exchange for consideration.” ASC 842-10-15-4 specifies that in determining whether the customer has the right to control the use of the identified asset, an entity would need to evaluate whether the customer has both of the following:

- **“The right to obtain substantially all of the economic benefits from use of the identified asset”** (emphasis added).
- “The right to direct the use of the identified asset.”

Economic benefits consist of direct or indirect benefits from the **use** of the asset (e.g., using, holding, or subleasing the asset) and include the asset’s primary output and by-products. They may be tangible or intangible (e.g., renewable energy credits).

Certain types of underlying assets may provide unique tax benefits or tax attributes to the owner. Often, such tax benefits or tax attributes are provided because a government has decided to incentivize investments in the development of the assets. These benefits or attributes may be critical to a buyer’s investment decision and often economically justify an investment in an otherwise uneconomic asset or technology.

Question

Should an entity consider tax attributes associated with the ownership of the underlying asset when evaluating whether a customer has the right to obtain substantially all of the economic benefits from the use of the asset?

Answer

No. An entity should not consider any tax attributes associated with the ownership of the underlying asset when evaluating whether a customer has the right to obtain substantially all of the economic benefits from the use of the asset.

ASC 842-10-15-17 indicates that economic benefits can be realized from a commercial transaction with a third party. Tax attributes, by nature, cannot be sold in a commercial transaction because they are related to the ownership of the asset.

This approach is consistent with the manner in which outputs are determined under ASC 840 and therefore is not expected to change in practice upon the adoption of ASU 2016-02.

Example 1

The owner of an electric automobile may receive an investment tax credit that is either a fixed dollar amount or a portion of the purchase price. However, the reporting entity should not consider the investment tax credit associated with the electric automobile in its evaluation of whether a customer has the right to obtain substantially all of the economic benefits from the use of the asset.

Because a lease conveys only the right to use (and not ownership of) the underlying asset, benefits related to ownership of an asset should not be included in the assessment of whether an arrangement contains a lease. Rather, this evaluation should be limited to those economic benefits resulting from the use of the asset during the contract period that can be realized from a commercial transaction with a third party. Investment tax credits are related to the ownership of an asset, and the benefits associated with the credits may not be sold to third parties.

Example 2

The owner of a renewable energy generation facility such as a wind or solar farm may receive production tax credits based on a dollar amount per unit of electricity that the facility produces. However, the reporting entity should not consider production tax credits associated with the renewable energy generation facility in its evaluation of whether a customer has the right to obtain substantially all of the economic benefits from the use of the asset.⁶

Although the amount of the production tax credit is derived from the output produced by an underlying asset (e.g., the credit is calculated as \$0.023 per kilowatt hour of electricity produced by a renewable energy generation facility), the benefits of the credit may be received only by the owner of the underlying asset. Similar to investment tax credits, production tax credits are related to the ownership of an asset, and the benefits associated with the credits may not be sold to third parties.

Driving Discussions — Definition of a Lease



Determining Whether a Lease Exists in Arrangements Involving Rights to Use Portions of Larger Assets

We have received a number of questions about so-called “secondary use” arrangements in which a customer shares the use of part of a larger asset for a defined period. Examples of such arrangements include advertising placed on the side of a fixed asset and nonutility customers’ attachment of distribution wires (e.g., cable wires) to utility poles. Often, we have been asked (1) how to assess economic benefits when two parties contemporaneously use the same asset and (2) what unit of account to use for the evaluation of control (the larger asset or the portion being shared).

ASC 842-10-15-16 provides guidance on evaluating whether a portion of an asset would be considered an “identified asset” and be potentially subject to ASC 842. Under this guidance, a “capacity or **other portion** of an asset that is not physically distinct . . . is not an identified asset, unless it represents substantially all of the capacity of the asset and thereby provides the customer with the right to obtain substantially all of the economic benefits from use of the asset” (emphasis added).

Questions sometimes arise regarding physical distinction, particularly in scenarios involving a larger asset, a specific portion of which is shared by one or more parties over a defined period for use in different ways. An example would be a building’s exterior wall that one party is granted the exclusive right to use for advertising while the occupants of the building continue to use the wall for support of their residence, protection from the elements, and so forth. Unlike situations involving the lease of one floor of a multistory building, which is functionally independent and unique, these scenarios involve simultaneous but different uses of a portion of a larger asset. Other examples include the placement of solar panels on a specific section of rooftop and the attachment of cable wires to a specific spot on a utility pole (in both cases, the owner continues to use the entire asset while allowing another party to use a portion of the asset for a different purpose over a defined period). To the extent that there are substantive substitution rights in these arrangements, a lease will generally not be present. However, we understand that many of the scenarios found in practice do not allow for substitution.

⁶ Tax attributes such as the Renewable Electricity Production Tax Credit are different from renewable energy credits. In accordance with ASC 842-10-15-17, renewable energy credits are by-products of the use of a renewable energy generation facility and reflect benefits that can be realized from a commercial transaction with a third party. Example 9, Case A, in ASC 842-10-55-108 through 55-111 illustrates a contract for energy/power that contains a lease. In ASC 842-10-55-111(a), the FASB concludes that the renewable energy credits in the example are an economic benefit from the use of a renewable energy generation facility.

We are continuing to work with others in the profession to develop guidance that can be used to analyze these arrangements. The following are some of the considerations we have discussed to date that may ultimately be relevant to the determination of whether a lease exists:

- Does the arrangement involve a shared use of the larger asset, including the portion specified in the arrangement?
- Is the portion being used by the customer functionally independent and therefore separable from the larger asset?
- Is the portion being used by the customer commercially significant to the asset owner by design?

Shared Use

Shared-use arrangements will typically involve the contemporaneous use of the same asset (or the same portion of a larger asset) for different purposes. An example might be an easement that gives the easement holder the right to bury a pipeline underground while the landowner retains meaningful rights to use the land for farming or other purposes. Likewise, many advertising scenarios feature shared use (e.g., an ad displayed on top of a baseball dugout, on the side of a bus, or on the floor of a grocery store). On the other hand, if the owner of the asset is not contemporaneously using the asset (or is not contractually allowed to use the asset), shared use may not exist. This might be the case for a cell tower operator that allows a customer to use a specific hosting site on the tower for a defined period. Shared-use arrangements may be less likely to contain leases, while exclusive-use arrangements (i.e., arrangements in which a customer has exclusive use of a portion of a larger asset) may be more likely to contain leases. Judgment may be involved in the determination of whether a particular arrangement features shared or exclusive use of the portion of the larger asset.

Functional Independence

It may be useful to evaluate the functional independence of the portion being used by the customer, including the functional use and design of the asset that is subject to the arrangement. To the extent that the portion being used by the customer has a discrete functional use (e.g., a specific floor of a building), it could be more likely that the portion being used is physically distinct and an identified asset. On the other hand, if the portion being used is not functionally distinguishable from the larger asset (e.g., a spot on a utility pole), there may be a reasonable basis to view the larger asset as the identified asset in the arrangement.

Commercial Significance by Design

It may also be useful to consider commercial significance by design — that is, the commercial objectives of the asset owner when it built or purchased the asset. To the extent that the asset was built or purchased with the commercial objective of leasing a specific portion or portions to others (e.g., specific hosting locations on a cell tower), it could be more likely that the portion being used for these purposes is physically distinct and therefore an identified asset. On the other hand, if the asset was built or purchased without such a commercial objective (e.g., a utility pole), there may be a reasonable basis to view the larger asset as the identified asset in the arrangement.

Determining Whether a Lease Exists

The above indicators may help entities assess circumstances in which the use of a portion of an asset might reasonably be viewed as a secondary, or incidental, use of that portion of the asset such that the owner retains substantive economic benefits from the use of the portion. Sometimes, it may be reasonable to view the larger asset as the identified asset in the arrangement and to assess control (including economic benefits) on that basis. Such an approach would generally result in an increased likelihood that the arrangement does not contain a lease since the customer does not obtain substantially all of the economic benefits from the use of the larger asset (the customer's economic benefits are limited to the portion it uses).

Next Steps

This issue continues to evolve, and it is possible that the FASB and SEC will want to share perspectives before any related implementation guidance is finalized. Companies that are involved in these types of arrangements should consult with their accounting advisers and monitor developments on the topic.



Contract for Network Services (Example 10, Case A, in ASC 842-10-55-124 Through 55-126)

We have received a number of questions regarding the outcome of Example 10, Case A, in ASC 842-10-55-124 through 55-126. That example involves a contract for network services under which a telecommunications company (the supplier) installs and configures multiple servers at a customer site to support the customer's network needs (primarily the storage and transportation of data). During the term of the arrangement, the supplier makes decisions about how to deploy the fleet of servers to satisfy customer requests. Although the arrangement involves dedicated equipment, some of which is maintained on the customer's premises, the conclusion reached in the example is that the arrangement does not contain a lease since the customer does not control the individual servers.

Some may find this outcome counterintuitive since the servers are dedicated solely to the customer for the term of the arrangement. However, the conclusion highlights an important change from the current guidance on leases. Specifically, under ASC 842, the customer must obtain control of the asset(s) in the arrangement to have a lease, and control is not limited to having the right to all of the productive output of the asset (one of the circumstances that would allow an entity to conclude that an arrangement is a lease under the current guidance in ASC 840). Rather, control under ASC 842 is a two-part test that focuses on (1) economic benefits and (2) the right to direct the use of the identified asset(s). In the example, the second condition is not met; therefore, the arrangement does not contain a lease.

A number of stakeholders have asked about the key factors that result in the conclusion that the customer in the example does not have the right to direct the use of the servers. For instance, if the right to dispatch a power plant (i.e., tell the owner-operator when to produce electricity) conveys to the customer the right to direct the use of the plant (as illustrated by Example 9, Case C, in ASC 842-10-55-117 through 55-123), why wouldn't the right to determine when and which data to store or transport by using the network likewise convey to the customer control of the underlying servers?

We understand the following with regard to the key factors behind the conclusion in Example 10, Case A:

- The focus of the analysis is on whether each individual server, as opposed to the entire network, is a lease. In the example, the supplier is providing a service (a network of a certain capacity and quality) by using dedicated assets. Therefore, the control analysis should be performed at the asset level (i.e., at the individual server level).
- The consideration of “how and for what purpose” the asset is used, as described in ASC 842-10-15-25, is likewise focused on decisions related to each individual server — not the output produced by the overall network.
- The fact pattern involves multiple assets (multiple individual servers), and the supplier retains the discretion to deploy each individual server in whatever manner the supplier decides will best fulfill the overall network service.
- Since each server on its own can perform different functions (e.g., store data, transport data), the supplier has the right to make meaningful decisions about which server(s) should be used to satisfy a particular customer request.
- The customer cannot decide how and for what purpose each individual server is used and cannot prevent the supplier from making those decisions. The customer’s decisions are limited to how the customer uses the network and do not extend to the individual servers.

We believe that these key factors help differentiate the conclusion in Example 10, Case A, from the conclusion in Example 10, Case B (ASC 842-10-55-127 through 55-130). In Case B, the arrangement involves a single server, and the customer makes the critical decisions about which data to store or transport by using that single server as well as how (or whether) to integrate that single server into its broader operations. Therefore, we believe that Case B is more analogous than Case A to Example 9, Case C, which involves dispatch rights over a power plant (also a single asset).

Understanding the key distinguishing factors in the above examples should help preparers identify leases under ASC 842. However, the illustrative examples are just that — examples. They each represent an application of the framework, which requires a detailed analysis of specific facts and circumstances. If you have questions about your arrangements and whether they should be analyzed in a manner similar to the analysis in Example 10, Case A, we recommend discussing those questions with your auditors or accounting advisers.



Easements

An easement is a right to cross or otherwise use someone else’s land for a specified purpose. Most easements provide limited rights to the easement holder, such as the right to cross over land or the right to construct and maintain specified equipment on the land. For example, an electric utility will typically obtain a series of contiguous easements to allow it to construct and maintain its electric transmission system on land owned by third parties. Easements can be perpetual or term-based and can be paid in advance or paid over time.

Historically, some companies have considered easements to be intangible assets under ASC 350. In fact, ASC 350 contains an illustrative example of easements acquired to support the development of a gas pipeline. In contrast, some companies may have considered easements to be leases or executory contracts. When preparing their financial statements, many companies have presented prepaid amounts related to easements in the PP&E section of their balance sheets because PP&E are closely associated with the easements that support them. We understand that FERC reporting requirements may have also influenced the balance sheet geography for companies regulated by that agency.

Questions have arisen about whether easements or rights-of-way are within the scope of the new leases standard. Many have asserted that these arrangements are intangibles under ASC 350 and would therefore qualify for the scope exception to ASC 842 related to leases of intangible assets. However, since easements generally involve rights related to the use of land, easements should first be analyzed under ASC 842 to determine whether they are or contain a lease. This assessment should be performed by all entities, including those that had a prior policy of treating easements as intangibles (see below for special considerations for companies that elect to apply the practical expedient in ASC 842-10-65-1(f) when transitioning to ASC 842).

When an easement is perpetual, we would not expect the arrangement to meet the definition of a lease given the lack of a stated term. For term-based easements (including those with long terms, such as 100 years), the analysis will most likely be more extensive and involve a consideration of control of the underlying land. Many easement arrangements may not convey control of the land to the easement holder given the limited rights conveyed as well as the economic benefits that the owner continues to enjoy (i.e., the easement holder may not obtain substantially all of the economic benefits of the land). For example, in an arrangement in which a company is allowed to run electric transmission assets through a farmer's fields, it will be important to understand whether the farmer can still use the acreage over or under which the assets run. If so, the easement holder may conclude that it does not control the associated land because the farmer retains (1) usage rights (e.g., the ability to grow crops), (2) economic benefits associated with the land that are other than insignificant, or (3) both (1) and (2). On the other hand, there may be easement arrangements that effectively convey control of the land to the easement holder through the rights conveyed or through use restrictions imposed on the landowner. The required accounting will depend on the facts and circumstances of each arrangement.

For high-volume users of easements, we recommend (1) segregating these arrangements on the basis of similar terms, (2) isolating the term-based arrangements, and (3) investigating the rights retained by the landowner as a starting point in the analysis. This may streamline the process since many easements will have similar or identical terms and therefore would be expected to result in similar accounting.

With respect to transition, the practical expedient in ASC 842-10-65-1(f) allows a company to forgo reassessing whether expired or existing contracts contain leases in accordance with the new definition of a lease under ASC 842. We believe that this guidance, if elected, will generally extend to a company's prior accounting conclusions about easements as long as those conclusions were appropriate under historical GAAP. That is, ASC 842-10-65-1(f) does not grandfather prior accounting conclusions that were incorrect. Thus, if an arrangement should have historically been accounted for as a lease under ASC 840 but was not, it would not be safe-harbored by the transition guidance.

We are aware of ongoing dialogue between certain industry participants and the FASB regarding the accounting for easements. The discussion above represents our current thinking based on knowledge of those interactions. To the extent that there is further standard setting related to the accounting for easements (under ASC 842 or otherwise), we will update our views accordingly.



Joint Operating Agreements

Companies in a number of industries enter into joint arrangements to achieve a common commercial objective. These arrangements may include the use of specified PP&E for a stated time frame. For example, entities in the oil and gas industry often enter into joint operating agreements (JOAs) in which two or more parties (i.e., operators and nonoperators) collaboratively explore for and develop oil or natural gas properties by using the experience and resources of each party. These agreements often require the use of leased equipment. Questions have arisen regarding the lease assessment requirements under the new leases standard for parties to joint arrangements. While we expect that the analysis of joint arrangements will be very much based on facts and circumstances, the example and analysis below should be helpful to companies as they consider these arrangements.

Example

Three companies, A, B, and C, form a JOA to execute an offshore drilling program. For the companies to fulfill the JOA's objective, a specific asset (e.g., a drill rig) will be necessary. Company A will act as the counterparty to major contracts of the JOA, including a five-year contract to lease a specific drilling rig from its owner (Lessor X).

Question 1: Which Party, If Any, Is Leasing the Rig?

Given A's role as primary obligor in the drilling rig's lease (the rig's owner may not be aware of the JOA and the parties that constitute it), A will generally be deemed the lessee in the arrangement. Accordingly, A will record the entire lease on its balance sheet. Even though other parties will receive economic benefits from the rig, those benefits arise from the JOA and do not affect the economic benefits analysis⁷ of the contract between A and the rig's owner, X.

⁷ To control the use of an identified asset under ASC 842, a customer is required to have the right to obtain substantially all of the economic benefits from the use of the asset throughout the period of use.

Example (continued)

Question 2: What Is the Effect of the JOA?

The JOA's terms may represent a sublease of the rig from A to the JOA. That is, the new leases standard requires the parties to the JOA to consider the terms and determine whether the JOA is a "virtual" lessee of the rig. Although the JOA is typically not a legal entity that prepares financial statements, a conclusion that the JOA is a lessee of the rig would have the following implications:

- Company A, as sublessor, would separately account for its sublease to the JOA (apart from its head lease with X, the rig's owner).
- Each party to the JOA would need to consider other GAAP (e.g., proportionate consolidation guidance) that may require it to record its pro rata portion of the lease (as a lessee).

Note that the "other GAAP" mentioned in Question 2 of the example above may vary by industry (e.g., proportionate consolidation guidance may not be relevant in some industries). Also note that the analysis should be performed at the appropriate level, which may not always be the JOA. ASC 842 speaks to arrangements involving a "joint operation or joint arrangement," and this could be a subset of a JOA to the extent that multiple parties have agreed to jointly use an identified asset for a defined time frame. For example, in a five-year JOA involving five parties, if three of the parties agree to jointly develop a property by using a specified drill rig for the first two years, it may be necessary to evaluate that two-year agreement to determine whether it contains a lease.

Finally, the above example is not meant to suggest that most JOAs will contain leases. Rather, it is meant to highlight and explain the analysis that ASC 842 requires in circumstances involving joint arrangements that feature the use of specified PP&E.

Joint arrangement accounting remains a topic of discussion between companies and auditors, and we would encourage entities affected by this issue to check with their auditors and accounting advisers for input on the accounting for specific arrangements.

Lessee Model

Q&A 4 Considerations Related to the Impairment of an ROU Asset

A lessee must subject an ROU asset to impairment testing in a manner consistent with its treatment of other long-lived assets (i.e., in accordance with ASC 360). If the ROU asset related to an operating lease is impaired, the lessee would amortize the remaining ROU asset in accordance with the subsequent-measurement guidance that applies to finance leases — typically, on a straight-line basis over the remaining lease term. Thus, the operating lease would no longer qualify for the straight-line treatment of total lease expense. However, in periods after the impairment, a lessee would continue to present the ROU asset amortization and interest expense as a single line item.

Question

How should a lessee include the effects of a lease that is part of an asset group when testing the asset group for impairment in accordance with ASC 360?

Answer

Under the new leases standard, since operating and finance leases are both accounted for as financings in the balance sheet, the effects of both types of leases should generally be included in the impairment calculation in a manner similar to the accounting for capital leases under ASC 840. That is, a lessee should:

- Include both the ROU asset and the lease liability in the carrying amount of the asset group.
- Include only the principal component of lease payments as cash outflows in the undiscounted cash flows of the asset group. Although the total lease expense in an operating lease is presented as a single line item in the income statement, the lease payments include both an interest component and a principal component. In a manner consistent with ASC 360-10-35-29, the lessee should exclude the interest component of the lease payments from the asset group's undiscounted cash flows.



Editor's Note

At the FASB's November 30, 2016, meeting, the Board generally agreed that lessees should exclude interest payments from calculations of the undiscounted cash flows when assessing an asset group for impairment under ASC 360. However, some Board members noted that an entity's decision to include interest in its impairment analysis could be viewed as an accounting policy election. Since including interest on operating leases would increase the possibility of an asset group impairment, we would not expect entities to elect such an accounting policy.

Lessor Model

Q&A 5 Commencement Loss Resulting From Significant Variable Payments in a Sales-Type or Direct Financing Lease

While the FASB's goal was to align lessor accounting with the new revenue guidance in ASC 606, an important distinction between the two may affect lessors in a number of industries. Under ASC 606, variable payments are estimated and included in the transaction price subject to a constraint. By contrast, under ASC 842, variable lease payments not linked to an index or rate are generally excluded from the determination of a lessor's lease receivable.

Accordingly, sales-type or direct financing leases that have a significant variable lease payment component may result in an entity's recognition of a loss at commencement because the measurement of the lease receivable plus the unguaranteed residual asset is less than the net carrying value of the underlying asset. This could occur, for example, if lease payments are based entirely on the number of units produced by the leased asset (i.e., payments are 100 percent variable), or when a portion of the expected cash flows from the lease is variable (e.g., 50 percent of the total expected cash flows are variable). However, these transactions typically do not represent an economic loss for the lessor.

Question

Should a lessor recognize a loss at lease commencement when its initial measurement of the net investment in a sales-type or direct financing lease is less than the carrying value of the underlying asset?

Answer

Yes. At the FASB's November 30, 2016, meeting, the Board acknowledged that a lessor's initial measurement of a sales-type or direct financing lease that includes a significant variable-lease payment component may result in a loss at lease commencement if the lease receivable plus the unguaranteed residual asset is less than the net carrying value of the underlying asset being leased. The Board discussed whether a loss at commencement would be appropriate in these situations or whether other possible approaches would be acceptable, such as (1) incorporating variable lease payments subject to a constraint (by reference to ASC 606) or (2) using a negative discount rate to avoid the loss at commencement. The Board expressed its belief that while stakeholders may disagree with the outcome of recognizing a loss at commencement, the new leases standard is clear about how the initial measurement guidance should be applied to sales-type and direct financing leases.

In discussions with the FASB staff, we observed that in situations similar to those outlined in Examples 1 and 2 below, the outcome of the calculation of the "rate implicit in the lease," which is based on how that term is defined in ASC 842-30-20, may result in a negative discount rate. However, at the FASB's November 30, 2016, meeting, the Board acknowledged that using a negative discount rate to determine the rate implicit in the lease (as defined in ASC 842-10-20) is inappropriate. After the Board discussed the issue at that meeting, the FASB staff indicated to us that it expects lessors to use a 0 percent discount rate when measuring the net investment in a lease if the rate implicit in the lease is negative.

Example 1

A lessee and manufacturer lessor enter into a five-year sales-type lease of the lessor's R2-series equipment. Before lease commencement, the lessor customizes the R2-series equipment specifically for the lessee.⁸ The asset has a carrying value of \$100, fair value at commencement of \$120, and an estimated unguaranteed residual value of \$50 at the end of the lease term. Payments are based entirely on the lessee's usage of the R2-series equipment. The lessor has significant insight into the lessee's equipment needs over the five-year term, and although the payments are 100 percent variable, the lessor has priced the lease with the expectation that it will receive an annual payment of \$20. The lessor thus charges the lessee a rate of 6.4 percent.⁹

The tables below illustrate the terms of the sales-type lease and the lessor's accounting for the lease under ASC 842.

Terms

Lease term	5 years
Fair value	\$ 120
Carrying amount	\$ 100
Annual fixed lease payments	—
Required discount rate*	0.0%
Estimated residual value at the end of the lease term	\$ 50

⁸ Accordingly, the lease would meet the criterion in ASC 842-10-25-2(e) for classification as a sales-type lease.

⁹ The lessor determined the rate it used to price the lease by discounting expected annual cash inflows of \$20, plus a terminal cash inflow of \$50 for the expected residual value of the asset, to the asset's fair value of \$120.

Example 1 (continued)

Sales-Type Lease — 100% Variable

Year	Net Investment in Lease	Interest Income	Variable Lease Revenue	Profit and Loss (P&L)
0	\$ 50.00**	—	—	\$ (50.00)
1	50.00	—	\$ 20.00	20.00
2	50.00	—	20.00	20.00
3	50.00	—	20.00	20.00
4	50.00	—	20.00	20.00
5	50.00	—	<u>20.00</u>	<u>20.00</u>
Subtotals			<u>\$ 100.00</u>	
Total P&L on lease				<u>\$ 50.00</u>

* In this example, instead of using the rate it used to price the lease as the discount rate when measuring its net investment in the lease (i.e., the true rate of 6.4 percent), the lessor uses a 0 percent discount rate, as discussed by the FASB staff.

** The net investment in the lease is initially measured as the sum of (1) the lease payments (\$0), discounted at a rate of 0 percent, and (2) the amount the lessor expects to derive from the asset after the lease term (\$50), discounted at a rate of 0 percent. Expected cash flows of \$100 are not included in the measurement of the net investment in the lease because those payments are variable.

Example 2

Assume the same facts as in Example 1. The lessor still charges the lessee a rate of 6.4 percent based on expected annual cash flows of \$20.¹⁰ However, the lessor prices the lease with 50 percent of the cash flows fixed and 50 percent of the cash flows variable based on the lessee's usage of the R2-series equipment.

The tables below illustrate the terms of the sales-type lease and the lessor's accounting for the lease under ASC 842.

Terms

Lease term	5 years
Fair value	\$ 120
Carrying amount	\$ 100
Annual fixed lease payments	\$ 10
Required discount rate*	0.0%
Estimated residual value at the end of the lease term	\$ 50

¹⁰ See footnote 9.

Example 2 (continued)

Sales-Type Lease — 50% Variable

Year	Net Investment in Lease	Interest Income	Variable Lease Revenue	P&L
0	\$ 100.00**	—	—	—
1	90.00	—	\$ 10.00	\$ 10.00
2	80.00	—	10.00	10.00
3	70.00	—	10.00	10.00
4	60.00	—	10.00	10.00
5	50.00	—	10.00	10.00
Subtotals			<u>\$ 50.00</u>	
Total P&L on lease				<u>\$ 50.00</u>

* In this example, instead of using the rate it used to price the lease as the discount rate when measuring its net investment in the lease (i.e., the true rate of 6.4 percent), the lessor uses a 0 percent discount rate, as discussed by the FASB staff.

** The net investment in the lease is initially measured as the sum of (1) the lease payments (\$50), discounted at a rate of 0 percent, and (2) the amount the lessor expects to derive from the asset after the lease term (\$50), discounted at a rate of 0 percent. Expected cash flows of \$50 that represent variable payments are not included in the measurement of the net investment in the lease.



Editor's Note

It is common for lease arrangements in a number of industries to include significant or wholly variable lease payments. It is not uncommon for such arrangements to result in sales-type or direct financing lease classification.

Arrangements in the energy sector are frequently accounted for as leases with wholly variable payment streams. For example, power purchase agreements related to renewable energy (i.e., from solar or wind generation facilities) (1) are commonly long-term and the major part of the economic life of the generation facility, (2) provide for payments at a fixed price per unit of electricity output (e.g., \$50 per megawatt hour (MWh)), and (3) require the lessee to take all of the output produced by the facility but do not specify a minimum level of production (i.e., the volume of output is wholly variable). Although the output quantity is weather-dependent, the lessor expects the arrangement to be profitable on the basis of historical weather data.

We are also aware of arrangements in the oil and gas industry in which a company builds a gathering and processing system and leases it to a single user under a variable payment structure. For example, an exploration company with rights to multiple oil wells on dedicated acreage may contract with a midstream company to construct and lease the infrastructure necessary to gather and process the oil extracted from the wells. The arrangement may be long-term and for a major part of the economic life of the infrastructure, and the payment for the use of the infrastructure may be 100 percent variable (e.g., a fixed price per unit multiplied by the number of units gathered or processed) without a minimum volume requirement. The midstream company would be willing to accept variable consideration in the arrangement if reserve data related to the wells suggest that a sufficient volume of oil will be extracted over the term of the contract to make the arrangement profitable.

In the real estate sector, a commercial real estate lease arrangement (e.g., a lease of retail space) may be priced in such a way that a significant amount of the expected payments are contingent on the lessee's sales (e.g., payments that are a fixed percentage of the retail store's sales for a month). The lessor would account for the arrangement as a sale-type lease if the lease (1) is for a major part of the economic life of the retail location or (2) contains a purchase option that the lessee is reasonably certain to exercise. Arrangements of this type allow the property owner to participate in the upside of the retail store's business and are expected to be profitable.

Finally, in the health care industry, it is not uncommon for a hospital to contract with a medical device owner for the use of specific medical equipment for a major part of the economic life of the equipment. This type of arrangement is often priced in such a way that the consideration is based entirely on the hospital's ongoing purchase of "consumables," which allow the equipment to function as designed, and may have no minimum volume requirement. The medical device owner is willing to accept variable consideration in the arrangement because demand for the associated health care services suggests that a sufficient volume of consumables will be purchased by the hospital over the term of the contract to make the arrangement profitable.

Q&A 6 Operating Lease Income Statement Profile

ASC 842-30-25-11 requires a lessor to recognize lease payments in an operating lease as income in profit or loss on a straight-line basis over the lease term "unless another systematic and rational basis is more representative of the pattern in which benefit is expected to be derived from the use of the underlying asset."

Some stakeholders have asked whether lessors should use "another systematic and rational basis" to recognize income from operating leases when the lease payments are uneven to reflect or compensate for anticipated market rentals or market conditions. This question is based on paragraph BC327 of ASU 2016-02, which states that a "lessor is expected to recognize uneven fixed lease payments on a straight-line basis **when the payments are uneven for reasons other than to reflect or compensate for market rentals or market conditions** (for example, when there is significant front loading or back loading of payments or when rent-free periods exist in a lease)" (emphasis added).

Question

Can a lessor depart from straight-line income recognition for operating leases when lease payments are uneven or stepped to reflect anticipated market rentals or market conditions?

Answer

No. A lessor should continue to recognize lease payments as income in the same manner as generally required under ASC 840 — that is, on a straight-line basis.

On the basis of discussions with the FASB staff, we understand that regardless of whether uneven rents are designed to reflect anticipated market conditions, paragraph BC327 of ASU 2016-02 is not intended to require or permit a lessor to deviate from straight-line recognition.

Example

Company A (lessee) enters into a 10-year lease with Company B (lessor) to lease a floor in a commercial building for use as office space. Company A agrees to make an annual payment at the end of each year as follows:

- Years 1 and 2 — \$100,000.
- Years 3 and 4 — \$120,000.
- Years 5 and 6 — \$140,000.
- Years 7 and 8 — \$160,000.
- Years 9 and 10 — \$180,000.

The stepped increase in lease payments is intended to compensate B for anticipated changes in market rentals throughout the lease term.

Assume that B concludes that the lease is an operating lease. Although the uneven lease payments are intended to reflect market rentals for the future periods, B should recognize lease payments as income on a straight-line basis. Accordingly, B recognizes annual lease income of \$140,000 for all 10 years of the lease.

Q&A 7 Determining an Impairment of the Net Investment in a Lease

ASC 842-30-35-3 provides guidance on how a lessor should determine an impairment related to the net investment in the lease. In describing the collateral that a lessor should consider when performing its evaluation, the guidance indicates that such collateral would exclude the cash flows that the lessor would expect to derive from the underlying asset following the end of the lease term. In particular, ASC 842-30-35-3 states:

A lessor shall . . . recognize any impairment in accordance with Topic 310 on receivables (as described in paragraphs 310-10-35-16 through 35-30). When determining the loss allowance for a net investment in the lease, a lessor shall take into consideration the collateral relating to the net investment in the lease. The collateral relating to the net investment in the lease represents the cash flows that the lessor would expect to derive from the underlying asset during the remaining lease term (for example, from sale of the asset or release of the asset for the remainder of the lease term), **which excludes the cash flows that the lessor would expect to derive from the underlying asset following the end of the lease term** (for example, cash flows from leasing the asset after the end of the lease term). [Emphasis added]

Although the guidance is explicit, some have questioned whether the FASB intended to require a lessor to exclude cash flows related to the residual asset or whether it would be appropriate to include such amounts because excluding them may lead to earlier recognition of an impairment loss on the net investment in the lease.

Question

Should a lessor include the cash flows that the lessor would expect to derive from the underlying asset at the end of the lease term when evaluating impairment of the net investment in a lease?

Answer

Yes. In response to a technical inquiry, the FASB staff confirmed that the unit of account used when the impairment model is applied from the lessor's perspective is meant to encompass amounts related to the entire net investment in the lease, which would include the residual asset. Therefore, when evaluating the net investment in a sales-type or direct financing lease for impairment, a lessor should use the cash flows it expects to derive from the underlying asset during the remaining lease term as well as the cash flows it expects to derive from the

underlying asset at the end of the lease term (i.e., cash flows expected to be derived from the residual asset). When determining the cash flows to be derived from the residual asset, a lessor should consider amounts it would receive for re-leasing or selling the underlying asset to a third party but should not consider the expected credit risk of the potential lessee or buyer of the underlying asset (i.e., it would not be appropriate for the lessor to include a credit risk assumption in its analysis since it does not know the identity of the theoretical buyer).

Lease Classification

Q&A 8 Use of ASC 840's Bright-Line Thresholds for Lease Classification Under ASC 842

ASC 840 requires an entity to classify a lease on the basis of an evaluation of, among other things, certain quantitative bright-line thresholds. That is, under ASC 840, a lease would be classified as a capital lease if the lease term is 75 percent or more than the remaining economic life of an underlying asset or if the sum of the present value of the lease payments and the present value of any residual value guarantees amounts to 90 percent or more of the fair value of the underlying asset. However, when developing the lease classification guidance in ASC 842-10-25-2, the Board decided not to require the use of bright lines.

Question

Although entities are no longer **required** to assess certain quantitative bright-line thresholds when classifying a lease, are they **permitted** to use quantitative thresholds when classifying a lease under ASC 842?

Answer

Yes. The implementation guidance in ASC 842-10-55 states that a **reasonable approach** to applying the lease classification criteria in ASC 842 is to use the same bright-line thresholds that exist in ASC 840. ASC 842-10-55-2 states the following:

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

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

On the basis of this implementation guidance, we would not object to an entity's application of ASC 840's bright-line thresholds when classifying a lease under the new leases standard. We would expect that under such an approach, an entity would classify a lease in accordance with the quantitative result. That is, if an entity applies ASC 840's bright-line thresholds and determines that a lease term is equal to 76 percent of an asset's useful life, the entity should classify the lease as a finance lease. The entity should not attempt to overcome the assessment with qualitative evidence to the contrary. Likewise, if the same entity determines that a lease term is equal to 74 percent of an asset's useful life, the entity should classify the lease as an operating lease. If an entity decides to apply the bright-line thresholds in ASC 840 when classifying a lease, we would expect the entity to apply those thresholds consistently to all of its leases.

Ingredients of the Lease Model

Q&A 9 Including Noncash Consideration in Lease Payments

Some leases require the lessee to make some or all of the lease payments with noncash consideration. For example, a lessee could be required to provide value in the form of hard assets, stock of the lessee or others, or guarantees of certain obligations of the lessor. The final value of the consideration at the time of payment may be different from the estimate at lease commencement.

Question

Should an entity (lessee or lessor) include noncash consideration in its determination of lease payments?

Answer

Generally, yes. Noncash consideration should generally be included in an entity's determination of lease payments and should be measured at fair value at lease commencement. That is, we believe that the fair value of the noncash consideration would generally be akin to an index or rate, which is included in lease payments at commencement.¹¹ Any fluctuations in the fair value of noncash consideration to be provided between the initial measurement of the ROU asset and liability and the final measurement determined in accordance with other U.S. GAAP should be recognized as variable lease payments. For noncash consideration in the form of a guarantee (other than a guarantee of the lessor's debt, as discussed below), the amounts accrued and ultimately paid under the guarantee would not be considered variable lease payments. Rather, the **providing of the guarantee** is the final lease payment because the lessee has delivered its stand-ready obligation under the guarantee.

Note, however, that a guarantee of the lessor's debt is specifically excluded from the scope of lease payments.¹²

Example 1

Company A provides Company B with materials and labor needed to build a tavern, and A has agreed to lease the tavern from B at the end of the construction period. Company A does not control the asset under construction.¹³ The fair value of the materials and labor provided to B should be recognized as a prepaid lease payment and included in the measurement of the ROU asset at lease commencement.

Example 2

Company X (the lessee) enters into an arrangement to lease an aerosol can factory from Company Y (the lessor) for three years. As consideration for the right to use the aerosol can factory, X agrees to transfer to Y 50, 60, and 70 shares of stock in Company Z, in arrears each year, respectively. As of lease commencement, the fair value per share of Z's stock is \$20. Company X uses its incremental borrowing rate of 9 percent when discounting the lease payments since the rate implicit in the lease is not known.

¹¹ See ASC 842-10-30-5(b).

¹² See ASC 842-10-30-6(b).

¹³ See ASC 842-40-55-3 through 55-6.

Example 2 (continued)

In accordance with the lease classification tests (for lessees and lessors) under ASC 842-10-25-2(d), the lease payments should include the amount of \$3,009, the present value of the three payments made in shares of Company Z stock. Assume that the lease is an operating lease. The lessee's lease liability should be measured at \$3,009. Further assume that the fair value of the stock during year 1 of the lease is \$25 per share on the final measurement date of the 50 shares. The lessee should recognize the incremental fair value not included in the lease liability as a variable lease cost (i.e., \$250, which represents 50 shares multiplied by the increase in the value of the stock since lease commencement). However, the shares to be delivered in years 2 and 3 should not be adjusted to their fair value on those dates because the fair value of the stock is an index or rate that is not adjusted after lease commencement until it is recognized.

Q&A 10 Nonrefundable and Refundable Deposits

Certain leasing arrangements may include a security deposit that is required to be paid to the owner of the leased asset at or before lease commencement. The security deposit is generally provided to support the lessee's intent and commitment to lease the underlying asset (i.e., upon receipt of a security deposit, the lessor typically stops marketing the asset for lease). Security deposits can be either nonrefundable or refundable depending on the terms of the contract.

ASC 842-10 defines lease payments for purposes of identifying the types of payments that an entity should consider when determining the classification, initial measurement, and subsequent measurement of a lease. Specifically, ASC 842-10-30-5 states, in part:

At the commencement date, the lease payments shall consist of the following payments relating to the use of the underlying asset during the lease term:

- a. Fixed payments, including in substance fixed payments, less any lease incentives paid or payable to the lessee (see paragraphs 842-10-55-30 through 55-31).
- b. Variable lease payments that depend on an index or a rate (such as the Consumer Price Index or a market interest rate), initially measured using the index or rate at the commencement date.

Question 1

Is a **nonrefundable** deposit a lease payment under ASC 842?

Answer

Yes. A nonrefundable deposit is a lease payment under ASC 842.

A nonrefundable deposit is an amount the lessee pays the lessor to secure the terms of the contract for both parties. This payment represents a portion of the consideration to be transferred during the contract term and is not refunded by the lessor. Because the payment to the lessor is nonrefundable, it is considered a fixed payment under ASC 842-10-30-5.

Question 2

Is a **refundable** deposit a lease payment under ASC 842?

Answer

No. A refundable deposit is **not** a lease payment under ASC 842.

A refundable security deposit is an amount that the lessee is required to submit to the lessor to protect the lessor's interest in the contract and the property. This amount is held by the lessor until the occurrence of an event that would allow the lessor to use some or all of the deposit to meet the contract requirements (e.g., use the deposit to recover any shortfall in payment by the lessee or to repair any damages to the leased property). In the absence of such a need, the lessor would be required under the contract to return the remaining, unused security deposit to the lessee at the end of the lease. Because the payment is refundable, it would **not** meet the definition of a lease payment under ASC 842-10-35-5.

Note that the portion of a refundable security deposit retained by the lessor to recover a shortfall in a lease payment would effectively be settling a portion of the lease liability associated with the missed payment. In contrast, any portion of the refundable security deposit retained by the lessor for other reasons (e.g., excess wear and tear on the underlying asset) would generally be considered a variable lease payment.¹⁴ In addition, any interest earned on the refundable security deposit retained by the lessor would be a variable lease payment in the period in which it is earned. As with other variable payment requirements, lessees should consider the implementation guidance in ASC 842-20-55-1 and 55-2 when evaluating whether a lessee should recognize costs from variable payments before the achievement of a specified target (see [Q&A 14](#)).

Q&A 11 Variable Payments Based on an Index or Rate

Background

Frequently, leases contain terms that revise or reset the amounts payable to the lessor over the lease term. Those adjustments to the amounts payable to the lessor are described in ASC 842 as variable lease payments. Generally, ASC 842 differentiates between two categories of variability in lease payments:

- Variability based on an index or rate (e.g., escalators based on the CPI, or rents that are referenced to or are increased on the basis of LIBOR).
- Other variability, including variability that is typically described as based on performance or usage of the asset (e.g., rents based on the percentage of retail store sales or on mileage driven using a leased car).

The new leases standard requires only limited types of variable payments to be included in the lease payments that will affect the lease classification and measurement. Specifically, ASC 842-10-30-5 provides that “[a]t the commencement date, the lease payments shall consist [in part] of the following payments relating to the use of the underlying asset during the lease term”:

- a. Fixed payments, including in substance fixed payments, less any lease incentives paid or payable to the lessee (see paragraphs 842-10-55-30 through 55-31).
- b. Variable lease payments that depend on an index or a rate (such as the Consumer Price Index or a market interest rate), initially measured using the index or rate at the commencement date.

In addition, ASC 842-10-30-6 explicitly states that “[l]ease payments do not include [v]ariable lease payments other than those in [ASC] 842-10-30-5(b).”

¹⁴ ASC 842 defines variable lease payments as “[p]ayments made by a lessee to a lessor for the right to use an underlying asset that vary because of changes in facts or circumstances occurring after the commencement date, other than the passage of time.” Therefore, any portion of a refundable security deposit that is retained by a lessor because of changes in facts and circumstances after the lease commencement date represents a variable lease payment and should be recognized as an expense from the lessee's perspective and as income in profit or loss from the lessor's perspective in the period when incurred (lessee) or earned (lessor).

Question

How should a lessee¹⁵ initially measure its lease liability and ROU asset at lease commencement when there are variable payments based on an index or rate?

Answer

The initial measurement of the lease liability and ROU asset should be determined on the basis of the lease payments, which, as stated in ASC 842-10-30-5(b), include “[v]ariable lease payments that depend on an index or a rate (such as the Consumer Price Index or a market interest rate).” An entity initially measures variable payments based on an index or rate by using the index or rate at lease commencement (i.e., the spot or gross index or rate applied to the base rental amount). The use of the spot rate at lease commencement is largely based on the FASB’s view that (1) the cost associated with forecasting future rates would not outweigh the benefits provided and (2) the use of forecasted rates or indexes would be inconsistent among preparers and often imprecise.

In contrast, payments based on a **change** in an index or a rate should **not** be considered in the determination of lease payments. Given the cost-benefit considerations related to the use of forecasting techniques, ASC 842 does not allow an entity to forecast changes in an index or rate to determine lease payments. Rather, adjustments to lease payments that are based on a change in an index or rate are treated as variable lease payments and recognized in the period in which the obligation for those payments was incurred.

For example, assume that lease payments are made in arrears and are based on a fixed amount (e.g., a \$100,000 base amount) adjusted each year by the CPI at the end of the year. If the CPI at lease commencement was 2.7 percent, the total lease payments used to measure the lease liability would be \$102,700 per year of the lease, which includes \$2,700 in variable lease payments based on an index or rate at lease commencement. In contrast, if the payments were based on a fixed amount (\$100,000) that will subsequently be adjusted in a manner corresponding to the **change** in the CPI each year throughout the lease term, the initial measurement of the lease liability and ROU asset **would not** take into account the future expected adjustments in the CPI. Therefore, the initial measurement of the lease liability and ROU asset would be based only on the fixed payments through the lease term (see the example below).

Example

A retailer enters into a lease of a retail space for five years with the following terms:

Lease term	5 years (no renewal options)
Lessee’s incremental borrowing rate*	7%
Lease classification	Operating lease
Annual lease payments	\$100,000 (base amount) adjusted for the change in the CPI year over year

¹⁵ While this Q&A specifically focuses on the consideration of variable payments based on an index or a rate when a lessee initially measures its lease liability and ROU asset, the concept would similarly apply when a lessor initially measures its net investment in a sales-type or direct financing lease.

Example (continued)

The first lease payment was made on January 1. Each subsequent payment is made on December 31. There were no initial direct costs or lease incentives. The lessee recognizes total lease expense and measures the lease liability and ROU asset in the manner shown in the table below.

Date	Year	CPI	Payment	Liability**	<A>				<C>		 - <A> = <D>		<A> + <C> + <D>	
					Interest		Fixed Lease Expense		Variable Lease Expense		Amortization Expense		Total Expense Recognized***	ROU Asset†
1/1/20X1	0	172	\$ 100,000	\$ 338,721										\$ 438,721
12/31/20X1	1	174	101,163	262,432	\$ 23,710	\$	100,000		—	\$	76,290	\$	100,000	362,432
12/31/20X2	2	175	101,744	180,802	18,370		100,000	\$	1,163		81,630		101,163	280,802
12/31/20X3	3	177	102,907	93,458	12,656		100,000		1,744		87,344		101,744	193,458
12/31/20X4	4	178	103,488	—	6,543		100,000		2,907		93,457		102,907	100,000
12/31/20X5	5	180	—	—	—		100,000		3,488		100,000		103,488	—
Total			<u>\$ 509,302</u>				<u>\$ 500,000</u>		<u>\$ 9,302</u>		<u>\$ 438,721</u>		<u>\$ 509,302</u>	

* The incremental borrowing rate is used because the rate the lessor charges the lessee is not known.

** The lessee measures the liability at the present value of the four remaining future lease payments (by using the base amount of rent at lease commencement) since the initial payment was made on January 1 (at lease commencement). The effect of the CPI was not included in the initial measurement of the liability because the variable payments are based on changes in the CPI rather than a specified index or rate on the commencement date. The lease liability and the ROU asset are not remeasured as a result of changes to the CPI.

*** The total lease expense recognized includes both the fixed lease expense at lease inception and the variable lease expense for the change in the CPI for the year.

† The ROU asset is measured at the present value of the lease payments at the commencement of the lease (the present value of four payments of \$100,000 (lease payments in arrears) plus \$100,000 of prepaid rent). In subsequent years, the ROU asset is amortized in a manner consistent with the model described above for operating leases. Note that amortization expense is calculated as the fixed lease expense less interest.

Q&A 12 Implications of Index- or Rate-Based Payment Adjustments

The subsequent remeasurement of a lease depends on whether the variability is associated with an index or rate or arises for other reasons. Specifically, ASC 842-10-35-4 and 35-5 require, in part, the following:

35-4 A lessee shall remeasure the lease payments if any of the following occur:

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

35-5 When a lessee remeasures the lease payments in accordance with paragraph 842-10-35-4, variable lease payments that depend on an index or a rate shall be measured using the index or rate at the remeasurement date.

Question

Do index- or rate-based payment adjustments in a lease require the lessee to remeasure the lease?

Answer

No. Changes in an index or rate alone would not give rise to a requirement to remeasure the lease. On the basis of discussions with the FASB staff, we understand that the guidance on remeasuring a lease liability after the resolution of a contingency is not meant to apply to index-based escalators even when those escalators serve to establish a new floor for the next lease payment. Therefore, even when the index or rate establishes a new floor (such as when the CPI increases and establishes a new rate that will be used as a benchmark for determining future lease payment increases), that adjustment would not result in a remeasurement of the lease liability and ROU asset. As a result, the additional payments for increases in the CPI will be recognized in the period in which they are incurred.

However, as highlighted in ASC 842-10-35-5, if a lessee remeasures the lease payments for any of the other reasons detailed in ASC 842-10-35-4, the lessee is required to remeasure variable lease payments that depend on an index or rate by using the index or rate in effect on the remeasurement date.



Editor's Note

While the FASB's and IASB's respective new leases standards are generally converged with respect to the recognition and measurement of variable lease payments, there is a notable difference. Under IFRS 16, for lease payments based on an index or rate, the lease liability and ROU asset are remeasured each period to reflect changes to the index or rate. Therefore, entities that are subject to dual reporting under both U.S. GAAP and IFRSs (e.g., a parent entity that applies U.S. GAAP and has international subsidiaries applying IFRSs for statutory reporting) will be required to account for their leases under two different remeasurement models.

Q&A 13 Rents Based on Fair Value

Some lease agreements (typically real estate leases) include variability in the form of a rent reset provision that requires the future lease payments after a specified point in time to be reset to the fair value rates at that time. For example, a 10-year lease of property in Chicago that requires annual rental payments of \$100,000 for years 1 through 5 may also include a provision to reset the rental payments in years 6 through 10 of the lease to the updated fair value rent as benchmarked to published rates for Chicago.

Question

Should the fair market rent reset feature described above be accounted for in accordance with the guidance on variable payments that are based on an index or rate?

Answer

Yes. Paragraph BC211 of ASU 2016-02 states the FASB's rationale for including certain variable lease payments that depend on an index or rate in the measurement of the lease liability and ROU asset:

For reasons similar to those for including in substance fixed payments in the measurement of lease assets and lease liabilities, the Board also decided to include variable lease payments that depend on an index or a rate in the measurement of lease assets and lease liabilities. Those payments meet the definition of assets (for the lessor) and liabilities (for the lessee) because they are unavoidable (that is, a lessee has a present obligation to make, and the lessor has a present right to receive, those lease payments). Any uncertainty, therefore, relates to the measurement of the asset or liability that arises from those payments and not to the existence of the asset or liability.

While ASC 842 does not define "index" or "rate," we believe that an index or rate is based on underlying economic performance (e.g., the CPI measures the variation in prices paid by a consumer household for certain retail goods and services). Similarly, fair market rent is indicative of the economic performance of a specific geographic region and is analogous to a formally published index or rate. Further, the FASB and IASB converged certain aspects of their new guidance on leases, including the treatment of rents subject to market rate resets as lease payments that vary on the basis of an index or rate. Paragraph 28 of IFRS 16 explicitly states that a variable payment that is based on an index or rate would include, among other things, "payments that vary to reflect changes in fair market rental rates."

Since variable rent based on fair market rental rates was determined to be analogous to variable rent based on an index or rate, we believe that the specific guidance on variable rental rates based on an index or rate (see [Q&As 11](#) and [12](#)) should be applied to variable rent based on fair market rental rates. Accordingly, a lessee should measure the lease liability and ROU asset on the basis of the rental rate in effect at lease commencement. Any subsequent change in the fair market rental rate would not require remeasurement of the lease liability and ROU asset (although remeasurement could be required for another reason) but would be recorded as variable lease income or expense in the appropriate period depending on the change in the fair market rental rate.

The example below illustrates the accounting for variable rent based on fair market rental rates.

Example

A retailer entered into a lease of a retail space for 10 years with the following terms:

Lease term	10 years (no renewal options)
Lessee's incremental borrowing rate*	6%
Lease classification	Operating lease
Annual lease payments	\$100,000 in years 1 through 5, adjusted to fair market rent for years 6 through 10

Example (continued)

The first lease payment was made on January 1. Each subsequent payment is made on December 31. The lessee recognizes total lease expense and measures the lease liability and ROU asset in the manner shown in the table below. As a reminder, variable lease payments that are based on an index or rate (including fair market rents) are considered lease payments and would be initially measured on the basis of the index or rate in place at lease commencement. Therefore, at lease commencement, the fair market rent expected for years 6 through 10 would be \$100,000 since that is the fair market rent at lease commencement.

				<A>				<C>		 - <A> = <D>		<A> + <C> + <D>		
Date	Year	Payment	Liability**	Interest*		Fixed Lease Expense		Variable Lease Expense		Amortization Expense		Total Expense Recognized***		ROU Asset†
1/1/20X1	0	\$ 100,000	\$ 680,169											\$ 780,169
12/31/20X1	1	100,000	620,979	\$ 40,810	\$	100,000		—	\$	59,190	\$	100,000	720,979	
12/31/20X2	2	100,000	558,238	37,259		100,000		—		62,741		100,000	658,238	
12/31/20X3	3	100,000	491,732	33,494		100,000		—		66,506		100,000	591,732	
12/31/20X4	4	100,000	421,236	29,504		100,000		—		70,496		100,000	521,236	
12/31/20X5	5	150,000	346,511	25,274		100,000		—		74,726		100,000	446,511	
12/31/20X6	6	150,000	267,301	20,791		100,000	\$	50,000		79,209		150,000	367,301	
12/31/20X7	7	150,000	183,339	16,038		100,000		50,000		83,962		150,000	283,339	
12/31/20X8	8	150,000	94,340	11,000		100,000		50,000		89,000		150,000	194,340	
12/31/20X9	9	150,000	—	5,660		100,000		50,000		94,340		150,000	100,000	
12/31/20X0	10	—	—	—		100,000		50,000		100,000		150,000	—	
Total		<u>\$ 1,250,000</u>				<u>\$ 1,000,000</u>		<u>\$ 250,000</u>		<u>\$ 780,170</u>		<u>\$ 1,250,000</u>		

* The incremental borrowing rate is used because the rate the lessor charges the lessee is not known.

** The lessee measures the liability at the present value of the remaining expected future lease payments (by using the base amount of rent at lease commencement) of nine payments since the first payment was made on January 1. The lease liability and ROU asset are not remeasured as a result of changes in fair market value in year 6.

*** The total lease expense recognized includes both the fixed amount at lease inception and the variable lease expense for the change in fair market rental rate beginning in year 6.

† The ROU asset is measured at the present value of the expected lease payments at the commencement of the lease (the present value of nine payments of \$100,000 (lease payments in arrears) plus \$100,000 of prepaid rent). In subsequent years, the ROU asset is amortized in a manner consistent with the model for operating leases. Note that amortization expense is calculated as the fixed lease expense less interest.

In this example, assume that the actual fair market rent increases to \$150,000 in year 6. When the lease payments are updated to reflect this increase, the lease liability and ROU asset are not remeasured for the change in fair market rent from \$100,000 in years 1 through 5 to \$150,000 in years 6 through 10. Rather, the additional \$50,000 is recorded as variable lease expense in each of the years in which it was incurred.

Next, assume the same facts, except that the fair market rental rate decreased from \$100,000 in years 1 through 5 to \$90,000 in years 6 through 10. In those circumstances, the lessee would record a \$10,000 reduction in lease expense in each of years 6 through 10 and would not remeasure the lease liability and ROU asset.

Q&A 14 Lessee Timing of Variable Payments

Background

Many lease arrangements contain variable payments based on the use or performance of the underlying asset. Examples include (1) a retail store lease that requires the lessee to pay a percentage of store sales each month, (2) a car lease that requires the driver to pay for each mile driven, and (3) a power purchase agreement that requires the lessee (the off-taker) to buy all electricity produced by a weather-dependent generating plant such as a wind farm.

Under ASC 842, variable payments not dependent on an index or rate are excluded from the initial measurement of the lease liability and ROU asset.

ASC 842-20-25-5(b) (for finance leases) and ASC 842-20-25-6(b) (for operating leases) both state that variable lease payments not included in the initial measurement of the lease should be recognized in profit or loss “in the period in which the obligation for those payments is **incurred**” (emphasis added). In addition, the implementation guidance in ASC 842-20-55-1 states that a “lessee should recognize costs from variable lease payments (in annual periods as well as in interim periods) before the achievement of the specified target that triggers the variable lease payments, provided the achievement of that target is considered **probable**” (emphasis added).

Question

In a lease arrangement in which the lessee pays a variable amount based on usage or performance, is the lessee required to assess the probability of future performance throughout the lease term and record a charge (and a corresponding liability) for the variable lease payment amount assessed as probable?¹⁶

Answer

It depends. We believe that the guidance in ASC 842-20-55-1 on the probable achievement of variable lease payment targets is meant to be narrowly applied to scenarios involving discrete performance targets or milestones that will be achieved over time (e.g., a specified level of cumulative store sales) and, in those limited scenarios, is meant to require recognition in each period over the lease term at an amount that reflects an appropriate apportionment of the expected total lease cost. This guidance ensures that the cost of the lease is appropriately allocated to both the periods of use that contribute to the variable payment requirement and the periods of use in which the variable payment requirement has been met. Such allocation is necessary when performance targets are cumulative and have the potential to cross reporting periods.

We do not believe that the guidance on the probable achievement of variable lease payment targets is meant to otherwise require an assessment of a probable level of performance over the lease term and require a charge in advance of actual performance when the variability arises and is resolved within a reporting period. For example, in a vehicle lease, a variable charge per mile driven that starts with the first mile and continues throughout the lease term can be discretely measured and expensed in the reporting period in which the charge is incurred. That is, it is unnecessary to assess probability of future mileage to ensure proper period attribution of the variable charges. Applying a probability model to this type of variable payment structure could lead to an inappropriate acceleration of variable expense attributable to future use.

The examples below illustrate the difference between the treatment of variability when discrete cumulative targets exists and the treatment when the variability is resolved within the reporting period.

Example 1

Retailer X is a lessee in an arrangement that requires X to pay \$500 plus 3 percent of store sales each month over a five-year lease term. Retailer X is not required to forecast its sales over the lease term and accrue for a level of sales deemed probable of occurring. Rather, X will recognize variable lease expense each month equal to 3 percent of sales.

¹⁶ “Probable” is defined as the “future event or events are likely to occur,” in a manner consistent with the term’s meaning in ASC 450 on contingencies.

Example 2

Utility Y is a lessee in a power purchase agreement in which it purchases all of the output from a wind farm owned by an independent power producer (IPP) at a fixed price per MWh. Since the wind farm is 100 percent weather-dependent, Y's lease payments are 100 percent variable (Y pays only for electricity produced). Studies performed before the wind farm was constructed indicate that there is a 95 percent likelihood that electrical output will equal or exceed 25,000 MWh per month. Despite the very high likelihood (95 percent is well above the "probable" threshold) of a minimum performance level, Y is not required to accrue for a corresponding amount of lease payments (i.e., an expectation of variable lease payments based on future production). Rather, Y will recognize variable lease expense each month as electricity is delivered and billed by the IPP.

Example 3

Retailer Z is a lessee in a five-year operating lease that requires it to pay base rent of \$500 per month plus an additional \$100 per month beginning when cumulative store sales exceed \$100,000. Retailer Z believes that it is probable that this sales target will be achieved by the end of year 2 (i.e., rent will become \$600 per month after the target is met).

Retailer Z should quantify the amount that it is probable for the entity to incur on the basis of its achievement of the target (\$3,600, or \$100 per month for 36 months) and should apportion that amount to each period beginning at commencement. That is, since eventual achievement of the cumulative sales target is deemed probable at commencement, the \$3,600 should be recognized ratably over the five-year term (i.e., \$500 per month for 24 months plus \$600 per month for 36 months, resulting in an expense of \$560 per month) even though the target has not yet been achieved. This is an appropriate accounting outcome because sales in years 1 and 2 contribute to the achievement of the target. Accordingly, years 1 and 2 should be burdened by an appropriate amount of the incremental lease expense.

On the basis of the above fact pattern, Z would recognize an incremental lease expense of \$60 per month beginning at lease commencement (i.e., \$3,600 divided by the 60 months of the lease term) to reflect the expected additional rent associated with the anticipated achievement of the sales target.

In addition, once the target is actually achieved, Z would remeasure the ROU asset and corresponding liability in accordance with ASC 842-10-35-4(b) since the entity would be able to conclude that a "contingency upon which some or all of the variable lease payments that will be paid over the remainder of the lease term are based is resolved such that those payments now meet the definition of lease payments."

Assuming that Z achieves the sales target as planned at the end of year 2 (and also assuming a 0 percent discount rate for simplicity), Z would recognize the following amounts in its financial statements:

January 1, 20Y1 (Commencement)

Initial recognition of the ROU asset and corresponding lease liability (calculated as \$500 per month for a five-year period)

ROU asset	30,000	
Lease liability		30,000

Example 3 (continued)**December 31, 20Y1**

Annual activity (reduction of ROU asset/lease liability and recognition of lease expense)

Lease liability	6,000	
Lease expense	6,000	
ROU asset		6,000
Cash		6,000

Recognition and accrual of variable lease expense ($(\$3,600 \div 60 \text{ months of term}) \times 12 \text{ months per year}$)

Variable lease expense	720	
Lease liability — variable lease payments		720

December 31, 20Y2

Annual activity (reduction of ROU asset/lease liability and recognition of lease expense)

Lease liability	6,000	
Lease expense	6,000	
ROU asset		6,000
Cash		6,000

Recognition and accrual of variable lease expense ($(\$3,600 \div 60 \text{ months of term}) \times 12 \text{ months per year}$)

Variable lease expense	720	
Lease liability — variable lease payments		720

Adjustment of ROU asset and corresponding liability (resolution of contingency)

ROU asset	2,160	
Lease liability — variable lease payments	1,440	
Lease liability		3,600

December 31, 20Y3

Annual activity (reduction of ROU asset/lease liability and recognition of lease expense post-triggering event)

Lease liability	7,200	
Lease expense ($(\$500 + \$60) \times 12$)	6,720	
ROU asset		6,720
Cash		7,200

December 31, 20Y4

Annual activity (reduction of ROU asset/lease liability and recognition of lease expense post-triggering event)

Lease liability	7,200	
Lease expense ($(\$500 + \$60) \times 12$)	6,720	
ROU asset		6,720
Cash		7,200

Example 3 (continued)**December 31, 20Y5**

Annual activity (reduction of ROU asset/lease liability and recognition of lease expense post-triggering event)

Lease liability	7,200	
Lease expense $((\$500 + \$60) \times 12)$	6,720	
ROU asset		6,720
Cash		7,200

Q&A 15 Determining a Subsidiary's Incremental Borrowing Rate When the Lease Terms Were Influenced by Parent or Group Credit

When initially measuring its lease liability, a lessee is required to use the rate implicit in the lease unless that rate cannot be readily determined. If the rate cannot be readily determined (which will generally be the case), the lessee should use its incremental borrowing rate when initially measuring its lease liability. In addition to performing the initial measurement, a lessee is required to remeasure its lease liability by using a revised discount rate upon the occurrence of certain discrete reassessment events (e.g., a change in lease term or a modification of a lease that does not result in a separate contract).

In some cases, leases are negotiated by a parent on behalf of its subsidiary so that the subsidiary can obtain the benefit of the parent's superior credit. In other cases, a consolidated group might have a centralized treasury function that negotiates on behalf of all of its subsidiaries for the same reason. The negotiations often include guarantees or other payment mechanisms that allow the lessor to look beyond just the subsidiary for payment. This raises the question of whether it would be appropriate for an entity to use a rate other than the subsidiary's incremental borrowing rate when accounting for a lease at the subsidiary level (assuming that the implicit rate cannot be readily determined).

Question

Would it be appropriate for a subsidiary to use an incremental borrowing rate other than its own to measure its lease liability when the implicit rate cannot be readily determined?

Answer

It depends. The appropriate incremental borrowing rate for measuring the lease liability would generally be based on the terms and conditions negotiated between the lessee and the lessor. Often, the pricing of the lease will solely depend on the credit standing of the subsidiary itself (i.e., the lessee in the arrangement). In other cases, the pricing may be significantly influenced by the credit risk evaluated at another level in an organization (e.g., the parent or consolidated group) on the basis of guarantees or other payment mechanisms that allow the lessor to look beyond just the subsidiary for payment. If the pricing of the lease depends solely on the lessee's credit standing when the lease was negotiated, the lessee's incremental borrowing rate should be used to measure the lease liability. However, if the pricing of the lease depends on the credit risk of an entity other than the lessee when the lease was negotiated (e.g., the lessee's parent or a consolidated group), it will generally be more appropriate to use the incremental borrowing rate of that other entity.

Decentralized treasury functions within an organization may be an indicator that it is appropriate for the reporting entity to use the incremental borrowing rate of the subsidiary (i.e., the lessee in the arrangement) when measuring the lease liability. However, this fact is not individually determinative and should be considered along with the determination of whether the subsidiary's (lessee's) credit standing was used in the negotiation of the lease agreement. This view is consistent with paragraph BC201 of ASU 2016-02, which states, in part:

The Board . . . considered that, in some cases, it might be reasonable for a subsidiary to use a parent entity or group's incremental borrowing rate as the discount rate. Depending on the terms and conditions of the lease and the corresponding negotiations, the parent entity's incremental borrowing rate may be the most appropriate rate to use as a practical means of reflecting the interest rate in the contract, assuming the implicit rate is not readily determinable. For example, this might be appropriate when the subsidiary does not have its own treasury function (all funding for the group is managed centrally by the parent entity) and, consequently, the negotiations with the lessor result in the parent entity providing a guarantee of the lease payments to the lessor. Therefore, the pricing of the lease is more significantly influenced by the credit standing of the parent than that of the subsidiary.

The examples below highlight scenarios found commonly in practice. Both assume that the credit of the parent or group is superior to the credit of the subsidiary/lessee.

Example 1

On January 15, 20X1, Group A negotiates and executes a lease on behalf of Subsidiary A, one of the subsidiaries consolidated by Group A. The treasury function is maintained at the Group A level (i.e., Subsidiary A does not have a stand-alone treasury function), and pricing of the lease was based on the creditworthiness of Group A. While both Group A and Subsidiary A are the named parties in the lease agreement, Subsidiary A is identified as the party that will occupy the leased property.

Since treasury operations (including the negotiation of lease agreements) are conducted centrally at the Group A level, it would generally be appropriate for Subsidiary A to use Group A's incremental borrowing rate (as opposed to Subsidiary A's rate) when measuring Subsidiary A's lease liability. This is because the negotiations with the lessor and the resulting pricing of the lease were based on the creditworthiness of Group A rather than that of Subsidiary A.

Example 2

On April 15, 201X, Lessee A negotiated a building lease with Lessor B. Lessee A has its own treasury function that negotiates all significant agreements, including leases. However, A's parent, ParentCo, provided a guarantee of lease payments to B as part of the negotiated terms of the lease.

Even though A has its own treasury function and negotiated the term of its lease, it would be reasonable to conclude that the pricing of the lease was significantly influenced by the creditworthiness of ParentCo (as evidenced by ParentCo's guarantee to the lessor). As a result, it would generally be appropriate for A as the reporting entity to measure the lease liability by using ParentCo's incremental borrowing rate.

Presentation and Disclosure

Q&A 16 Whether an Entity That Presents a Classified Balance Sheet Is Required to Classify Its ROU Assets and Lease Liabilities as Current and Noncurrent

ASC 842-20-45-1 states:

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

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

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

Question 1

Is an entity that presents a classified balance sheet required to classify its ROU assets as current and noncurrent?

Answer

No. Entities typically exclude from current assets those that are depreciated or amortized (e.g., PP&E and intangible assets, respectively) in accordance with ASC 210-10-45-4(f). Under ASC 842, the ROU asset is required to be amortized and is therefore akin to other amortizable assets.

Question 2

Is an entity that presents a classified balance sheet required to classify its lease liabilities as current and noncurrent?

Answer

Yes. ASC 210-10-45-6 states, in part:

The concept of current liabilities includes estimated or accrued amounts that are expected to be required to cover expenditures within the year for known obligations.

An entity should classify the portion of its lease liabilities that is expected to be paid within the year as current liabilities.

Example

On December 31, 202X, Company A, as lessee, commenced a lease with a term of three years and an annual lease payment of \$4,660. After discounting the lease payments at a discount rate of 8 percent, A determines that (1) its lease liability is \$12,009 and (2) \$3,699 of the liability will be paid within one year from the balance sheet date. As of December 31, 202X, A should classify \$3,699 as a current liability and the remaining \$8,310 as a noncurrent liability in its classified balance sheet.

Q&A 17 Excluding Leases With a Term of One Month or Less From Short-Term Lease Expense Disclosure

A short-term lease is a lease that, on the commencement date, has a lease term of 12 months or less and does not include an option to purchase the underlying asset that the lessee is reasonably certain to exercise. A lessee may elect not to apply the recognition requirements in ASC 842 (under which a lease liability and an ROU asset are reflected on the balance sheet) to short-term leases. Instead, a lessee may recognize the lease payments in profit or loss on a straight-line basis over the lease term. The accounting policy election for short-term leases must be made and applied consistently by class of underlying asset.

While lessees in short-term leases are provided relief from the requirements in the new leases standard related to the recognition and measurement of lease liabilities and ROU assets on the balance sheet, such lessees are required to disclose short-term lease cost. However, the disclosure requirement indicates that the short-term lease cost excludes expenses related to leases with a term of one month or less.¹⁷ Although we expect that most entities will find respite in the “one month or less” exclusion, entities may sometimes find it more burdensome to extract leases with a term of one month or less and prefer to disclose expenses related to all short-term leases.

¹⁷ See ASC 842-20-50-4(c).

Question

Is it acceptable for a lessee to include expenses related to leases with a term of one month or less in its short-term lease expense disclosure?

Answer

Yes. We believe that an entity may elect to include all expenses related to leases with a term of one month or less (or all short-term lease expenses by class of underlying asset) in the short-term lease expense disclosure (despite the explicit exclusions). Since it is our understanding that the one month or less exclusion was intended to provide relief, we believe that it would not be inconsistent with the disclosure principles to disclose all of the short-term lease expenses (including expenses related to leases with a term of one month or less) if doing so would be less burdensome. Entities should consider disclosing their policy if leases with a term of one month or less are included in their short-term lease expense disclosures.

Driving Discussions — Presentation and Disclosure



SAB Topic 11.M Disclosure Requirements

The SEC staff has recently been reminding SEC registrants of the best practices to follow in the periods leading up to the adoption of new accounting standards, including ASU 2016-02. The staff's comments have focused on ICFR, auditor independence, and disclosures related to implementation activities. SAB Topic 11.M provides disclosure requirements for those accounting standards not yet adopted. Specifically, when an accounting standard has been issued but does not need to be adopted until some future date, an SEC registrant should disclose the impact that the recently issued accounting standard will have on the SEC registrant's financial position and results of operations when the standard is adopted in a future period.

At the September 22, 2016, EITF meeting, the SEC staff made an announcement regarding SAB Topic 11.M. While the SEC staff acknowledged that an SEC registrant may be unable to reasonably estimate the impact of adopting the new leases standard, the SEC registrant should consider providing additional qualitative disclosures about the significance of the impact on its financial statements. In particular, the staff indicated that it would expect such disclosures to include a description of:

- The effect of any accounting policies that the SEC registrant expects to select upon adopting the ASU.
- How such policies may differ from the SEC registrant's current accounting policies.
- The status of the SEC registrant's implementation process and the nature of any significant implementation matters that have not yet been addressed.

As a result of these recent remarks, we would expect the SAB Topic 11.M disclosure to be further refined and be more robust as the effective date of the new leases standard approaches. For additional information, see Deloitte's September 22, 2016, [Financial Reporting Alert](#).



Annual Disclosures Needed in First Quarterly Filing

Although the new leases standard may not require certain of its prescribed disclosures to be provided in interim financial statements, SEC registrants are required under SEC rules and staff interpretations to provide both annual and interim disclosures in the first interim period after the adoption of a new accounting standard and in each subsequent quarter in the year of adoption. Specifically, Section 1500 of the [SEC's FRM](#) states:

[Regulation] S-X Article 10 requires disclosures about material matters that were not disclosed in the most recent annual financial statements. Accordingly, when a registrant adopts a new accounting standard in an interim period, the registrant is expected to provide both the annual and the interim period financial statement disclosures prescribed by the new accounting standard, to the extent not duplicative. These disclosures should be included in each quarterly report in the year of adoption.

As a result, a calendar-year-end SEC registrant will need to comply with the new leases standard's full suite of disclosure requirements in each quarter, beginning with the registrant's first quarter ended March 31, 2019, to the extent that the disclosures are material and do not duplicate information.

Transition

Q&A 18 Transition Considerations Related to the Impairment of an ROU Asset

Background

ASC 360 provides guidance on identifying, recognizing, and measuring an impairment of a long-lived asset or asset group¹⁸ that is held and used. Under the ASC 360 impairment testing model, a lessee is required to test a long-lived asset (asset group) for impairment when impairment indicators are present. Under this testing approach, a lessee would be required to test the asset (asset group) for recoverability and, when necessary, recognize an impairment loss that is calculated as the difference between the carrying amount and the fair value of the asset (asset group).

A lessee must subject an ROU asset to impairment testing in a manner consistent with its treatment of other long-lived assets (i.e., in accordance with ASC 360). Also, upon transition, a lessee is required to include any associated impairment losses in its initial measurement of an ROU asset.

If the ROU asset related to an operating lease is impaired, the lessee would amortize the remaining ROU asset in accordance with the subsequent-measurement guidance that applies to finance leases — typically, on a straight-line basis over the remaining lease term. Thus, the operating lease would no longer qualify for the straight-line treatment of total lease expense. However, in periods after the impairment, a lessee would continue to present the ROU asset amortization and interest expense as a single line item.

Question

Upon transition to ASC 842, is a lessee required to reallocate prior impairment losses of an asset group to the ROU asset?

¹⁸ The ASC master glossary defines an asset group as "the unit of accounting for a long-lived asset or assets to be held and used, which represents the lowest level for which identifiable cash flows are largely independent of the cash flows of other groups of assets and liabilities."

Answer

No. An ROU asset will typically be added to an existing asset group under ASC 360. However, the effect of recognizing an ROU asset on an asset group's allocation of a prior impairment loss is an indirect effect of a change in accounting principle. In accordance with ASC 250-10-45-3 and ASC 250-10-45-8, indirect effects of a change in accounting principle should not be recognized.

At the FASB's November 30, 2016, meeting, the Board indicated that on the effective date of the new leases standard and in all comparative periods presented, a lessee should not revisit prior impairment loss allocations within the asset group. In addition, the Board indicated that a lessee should not include in the initial measurement of an ROU asset at transition any allocation of prior impairment losses recognized within the asset group. Therefore, lessees should not revisit any impairment losses that were allocated to the asset group before the effective date of the standard regardless of whether an impairment loss was recognized in a comparative period. Further, the Board emphasized that the only impairment-related circumstances that could affect the ROU asset before the effective date of ASC 842 are (1) amounts related to the impairment of a sublease subject to the ASC 840 guidance and (2) recognition of a liability for operating leases subject to the exit and disposal guidance in ASC 420.



Editor's Note

The FASB's clarification that a lessee should not revisit any impairment losses that were allocated to the asset group before the effective date of the standard regardless of whether an impairment loss was recognized in a comparative period would appear to render inoperable the transition guidance that requires an entity to include any impairment in the measurement of an ROU asset. That is, the conclusion reached by the FASB at its November 30, 2016, meeting may be interpreted to mean that it is not possible to have an impairment of an ROU asset at transition. Although such an interpretation would relieve entities from the requirement to recalculate and allocate previous impairments, we believe that an entity could reasonably conclude that an ROU asset is impaired at transition or as of the earliest comparative period. For example, a retail company may treat each of its stores as an asset group and may have previously determined that all of the assets in a particular group (primarily leasehold improvements) were impaired to zero in a prior period. Further, assume that incremental impairments would have been required had other recognized assets existed within the asset group. In this instance, the retailer may determine that the ROU asset is also partially or fully impaired and that as a result, the ROU asset should be adjusted as of the earlier impairment date for the asset group. This matter will most likely be raised with the FASB staff. Affected companies should monitor developments and consider consulting with their auditors or accounting advisers.

Q&A 19 Classification Date When "Package of Three" Is Not Elected

ASU 2016-02 provides various practical expedients, including ASC 842-10-65-1(f)(2), which states:

An entity need not reassess the lease classification for any expired or existing leases (that is, all existing leases that were classified as operating leases in accordance with Topic 840 will be classified as operating leases, and all existing leases that were classified as capital leases in accordance with Topic 840 will be classified as finance leases).

Therefore, under this practical expedient, an entity would not reassess the lease classification. Instead, the lease classification determined under existing U.S. GAAP (ASC 840) would be retained. This practical expedient is part of the "package of three" transition practical expedients. The package must be elected in its entirety; otherwise, none of the transition practical expedients in the package may be applied at all.

Question

Upon transition to ASC 842, if a lease commenced before the earliest comparative period presented and an entity did **not** elect the practical expedient package in ASC 842-10-65-1(f), what date should the entity use to determine lease classification as of the earliest comparative period presented?

Answer

The lease should be classified in accordance with the ASC 842 lease classification criteria and facts and circumstances as of the later of (1) the lease commencement date or (2) the date the lease was last deemed modified in accordance with the modification guidance in ASC 840.¹⁹ If a lease was renewed or extended before the earliest period presented, the renewal or extension date would be considered the lease commencement date for this purpose unless the renewal was assumed to be reasonably certain as of the initial lease commencement date.

Example

Entity A, a public calendar-year entity, enters into a lease agreement and obtains the right to use an office building on June 1, 2013. On June 1, 2016, A and the lessor modify the terms of the lease whereby the leased space is reduced and the lease payments on the remaining space is increased to reflect current market rates. The change to the terms represents a modification in accordance with ASC 840-10-35-4. As a public calendar-year entity, A must determine the appropriate classification of the lease as of January 1, 2017, the beginning of the earliest comparative period presented. Because the lease was modified after lease commencement, the lease classification assessment is performed under ASC 842 as of June 1, 2016 (the ASC 840 modification date).



Editor's Note

The Q&A above addresses the date as of which to assess lease classification and what inputs should be used as of the assessment date. The inputs used (e.g., lease payments and discount rate) as of the classification date would not be the same for measurement of the lease. For example, for an operating lease that commenced before the earliest comparative period presented, an entity should measure the lease liability and ROU asset by using the remaining lease payments and discount rate that existed as of the beginning of the earliest comparative period presented.

Q&A 20 Application of the Use-of-Hindsight Practical Expedient

ASC 842-10-65-1(g) states that an entity may elect, as a practical expedient, to use hindsight in determining the lease term and in assessing impairment of ROU assets when transitioning to ASC 842.

Specifically, ASC 842-10-65-1(g) states:

An entity also may elect a practical expedient, which must be applied consistently by an entity to all of its leases (including those for which the entity is a lessee or a lessor) to use hindsight in determining the lease term (that is, when considering lessee options to extend or terminate the lease and to purchase the underlying asset) and in assessing impairment of the entity's right-of-use assets. This practical expedient may be elected separately or in conjunction with the practical expedients in [ASC 842-10-65-1(f)].

Question 1

When applying the use-of-hindsight practical expedient in ASC 842-10-65-1(g), should an entity consider only discrete events (e.g., the lessee's renewal of the lease) that occurred from the original lease commencement date to the date of adoption?

¹⁹ See ASC 840-10-35-4.

Answer

No. When applying the use-of-hindsight practical expedient, an entity would not be limited to considering only known events that had or had not occurred. Rather, a broader view is appropriate, and therefore, in addition to discrete events, an entity should consider changes in facts and circumstances from commencement through the effective date of ASC 842 when determining the lease term and assessing the impairment of the ROU asset. For example, in addition to considering known events such as renewal options that had been exercised by the lessee, an entity should consider other events and changes in factors as discussed in ASC 842-10-55-26 (e.g., a strategic shift in business, changes in market rentals, evolution of the industry as a whole) that may affect whether it is reasonably certain that the lessee will exercise (or not exercise) any remaining renewal options.

The response to this question was informally discussed with the FASB staff, which agreed with the overall conclusion reached.

Question 2

What date does the hindsight assessment extend to when an entity applies the use-of-hindsight practical expedient in ASC 842-10-65-1(g)?

Answer

When performing its hindsight assessment, an entity should consider events and circumstances that occurred up to the effective date of the new leases standard.

Example

In 2004, Company A entered into a 15-year lease of a store that included three 5-year renewal options. On January 1, 2019, when A adopts and transitions to the new leases standard, it elects to apply the use-of-hindsight practical expedient in ASC 842-10-65-1(g). Since the execution of the lease, the following events had occurred:

- On November 9, 2017, A exercised the first of the three 5-year renewal options.
- During 2018, the market rent in the area had increased to a point such that A's rent is now significantly discounted.
- On January 15, 2019, the CEO of A decided on a strategic shift in business such that the company would exit brick-and-mortar retail and move to online only.

When applying hindsight in determining the lease term, A should consider the events that occurred up to the effective date of the new leases standard. Therefore, since A adopted the new guidance as of January 1, 2019, A should consider (1) that it exercised the first renewal option in 2017 and (2) the effect of the significant increase in market rent in 2018 on its assessment of whether it would exercise additional renewal options. Company A should **not** consider its decision to exit brick-and-mortar retail when evaluating the lease term since this event occurred after the effective date of the new leases standard.

Q&A 21 Accounting for Other Lease-Related Balances When Transitioning From a Direct Financing Lease or Sales-Type Lease to an Operating Lease

Upon transition, if an entity does not elect the practical expedients in ASC 842-10-65-1(f), it is required to evaluate the classification of its leases under ASU 2016-02 (see [Q&A 19](#) for additional information about assessing the classification of a lease at transition when the “package of three” is not elected). While it is expected that lease classification under ASC 842 would generally be consistent with that under ASC 840, there are instances in which a lease classification could change when the new guidance is adopted.

Example

On October 1, 2010, Company A acquired an office building that had various leases in place; as a result, A became a lessor of office space. The lease agreements with the existing tenants included escalating lease payments over the contract period. Company A determined on the basis of the ASC 840 lease classification criteria that the existing leases should be classified as direct financing leases (DFLs). Therefore, on the acquisition date, A recognized a net investment in the leases and accounted for them in accordance with ASC 840.

On January 1, 2019, A adopts the new leases standard and does not elect the practical expedients in ASC 842-10-65-10-65-1(f). As a result, A evaluates the classification criteria in ASU 2016-02 and concludes that its existing DFLs should be classified as operating leases under the new guidance. Such an outcome could arise for a variety of reasons, including the use of hindsight that results in a different lease term assumption.

Assume that as a result of the rent escalations in the lease agreement, if the lease had been classified as an operating lease in accordance with ASC 840, A would have recognized a "straight-line rent receivable"²⁰ of \$25,000 as of the earliest period presented. Similarly, as of lease commencement, A would have recognized an in-place lease intangible,²¹ net of amortization, of \$55,000, which represents the inherent value associated with full occupancy of the property by tenants on the acquisition date.

Question

Should A recognize the straight-line rent receivable or the in-place lease intangible asset when transitioning from a DFL under ASC 840 to an operating lease under ASU 2016-02?

Answer

Yes. The straight-line rent receivable and the in-place lease intangible should be established in transition as if they had always be recorded in connection with the operating lease.

The transition guidance in ASC 842-10-65-1(y) addresses how to transition leases previously classified as DFLs under ASC 840 to operating leases under ASC 842. In particular, ASC 842-10-65-1(y) states the following:

For each lease classified as an operating lease in accordance with this Topic, **the objective is to account for the lease**, beginning on the later of the beginning of the earliest comparative period presented in the financial statements and the commencement date of the lease, **as if it had always been accounted for as an operating lease in accordance with this Topic**. Consequently, a lessor shall do all of the following:

1. Recognize the underlying asset⁽²²⁾ at what the carrying amount would have been had the lease been classified as an operating lease under Topic 840.
2. Derecognize the carrying amount of the net investment in the lease.
3. Record any difference between the amounts in (y)(1) and (y)(2) as an adjustment to equity.
4. Subsequently account for the operating lease in accordance with this Topic and the underlying asset in accordance with other Topics. [Emphasis added]

The transition method in ASC 842 is not a full retrospective approach. However, the objective under ASC 842-10-65-1(y), as validated by the FASB staff, is to account for a lease as if it had always been accounted for as an operating lease in accordance with ASC 842.

Therefore, while the transition guidance discusses only certain balances (e.g., the recognition of the underlying asset at what the carrying amount would have been had the lease been

²⁰ A straight-line rent receivable is a deferred balance that represents the difference between the total lease payments received from an entity's customer since inception and the straight-line rent income recognized.

²¹ In-place leases provide value to the acquiring entity in that cash outflows necessary to originate leases (such as marketing, sales commissions, legal costs, and lease incentives) are avoided. Also, in-place leases enable the acquiring entity to avoid lost cash flows during an otherwise required lease-up period.

²² ASC 842-10-20 defines an underlying asset as an "asset that is the subject of a lease for which a right to use that asset has been conveyed to a lessee. The underlying asset could be a physically distinct portion of a single asset."

classified as an operating lease under ASC 840), we believe that the guidance is not intended to be all-inclusive and that the broad objective would be applicable to all balances that would have otherwise been recognized had the lease always been accounted for as an operating lease.

Straight-Line Rent Receivable

On the basis of the analysis above, when Company A transitions to ASC 842, it should do the following as of the beginning of the earliest period presented (i.e., January 1, 2017):

- Derecognize the net investment in the lease.
- Recognize the underlying asset at the carrying amount of what the asset would have been if it were always accounted for as an operating lease under ASC 840.
- Recognize a straight-line rent receivable balance in the amount at which it **would have been recorded** if the lease was always accounted for as an operating lease under ASC 842 (i.e., \$25,000, which is the build-up of a straight-line rent receivable from lease commencement to the earliest period presented when A transitions to ASC 842).

In addition, A should recognize any resulting difference as an adjustment to opening equity and subsequently account for the operating lease in accordance with ASC 842.

In-Place Lease Intangible

Company A should apply the guidance in ASC 805-20-25-10A and recognize an in-place intangible as of January 1, 2017 (i.e., the beginning of the earliest year presented). That is, A should determine what the in-place intangible would have been as of October 1, 2010 (the date of initial acquisition) and factor in amortization of the intangible through January 1, 2017, the beginning of the earliest year presented. The resulting amount would be the in-place lease intangible amount that would have been recognized if the lease had always been accounted for as an operating lease. Company A should recognize an in-place lease intangible of \$55,000 and amortize it over the remaining lease term.



Editor's Note

While the facts above appear specific to a more unique fact pattern that may not be common for many entities upon transition, we believe that the principle outlined above — account for the operating lease in transition as if it had always been an operating lease — is the critical takeaway. Specifically, we think that it is important to consider the objective of the transition guidance in each relevant paragraph of ASC 842-10-65-1 versus the explicit and at times very prescriptive mechanical application guidance.

For example, while ASC 842-10-65-1(h) explicitly describes the applicability of the guidance depending on whether “an entity has previously recognized an asset or a liability in accordance with [ASC] 805 on business combinations relating to favorable or unfavorable terms of an operating lease acquired as part of a business combination,” we believe that it would be similarly appropriate to consider and carry forward other lease-related balances that would have been recognized, such as in-place lease intangibles.

Q&A 22 Build-to-Suit Transition

Background

Build-to-suit arrangements broadly describe situations in which a lessee is involved in construction of an asset it will eventually lease, including projects undertaken from the

ground up as well as construction of major structural improvements on existing assets. Under ASC 840, an entity considers whether it has taken on substantially all of the risks of construction and as a result must be considered, from an accounting perspective, the deemed owner during construction. The accounting prescribed for a deemed owner requires the lessee to record the entire cost of the asset and a corresponding financing obligation on its balance sheet for amounts not directly funded during the construction period. Further, upon completion of construction, the lessee must apply sale-leaseback accounting to determine whether it can derecognize the project. Many entities are unable to derecognize the project after construction because of various forms of continuing involvement that preclude sale treatment. This has been a particularly pervasive outcome for build-to-suit arrangements that involve real estate. Overall, the build-to-suit rules in ASC 840 are widely considered to be overly complex in application and to result in overly punitive accounting outcomes.

ASU 2016-02 removed the risk principle governing the deemed owner determination and replaced it with a model in which a lessee will be deemed to own an asset during construction only if the lessee has “control”²³ of the asset during the construction period. See [Q&A 27](#) for our interpretive guidance on how to assess whether the lessee controls the asset during the construction period.

The transition guidance in ASC 842-10-65-1(u) for build-to-suit lease arrangements states:

A lessee shall apply a modified retrospective transition approach for leases accounted for as build-to-suit arrangements under Topic 840 that are existing at, or entered into after, the beginning of the earliest comparative period presented in the financial statements as follows:

1. If an entity has recognized assets and liabilities solely as a result of a transaction's build-to-suit designation in accordance with Topic 840, the entity should derecognize those assets and liabilities at the later of the beginning of the earliest comparative period presented in the financial statements and the date that the lessee is determined to be the accounting owner of the asset in accordance with Topic 840. Any difference should be recorded as an adjustment to equity at that date. The lessee shall apply the lessee transition requirements in (k) through (t) to the lease.
2. If the construction period of the build-to-suit lease concluded before the beginning of the earliest comparative period presented in the financial statements and the transaction qualified as a sale and leaseback transaction in accordance with Subtopic 840-40 before the date of initial application, the entity shall follow the general lessee transition requirements for the lease.

The transition guidance above specifies that any build-to-suit assets and liabilities recognized under ASC 840 should be derecognized in transition. However, the transition guidance does not explicitly address whether the new standard's principles of controlling an asset under construction should be applied during the comparative periods, which may result in immediately rerecognizing those assets and liabilities.

Question 1

Must the new standard's principles of controlling an asset during construction be applied to the comparative periods when construction was completed and the lease commenced before the ASU's effective date?²⁴

Answer

No. An entity is not required to assess the ASU's principles of control during the comparative periods (regardless of whether the lessee was the deemed owner under ASC 840) as long as construction is complete and the lease commenced before the ASU's effective date. The FASB staff agreed with this application of transition for build-to-suit arrangements.

²³ ASC 842-40-55-5 provides indicators for lessees to consider when determining whether the lessee controls the underlying asset that is being constructed.

²⁴ For this purpose, “effective date” represents the date on which an entity is first required to adopt ASC 842. For example, for a public calendar-year entity, this date would be January 1, 2019, because ASC 842 is effective in periods beginning after December 15, 2018.

Therefore, the transition derecognition guidance in ASC 842-10-65-1(u) should be applied. Accordingly, the lessee should (1) derecognize the impact of any build-to-suit arrangements in which the lessee was the deemed owner in the comparative periods and (2) recognize the difference in equity.

Question 2

How should a lessee transition for a build-to-suit arrangement when construction was not completed and the lease had not commenced as of the effective date?

Answer

The transition approach in those circumstances is summarized in the table below.

ASC 840 Determination	ASC 842 Determination ²⁵	Transition Approach
Lessee was the deemed owner	Lessee has control during construction	No change in accounting; asset and financing obligation remain on the balance sheet during the comparative periods and as of the effective date.
Lessee was the deemed owner	Lessee does not have control during construction	Derecognize the asset and financing obligation, and reflect the difference in equity at the later of the beginning of the earliest comparative period presented in the financial statements and the date as of which the lessee was determined to be the accounting owner of the asset in accordance with ASC 840.
Lessee was not the deemed owner	Lessee has control during construction	Recognize the asset and financing obligation at the later of the beginning of the earliest comparative period presented in the financial statements and the date as of which the lessee is determined to be the accounting owner of the asset in accordance with ASC 842. See the example below.

Example

Company A, a calendar-year public entity, has entered into an agreement with Company B to lease a newly constructed television studio. Company B began building the television studio on June 8, 2017, and construction is expected to be complete on November 5, 2019. The lease will commence once construction is complete. During the construction period, A can acquire the television studio in process of construction and therefore is deemed to control the construction project under ASC 842. Assume that A was not determined to be the deemed owner in accordance with ASC 840. When A initially applies ASC 842, it must recognize the cost of the in-process asset (and an offsetting financing obligation) during the comparative periods beginning June 8, 2017.

²⁵ The lessee's evaluation of whether the lessee controls the asset under construction should be performed at all points in time during the comparative periods presented.

Q&A 23 Selected Financial Data Table Requirements Under SEC Regulation S-K, Item 301

SEC Regulation S-K, Item 301, requires an SEC registrant to disclose certain financial data for “[e]ach of the last five fiscal years of the registrant” and “[a]ny additional fiscal years necessary to keep the information from being misleading.” The SEC staff generally expects all periods to be presented on a basis consistent with the annual financial statements, including the two earliest annual periods presented before those included in the audited financial statements (“years 4 and 5”).

Question

Is an SEC registrant required to reflect the accounting requirements of ASU 2016-02 in all five annual periods presented in the selected financial data table prescribed by SEC Regulation S-K, Item 301?

Answer

No. As noted in the [highlights](#) of the March 21, 2016, CAQ SEC Regulations Committee joint meeting with the SEC staff, the SEC staff stated that it would **not** expect SEC registrants, when adopting the ASU, to reflect the requirements of the new leases standard for all five periods in the selected financial data table. Rather, the staff would expect the selected financial data table to conform to the transition provisions of the new guidance, which require lessees to apply the new standard to capital and operating leases that exist on or after the date of the standard’s initial application (i.e., the beginning of the earliest comparative period presented in the financial statements). Accordingly, the table should include financial information that reflects the application of the ASU for only the most recent three years presented (i.e., years 4 and 5 would not be presented on the same basis as the annual financial statements).

Since the more recent periods reflect the requirements of the new leases standard and the earlier periods do not, the SEC registrant should disclose the lack of comparability of the data presented for the earlier periods in the selected financial data table (if applicable and material).

Q&A 24 Requirements for Revised Financial Statements — New or Amended Registration Statements

As a result of certain subsequent events, SEC registrants may be required to retrospectively adjust previously issued financial statements. For example, items in certain SEC registration statements (e.g., Item 11(b)(ii) of Form S-3)²⁶ may require SEC registrants to provide revised financial statements in a new or amended registration statement if there has been a material retrospective change in accounting principle. For situations in which an SEC registrant adopts the new leases standard and subsequently files a registration statement that incorporates by reference interim financial statements reflecting the impact of the adoption of the new standard, questions have arisen about how the SEC registrant would be required to retrospectively revise its annual financial statements that are incorporated by reference in that registration statement (i.e., the annual financial statements in its Form 10-K). Those annual financial statements would include one more year (the “fourth year”) than what would otherwise be required if the SEC registrant did not file a registration statement.

Question

If an SEC registrant files a new or amended registration statement during an interim period in the year it initially adopts ASU 2016-02, is it required to retrospectively revise the financial statements for all three annual periods that are included or incorporated by reference in the filing (i.e., including the “fourth year”)?

²⁶ Other registration statements, such as Form S-4, include similar requirements.

Answer

No. The transition requirements of ASU 2016-02 do not require retrospective revision of the “fourth year.” The reissuance of the financial statements in the new registration statement would accelerate the requirement to retroactively restate financial statements, but it does not change the date of initial application.

For example, the date of initial application is typically January 1, 2017, for a calendar-year company that adopts ASU 2016-02 on January 1, 2019, because that will be the first day of the comparative three-year period presented in the December 31, 2019, financial statements in the year of adoption. Paragraph 11210.1 in the [SEC’s FRM](#) clarifies that, in this adoption fact pattern, if a company files a new registration statement after the first quarter of adoption but before the filing of the December 31, 2019, Form 10-K, the date of initial application would still be January 1, 2017. This fact pattern assumes that the new registration statement would require the financial statements for the fiscal years ended December 31 of 2018, 2017, and 2016, respectively, along with any required fiscal 2019 interim financial statements. The FRM also clarifies that reissuance of the financial statements in the new registration statement would accelerate the requirement to retrospectively restate financial statements for the years ended December 31 of 2018 and 2017, respectively, but does not change the date of initial application. Accordingly, the financial statements for the year ended December 31, 2016, that are included or incorporated by reference in the new registration statement would not be retrospectively restated. The financial statements for the year ended December 31, 2016, the earliest year presented, will reflect the legacy ASC 840 accounting requirements.

See Section 11210 of the SEC’s FRM for further guidance.

Other Key Provisions

Q&A 25 Identifying, and Allocating Consideration to, the Components of a Contract

ASC 842 provides guidance on identifying components of a contract (i.e., lease and nonlease components). In particular, ASC 842-10-15-30 states:

The consideration in the contract shall be allocated to each separate lease component and nonlease component of the contract (see paragraphs 842-10-15-33 through 15-37 for lessee allocation guidance and paragraphs 842-10-15-38 through 15-42 for lessor allocation guidance). Components of a contract include only those items or activities that transfer a good or service to the lessee. Consequently, the following are not components of a contract and do not receive an allocation of the consideration in the contract:

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

Question

How are fees charged as reimbursement of the lessor’s costs accounted for in a lease?

Answer

An entity would first need to identify the various components of a contract. ASC 842-10-15-30 notes that “[c]omponents of a contract include only those items or activities that transfer a good or service to the lessee.” For example, a contract may include a separate lease component (e.g., the right to use the underlying asset that is the subject of the agreement) as well as additional goods or services that are transferred to the lessee (e.g., maintenance services).

Contracts often include other costs or fees that do **not** provide a separate good or service to the lessee — for example, costs paid by the lessee, such as (1) the cost of administrative tasks performed to set up a contract or initiate the lease or (2) reimbursement or payment of the lessor's costs (e.g., property taxes and insurance related to the leased asset). These types of costs do **not** transfer a good or service to the lessee and would therefore not be considered a separate component.

An entity is required to allocate the total consideration in a contract (inclusive of all amounts charged for administrative start-up, property taxes, and some insurance²⁷) to its identified separate lease component(s)²⁸ and nonlease component(s). The manner of allocating the consideration depends on whether the entity is the lessee or lessor in the arrangement.

Lessee

A lessee that does not elect to account for its lease and nonlease components as a single lease component in accordance with the practical expedient in ASC 842-10-15-37 would allocate the consideration in the contract to the separate lease and nonlease components on a relative stand-alone price basis by using observable stand-alone prices when available. When observable stand-alone prices are not available, a lessee can estimate the stand-alone price by maximizing the use of observable information. Any activity in a contract that does not transfer a separate good or service to the lessee is not considered a separate component and therefore would not receive an allocation of consideration in the contract (e.g., property taxes and some insurance would not represent a separate component, and any contractually stated amounts related to these activities would therefore be allocated between the identified lease and nonlease components).

Lessor

A lessor would allocate the consideration in the contract to the separate lease components and the nonlease components by applying the guidance in ASC 606-10-32-28 through 32-41 of the new revenue standard (which generally requires an allocation based on the relative stand-alone selling prices of the components). In addition, as stated in ASC 842-10-15-38, a lessor would “allocate any capitalized costs (for example, initial direct costs or contract costs capitalized in accordance with [ASC] 340-40 . . .) to the separate lease components or nonlease components to which those costs relate.” As would be the case under the lessee allocation method, any activity in a contract that does not transfer a separate good or service to the lessee is not considered a separate component and therefore would not receive an allocation of consideration in the contract (e.g., property taxes and some insurance would not represent a separate component, and any contractually stated amounts related to those activities would therefore be allocated between the identified lease and nonlease components).

²⁷ The cost of insurance that protects the lessor's interest in the asset will generally be part of the contract consideration and require allocation. On the other hand, the cost of insurance that protects the lessee (e.g., renter's insurance) will not be part of the contract consideration regardless of whether such insurance is required under the terms of the lease since the cost of that insurance does not represent reimbursement of lessor costs.

²⁸ A contract could include one lease component or multiple, separate lease components.

Example

Lessee X enters into a five-year lease (a gross lease) of a building from Lessor Y under which X is required to make a fixed annual lease payment of \$35,000 (payments total \$175,000 over the five-year term). In accordance with the terms of the contract, the \$35,000 annual payment comprises \$20,000 for building rent, \$7,000 for common area maintenance, \$5,000 for property taxes, and \$3,000 for building insurance. From the lessee's perspective, the estimated stand-alone price²⁹ of the building rent (excluding taxes and insurance) is \$22,000, and the estimated stand-alone price of the maintenance service is \$8,000. From the lessor's perspective, the stand-alone selling price³⁰ of the building rent (excluding taxes and insurance) is \$21,500, and the stand-alone selling price of the maintenance services is \$7,650.

In evaluating the separate components in the contract, both the lessee and lessor would need to determine what goods and services are being provided in the contract, which may include both lease and nonlease components. In this contract, the primary good or service is the right to use the underlying asset and is considered a lease component. In addition, the contract requires Y to provide maintenance services, which represent a nonlease component (i.e., a service to be accounted for in accordance with ASC 606).

The contract also requires the lessee to pay the lessor additional consideration attributable to property taxes and insurance. However, in accordance with ASC 842-10-15-30, those additional fees would **not** be considered separate components (either lease components or nonlease components) since each fee is a reimbursement of the lessor's costs. Therefore, despite requiring the payment of four separately described fees in the contract, the arrangement includes only two components. The total fees of \$35,000 are required to be allocated between the two identified goods and services representing the lease component and nonlease component.

As a result, the lessee allocates the consideration in the arrangement as follows:

	Stand-Alone Prices	% of Total Stand-Alone Price	Relative Stand-Alone Prices*
Building rent, excluding taxes and insurance	\$ 22,000	73.3%	\$ 25,655
Maintenance service	<u>8,000</u>	26.7%	<u>9,345</u>
	<u>\$ 30,000</u>	100.0%	<u>\$ 35,000</u>

* The total consideration that is allocated between the lease and nonlease components includes those amounts that are not considered a separate component (e.g., in this case, the \$5,000 property taxes and \$3,000 for insurance).

In contrast, the lessor allocates the consideration in the arrangement as follows:

	Stand-Alone Selling Prices	% of Total Stand-Alone Selling Price	Allocated Transaction Price*
Building rent, excluding taxes and insurance	\$ 21,500	73.8%	\$ 25,830
Maintenance service	<u>7,650</u>	26.2%	<u>9,170</u>
	<u>\$ 29,150</u>	100.0%	<u>\$ 35,000</u>

* While the consideration that is to be allocated between the lease and nonlease components will be the same for both the lessee and lessor, the allocation percentage and resulting relative stand-alone prices (lessee) and allocated transaction price (lessor) may vary as the lessee and lessor each consider their own assumptions when calculating these balances.

²⁹ The ASC master glossary defines "standalone price" as the "price at which a customer would purchase a component of a contract separately."

³⁰ The ASC master glossary defines "standalone selling price" as the "price at which an entity would sell a promised good or service separately to a customer."



Editor's Note

Lessee's Election Not to Separate Nonlease Components From Lease Components

As a reminder, ASC 842-10-15-37 allows a lessee, as an accounting policy election by class of underlying asset, to choose **not** to separate its nonlease components from its lease components. If this practical expedient is elected, the lessee is permitted to account for each separate lease component³¹ and the nonlease component associated with that lease component as a single lease component. It is important to note that if an entity makes this election, the calculated lease liability and corresponding ROU asset will be higher than it would be if the nonlease components were subject to separate accounting. In addition to grossing up the balance sheet, not separating lease and nonlease components may affect lease classification (i.e., the present value of the sum of the lease payments, inclusive of the nonlease components, and any residual value guaranteed by the lessee may equal or exceed substantially all of the fair value of the underlying asset).

Lessee's Payment of Lessor-Related Costs

Often, a lessee is responsible for the payment of lessor-related costs (e.g., some types of insurance and real estate taxes). Depending on the terms of the contract, these costs may be remitted to the lessor as a reimbursement of what was paid or may be directly paid to the third party (e.g., insurance company or taxing authority). These costs are often variable and paid on the basis of the actual costs and are not considered part of the consideration in the contract. Payments for insurance and real estate taxes would not be considered a separate component in the contract and would be allocated between any lease and nonlease components in the contract regardless of whether:

- The payments are fixed and considered part of the consideration or are variable and outside of the consideration in the contract.
- The lessee is paying the insurance company and taxing authority directly or is reimbursing the lessor.

Q&A 26 Impact of Sublease Renewals on Head Lease Term

Background

An entity must determine the lease term to perform lease classification and measurement. ASC 842-10-30-1 requires an entity to determine the lease term as follows:

An entity shall determine the lease term as the noncancellable period of the lease, together with all of the following:

- a. Periods covered by **an option to extend the lease if the lessee is reasonably certain to exercise that option**
- b. Periods covered by an option to terminate the lease if the lessee is reasonably certain not to exercise that option
- c. Periods covered by **an option to extend (or not to terminate) the lease in which exercise of the option is controlled by the lessor**. [Emphasis added]

ASC 842-10-55-26 provides that an entity should consider all economic factors in determining whether it is reasonably certain that a renewable option will be exercised. Further, an entity must consider a sublease in determining the lease term of the head lease.

³¹ See footnote 28.

Question

If a sublessee has contractual renewal options on a leased asset, does the head lease automatically include all periods covered by those renewal options since their exercise would force renewal of the head lease and the sublease renewals are outside the head lessee's control?

Answer

Not necessarily. At the FASB's November 30, 2016, meeting, the Board indicated that the head lessee must determine whether the sublessee is reasonably certain to exercise its renewal options because the head lessee must determine the lease term for the head lease. If the exercise of the sublease renewal options is reasonably certain, the renewal of the head lease is also reasonably certain. However, if the head lessee determines that it is not reasonably certain that the sublessee will exercise its renewal options, the head lessee should not include additional renewal options that extend past the sublessee's noncancelable term in the absence of other economic factors. That is, the sublease is one of many factors for an entity to consider in determining the lease term of the head lease.

Note that the head lessee would reassess its lease term in accordance with ASC 842-10-55-28 upon the occurrence of certain events, including "[s]ubleasing the underlying asset for a period beyond the exercise date of the option." Therefore, upon notice by the sublessee that it is renewing or extending its sublease, the head lessee must reassess the lease term of the head lease, including whether the exercise of any remaining renewal options is reasonably certain.

Example

Under a lease agreement (the "Head Lease"), Company A leases equipment from Company B. Under another lease agreement (the "Sublease"), A immediately leases the equipment to Company C. The noncancelable lease period of the Head Lease is 10 years, with two 5-year renewals at A's option for a fixed amount. The Sublease has a mirrored 10-year noncancelable period, with two 5-year renewals at C's option. If C exercises its renewal option on the Sublease, it will force A to renew the Head Lease.

If it is not reasonably certain that C will exercise its renewal options, A could determine, in the absence of other asset- or market-based factors, that the lease term of the Head Lease is limited to 10 years (i.e., the noncancelable period). If and when C renews its Sublease, A must reassess the lease term by including the first 5-year renewal and determining whether C's exercise of the second 5-year renewal option is reasonably certain.

Q&A 27 Lessee Control of the Asset During Construction

Background

Under ASC 840, controlling an asset during construction is based on risks and rewards. In contrast, ASC 842 introduces provisions that are based on control. See [Q&A 22](#) for additional information about the impact of these changes.

ASC 842-40-55-5 provides the following specific criteria that indicate (if at least one of the criteria is met) that the lessee controls the underlying asset during construction before the lease commences:

- 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 842-10-55-7) 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.

However, ASC 842-40-55-5 also indicates, in part:

The list of circumstances [in ASC 842-40-55-5] in which a lessee controls an underlying asset that is under construction before the commencement date is not all inclusive. There may be other circumstances that individually or in combination demonstrate that a lessee controls an underlying asset that is under construction before the commencement date.

Question

In the absence of meeting one of the specific criteria in ASC 842-40-55-5, how should a lessee determine whether it “controls an underlying asset” during construction?

Answer

In general, the determination should be based on the concept of control in ASC 606.³² The first three criteria in ASC 842-40-55-5 are grounded in principles of ASC 606, which indicate that the lessee has control of the asset during construction if (1) the lessee holds a call option, (2) the lessor has an enforceable right to payment for performance to date and the asset does not have an alternative use, or (3) the lessee has title to the asset under construction. The concept in the last two criteria is not in ASC 606 but, in our view, is based on an assumption that the lessor should be able to legally use the underlying land (e.g., cannot be forced to vacate the property) during substantially all of the economic life of the property improvement that is being constructed on the land (see [Q&A 30](#)).

We do not believe that the concept of controlling an asset under construction should be based on the definition of a lease under ASC 842, which includes guidance on whether a contract conveys the right to control the use of an identified asset. Although the concepts sound similar, the FASB explicitly excluded from the scope of ASC 842 leases of assets under construction, partially as a result of the difficulty of applying the lease definition before an asset is placed in service (e.g., the difficulty of assessing the economic benefits associated with an asset that is not yet operational).

When the above principles are applied, it would not be appropriate to conclude that a lessee controls the asset under construction solely because of its involvement in designing the asset or acting as the general contractor over the construction project. This involvement is typical of many “build-to-suit” arrangements. In these cases, the lessee would typically not control the asset during construction because the lessee does not (1) take title to the asset, (2) provide the lessor with an enforceable right to payment, or (3) prevent the lessor from using the underlying land for substantially all of the economic life of the property improvements.

³² As stated in paragraph BC400(b) of ASU 2016-02, the FASB “observed that, in concept, the evaluation under [ASC] 842-40 on whether an entity controls an asset that is under construction is similar to the evaluation undertaken in the revenue recognition guidance in accordance with [ASC] 606-10-25-27 to determine whether a performance obligation is satisfied over time.”

Example

Lessee enters into a construction and lease agreement with Lessor to build a new corporate headquarters. Lessor will retain title to the building throughout the construction period and agrees to pay up to \$50 million toward construction. Lessee designed the building to Lessee's specifications and is contracted by Lessor to be the general contractor during the construction project. Assume that none of the specific criteria in ASC 842-40-55-5 are present.

Lessee would not control the asset during construction because its role as general contractor and designer of an asset is not an indicator of control under the specific criteria of ASC 842-40-55-5 or the ASC 606 principles of control. Likewise, Lessee's exposure to overrun risk (since Lessor will pay only up to \$50 million of the construction costs) does not affect the control analysis, whereas before the adoption of ASC 842, this would have resulted in a determination that Lessee is the deemed accounting owner because of its exposure to construction risk.

Q&A 28 Right to Obtain a Partially Constructed Asset During Construction

ASC 842-40-55-5(a), which provides one of the specific criteria that indicate that the lessee controls the underlying asset during construction before the lease commences, states the following:

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).

Question

Does the lessee have control of an asset during the entire construction period if it holds a call option that is exercisable at any time?

Answer

It depends. If a call option is exercisable by the lessee at any point during construction, the lessee controls the underlying asset and should recognize the construction in process. Importantly, "at any point" does not mean at **all** points; therefore, entities must also consider options that arise (or become exercisable) during the construction period regardless of whether they are based on the passage of time or a substantive contingency. In the case of a substantive contingency, an entity would be deemed to control the asset under construction once it has the current ability to exercise the option. On the other hand, if the only barrier preventing exercise is the passage of time, we believe that an entity would be deemed to control the asset under construction from the beginning of the construction period.

An entity should carefully analyze a call option that becomes exercisable upon the occurrence of a contingent event to determine whether the lessee can unilaterally cause the call option to become exercisable. For example, some construction and lease agreements provide that if the lessee defaults on its obligation to perform under the agreement, the lessee could be obligated to purchase the construction in process. Under this provision, the lessee would control the underlying asset because it could unilaterally default under the agreement and thereby become able to obtain the underlying asset. In contrast, if the obligation or option to purchase the construction in process was outside the control of the lessee (e.g., bankruptcy or third-party events), the lessee would not have control over the construction in process until the contingent event occurred. Once the lessee is deemed to control the construction in process, the lessee must apply sale-leaseback accounting rules to determine whether it can derecognize the project. Scenarios in which the lessee must apply sale-leaseback accounting rules to make such a determination include those in which the lessee maintains control up to completion of construction, as well as those in which the option that conveyed control expires unexercised during the construction period.

Example

Lessee enters into a construction and lease agreement with Lessor to build a new corporate headquarters. Lessor will retain title to the building throughout the construction period and agrees to pay up to \$50 million toward construction. The construction is expected to be completed in 18 months. At any point during the construction, Lessee has the right (but not the obligation) to purchase the construction in process at Lessor's cost plus a profit margin. If the call option is not exercised and construction is completed, Lessee will lease the asset from Lessor for a lease term of 15 years with an option to purchase the building at the end of the lease term at a fixed price.

Lessee would control the asset during construction and recognize the construction in process. At the end of construction, Lessee must consider the sale-leaseback guidance in ASC 842-40-25-1 through 25-3. In this case, Lessee would not qualify for sale accounting because of the call option that exists during the lease period (see [Q&A 31](#)).



Editor's Note

Lessor put options should also be considered in scenarios involving construction of an asset to be leased. In a manner consistent with the guidance on put options in ASC 606, an entity should assess a put option held by the lessor to determine whether the lessor has a significant economic incentive to exercise the option. If such an incentive exists, it would be assumed that the lessee controls the construction in process.

Q&A 29 Enforceable Right to Payment During Construction

ASC 842-40-55-5(b), which provides one of the specific criteria that indicate that the lessee controls the underlying asset during construction before the lease commences, states the following:

The lessor has an enforceable right to payment for its performance to date, and the asset does not have an alternative use (see paragraph 842-10-55-7) 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.

Question

When would the criterion in ASC 842-40-55-5(b) apply?

Answer

The criterion in ASC 842-40-55-5(b) would apply only when (1) the lessor has an enforceable right to payment for **all** of its performance to date (i.e., throughout the development or construction of the asset) **and** (2) the asset has no alternative use to the owner-lessor. This criterion is derived from the guidance in ASC 606 on recognizing revenue as control is transferred to a customer over time³³ (e.g., when the transfer of control results in the customer's ownership of a partially completed asset during the asset's development or construction).

We expect the circumstances listed above to be uncommon for an asset under construction because a lessee is not typically required to pay for **all** of the performance to date throughout construction. Rather, the lessor will be paid, at least in part, through lease payments over the period of the lease term after construction has ended. A significant amount of required prepaid rent would not meet the criterion in ASC 842-40-55-5(b) unless the lease provided for the nonrefundable right to payment for all the costs incurred by the lessor plus a reasonable profit margin. That is, the required payments must compensate the developer for all construction efforts throughout the asset's construction for the future lessee to control the asset and, therefore, to be the deemed owner of the asset during construction.

³³ See ASC 606-10-25-27.

Further, many build-to-suit arrangements may require the lessee to pay the lessor upon the occurrence of certain contingent events outside the control of the lessor (e.g., default by the lessee). This requirement alone would not meet the criterion in ASC 842-40-55-5(b) because the lessor cannot force the lessee to make payment in the absence of a default under the lease agreement.

Finally, in the rare circumstances that the first part of this criterion is met, the asset under construction may have an alternative use to the lessor under ASC 842-10-55-7.

Q&A 30 Controlling an Asset During Construction When the Land Is Sold in a Failed Sale-Leaseback

ASC 842-40-55-5(d), which provides one of the specific criteria that indicate that the lessee controls the underlying asset during construction before the lease commences, states the following:

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. [Emphasis added]

Examples of when the transfer of land may not qualify as a sale include circumstances in which the seller/lessee retains a call option on the land or the leaseback is determined to be a finance lease.

Question

How should the criterion in ASC 842-40-55-5(d) be assessed when land is sold to the lessor but is accounted for as a financing rather than a sale?

Answer

In our view, the concept in this criterion is based on an assumption that the lessor of the property improvements should be able to use the underlying land during substantially all of the economic life of the property improvements that are being constructed on the land. When the lessor does not have appropriate rights to the land, the lessee would control the property improvements during construction if the following conditions are met:

- *The lessee of the property improvements controls the land* — This condition is met if any of the following can be shown:
 - The lessee holds title to the land.
 - The lessee previously sold the land but did not qualify for sale accounting.
 - The lessor of the property improvements has title to the land, but the lessee sold the land to the lessor in a failed sale-leaseback.
- *The lessee controls the constructed asset* — Even if the first condition is met (i.e., the lessee controls the land), the lessee does not control the constructed asset if the lessee has leased the land to the lessor for substantially all of the economic life of the to-be-constructed asset.

Read literally, the second condition can never be met in a financing of the land through a previous failed sale or sale-leaseback because the lessee cannot lease out the land that it has already legally sold to the lessor. However, we believe that the principle underlying the criterion in ASC 842-40-55-5(d) should be considered. That is, does the lessor have the right to legally use the land for substantially all of the economic life of the property improvements? An entity must consider all facts and circumstances when determining whether this principle is met.

Example 1

Company A sells land to Company B and contemporaneously enters into a construction and lease agreement for B to build a new corporate headquarters for A. Upon completing construction of the new headquarters building, B will lease the land and the building to A for a period of 40 years. At the end of 40 years, A will have the right to purchase the land and corporate headquarters at a fixed price. The corporate headquarters has an estimated economic life of 40 years. Assume that none of the other criteria in ASC 842-40-55-5 are present in the arrangement related to the to-be-constructed property improvements.

Company A determines, in accordance with ASC 842-40-25-3, that the call option precludes accounting for the transfer of the land as a sale. However, in the assessment of whether A controls the corporate headquarters during construction, it is noted that B has the legal right to use the land for the entire 40-year economic life of the asset to be constructed. That is, the option is not exercisable until the property improvement has no remaining economic life. Therefore, on the basis of these facts and circumstances, A concludes that it does not control the corporate headquarters during construction.

Example 2

Assume the same facts as those in Example 1, except that Company A does not have a purchase option on the land. However, the leaseback of the land is determined to be a finance lease under ASC 842 because the present value of the lease payments equals or exceeds substantially all of the fair value of the land transferred.

Company A determines, in accordance with ASC 842-40-25-2, that B is not considered to have obtained control of the land because the leaseback is a finance lease. However, in assessing whether A controls the corporate headquarters during construction, A notes that B has the legal right to use the land for the entire 40-year economic life of the asset to be constructed. That is, although A did not derecognize the land for accounting purposes, the lessor uses the land in the construction and lease of the property improvements for the entire economic life. Therefore, on the basis of these facts and circumstances, A concludes that it does not control the corporate headquarters under construction.

Q&A 31 Real Estate Sale and Leaseback With Repurchase Option

Background

Under ASC 842, the seller-lessee in a sale-leaseback transaction must evaluate the transfer of the underlying asset (sale) in accordance with ASC 606 to determine whether the transfer qualifies as a sale (i.e., whether control has been transferred to the buyer).

The existence of a leaseback by itself would not indicate that control has not been transferred (i.e., it would not preclude the transaction from qualifying as a sale) unless the leaseback is classified as a finance lease. In addition, if the arrangement includes an option for the seller-lessee to repurchase the asset, the transaction would not qualify as a sale unless (1) the option is priced at the fair value of the asset on the date of exercise and (2) there are alternative assets that are substantially the same as the transferred asset and readily available in the marketplace.

If the transaction does not qualify as a sale, the seller-lessee and buyer-lessor would account for it as a financing arrangement (i.e., the seller-lessee would record a financial liability, and the buyer-lessor would record a receivable).

Question

Would the inclusion of a seller-lessee repurchase option in a sale and leaseback of real estate preclude the transfer from qualifying as a sale under ASC 606?

Answer

Yes. Sale-leaseback transactions involving real estate that include a repurchase option will not meet the criteria of a sale under ASC 606 regardless of whether the repurchase option is priced at fair value.

ASC 842-40-25-3 states that for the transfer of an asset that is subject to a repurchase option in a sale and leaseback transaction to qualify as a sale, two criteria must be met: (1) the option is priced at the fair value of the asset on the date of exercise and (2) there are alternative assets that are substantially the same as the transferred asset and readily available in the marketplace. During the FASB's redeliberations on ASU 2016-02, the Board noted that sale-leaseback transactions involving real estate that include a repurchase option would not meet the second criterion in ASC 842-40-25-3. Paragraph BC352(d) of ASU 2016-02 notes, in part:

When the Board discussed [ASC 842-40-25-3], Board members generally observed that real estate assets would not meet criterion (2). This is because real estate is, by nature, "unique" (that is, no two pieces of land occupy the same space on this planet) such that no other similar real estate asset is "substantially the same."

Therefore, regardless of whether the repurchase option is priced at fair value, the unique nature of real estate would prevent a sale-leaseback transaction involving real estate that includes a repurchase option from satisfying the second criterion in ASC 842-40-25-3 since there would be no alternative asset that is substantially the same as the one being leased. Accordingly, in a manner similar to current U.S. GAAP, the new leases standard would preclude sale-leaseback accounting for transactions involving any repurchase options on real estate.

Driving Discussions — Other Key Provisions



Impact of ASC 842 on Debt Covenants and Bank Capital Requirements

Since ASC 842 requires a lessee to recognize a lease liability and corresponding ROU asset for all of its leases (including operating leases), financial statement preparers and users have raised questions about the impact of the new operating lease liabilities and ROU assets on an entity's metrics (e.g., debt covenants and bank capital requirements).

Impact on Debt Covenants

During the FASB's redeliberations, the Board considered concerns about the potential impact of additional liabilities resulting from the application of ASC 842. In particular, paragraph BC14 of ASU 2016-02 states:

The Board further considered the concern that the additional lease liabilities recognized as a result of adopting Topic 842 will cause some entities to violate debt covenants or may affect some entities' access to credit because of the potential effect on the entity's GAAP-reported assets and liabilities. Regarding access to credit, outreach has demonstrated that the vast majority of users, including private company users, presently adjust an entity's financial statements for operating lease obligations that are not recognized in the statement of financial position under previous GAAP and, in doing so, often estimate amounts significantly in excess of what will be recognized under Topic 842. The Board also considered potential issues related to debt covenants and noted that the following factors significantly mitigate those potential issues:

- a. A significant portion of loan agreements contain "frozen GAAP" or "semifrozen GAAP" clauses such that a change in a lessee's financial ratios resulting solely from a GAAP accounting change either:
 1. Will not constitute a default
 2. Will require both parties to negotiate in good faith when a technical default (breach of loan covenant) occurs as a result of new GAAP.

- b. Banks with whom outreach has been conducted state that they are unlikely to dissolve a good customer relationship by “calling a loan” because of a technical default arising solely from a GAAP accounting change, even if the loan agreement did not have a frozen or semifrozen GAAP provision.
- c. Topic 842 characterizes operating lease liabilities as operating liabilities, rather than debt. Consequently, those amounts may not affect certain financial ratios that often are used in debt covenants.
- d. Topic 842 provides for an extended effective date that should permit many entities’ existing loan agreements to expire before reporting under Topic 842. For those loan agreements that will not expire, do not have frozen or semifrozen GAAP provisions, and have covenants that are affected by additional operating liabilities, the extended effective date provides significant time for entities to modify those agreements.

While the FASB has clearly articulated its view that lease liabilities resulting from operating leases under ASC 842 are intended to be characterized as an operating liability outside of debt, it is important to note that the FASB does not have the ability to dictate how banks and other lenders view such amounts.

It is unclear whether banks and other lenders will take a consistent approach in evaluating lease liabilities for debt covenant purposes. Therefore, we encourage preparers and other stakeholders to start discussions with these organizations to better understand the implications of the new guidance on existing and future lending agreements. Our experience to date suggests that banks and other lenders have been sympathetic and willing to work with companies affected by the new rules.

Impact on Bank Capital Requirements

A bank regulatory capital requirement (expressed as a ratio of capital to risk-weighted assets or average assets) is the amount of capital that banks or bank holding companies have to hold as required by banking regulators (e.g., the Federal Deposit Insurance Corporation, the Federal Reserve Board, and the Office of the Comptroller of the Currency in the United States). Most intangible assets are deducted from regulatory capital, while tangible assets are not. Since ASC 842 does not provide definitive guidance on whether an ROU asset represents a tangible or an intangible asset, stakeholders have asked how bank regulators will treat ROU assets when establishing required capital.

On April 6, 2017, the Basel Committee on Banking Supervision (of which the United States is a member) issued FAQs on how an ROU asset would be treated for regulatory capital purposes. Specifically, the FAQs note that the ROU asset:

- Should not be deducted from regulatory capital since the underlying asset being leased is a tangible asset.
- Should be included in the risk-based capital and leverage ratio denominators.
- Should be risk-weighted at 100 percent, which is consistent with the risk weight applied historically to owned tangible assets and to a lessee’s leased assets under leases accounted for as capital leases under the current guidance in ASC 840.

Entities with any questions on the above FAQ responses should reach out to their accounting advisers or primary federal regulator.

Find Out More

The following Deloitte publications and resources contain additional information about the FASB's and IASB's new leases standards:

- [*Heads Up*, "FASB's New Standard Brings Most Leases Onto the Balance Sheet."](#)
- [*IFRS in Focus*, "IASB Issues IFRS 16 — Leases."](#)
- [*"Operationalizing the New Lease Standard — Lease Accounting."*](#)

Appendix A — Glossary of Standards and Other Literature

The following are the titles of standards and other literature mentioned in this publication:

FASB Accounting Standards Codification (ASC) Topics

ASC 210, *Balance Sheet*

ASC 250, *Accounting Changes and Error Corrections*

ASC 310, *Receivables*

ASC 340, *Other Assets and Deferred Costs*

ASC 350, *Intangibles — Goodwill and Other*

ASC 360, *Property, Plant, and Equipment*

ASC 450, *Contingencies*

ASC 606, *Revenue From Contracts With Customers*

ASC 805, *Business Combinations*

ASC 840, *Leases*

ASC 842, *Leases*

FASB Accounting Standards Update (ASU)

ASU 2016-02, *Leases (Topic 842)*

SEC Staff Accounting Bulletins (SABs)

Topic 1.M, “Materiality” (SAB 99)

Topic 11.M, “Disclosure of the Impact That Recently Issued Accounting Standards Will Have on the Financial Statements of the Registrant When Adopted in a Future Period”

SEC Division of Corporation Finance *Financial Reporting Manual*

Topic 1, “Registrant’s Financial Statements”; Section 1500, “Interim Period Reporting Considerations (All Filings)”

Topic 11, “Reporting Issues Related to Adoption of New Accounting Standards”; Section 11200, “New Leasing Standard (FASB ASC Topic 842)”

SEC Regulation S-K

Item 301, “Selected Financial Data”

Item 308(c), “Internal Control Over Financial Reporting; Changes in Internal Control Over Financial Reporting”

SEC Regulation S-X

Article 10, “Interim Financial Statements”

International Standard

IFRS 16, *Leases*

Appendix B — Abbreviations

Abbreviation	Description
AICPA	American Institute of Certified Public Accountants
ASC	FASB Accounting Standards Codification
ASU	FASB Accounting Standards Update
CAQ	Center for Audit Quality
CEO	chief executive officer
CPI	consumer price index
DFL	direct financing lease
EITF	Emerging Issues Task Force
FAQ	frequently asked question
FASB	Financial Accounting Standards Board
FERC	Federal Energy Regulatory Commission
FRM	SEC Financial Reporting Manual
GAAP	generally accepted accounting principles
IASB	International Accounting Standards Board
ICFR	internal control over financial reporting
IFRS	International Financial Reporting Standard
IPP	independent power producer
JOA	joint operating agreement
LIBOR	London Interbank Offered Rate
MWh	megawatt hour
P&L	profit and loss
PCAOB	Public Company Accounting Oversight Board
PP&E	property, plant, and equipment
Q&A	question and answer
ROU	right of use
SAB	SEC Staff Accounting Bulletin
SEC	Securities and Exchange Commission
TRG	transition resource group

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