No. 2016-11
14 April 2016

Technical Line

FASB — final guidance

How the FASB's new leases standard will affect real estate entities

In this issue:

What you need to know

- The FASB has issued final guidance that requires lessees to recognize most leases on their balance sheets.
- Lessees and lessors will classify most leases using a principle that is generally consistent with current US GAAP but without the bright lines. Lease classification determines how lease-related expense and revenue is recognized as well as what lessors record on the balance sheet.
- The guidance eliminates today's real estate-specific provisions and changes what qualifies as initial direct costs.
- For calendar-year public business entities, the guidance is effective in 2019, and interim periods within that year. For other calendar-year entities, it is effective in 2020, and interim periods in 2021. Early adoption is permitted for all entities.

Overview

Real estate entities will need to change certain lease accounting practices when implementing the new leases standard, Accounting Standards Codification (ASC) 842, *Leases,* issued by the Financial Accounting Standards Board (FASB or Board). ASC 842 significantly changes the accounting for lessees that are real estate tenants, requiring them to recognize most leases on their balance sheets as lease liabilities with corresponding right-of-use assets.

Building a better working world

For lessors, ASC 842 does not make fundamental changes to today's lessor accounting model. However, it modifies what qualifies as a sales-type and direct financing lease as well as the related accounting. ASC 842 also eliminates today's real estate-specific provisions that apply to all entities and changes which costs qualify as initial direct costs.

Like ASC 840, ASC 842 requires lessees to classify most leases as either finance leases (generally capital leases under ASC 840) or operating leases. Lessors are required to classify all leases as either sales-type, direct financing or operating leases.

Leases are classified using a principle that is generally consistent with ASC 840 but without today's bright lines (i.e., the "75% of economic life" and "90% of fair value" tests). Lease classification determines how and when a lessee and a lessor recognize lease expense and income, respectively, and what assets a lessor records.

For lessees, the income statement recognition pattern for finance leases and operating leases is similar to that of today's capital leases and operating leases, respectively. That is, finance leases generally have a front-loaded expense recognition pattern, and operating lease expense is generally recognized on a straight-line basis.

Entities will need to adjust their accounting policies, processes and internal controls to implement the new standard.

ASC 842 is effective for public business entities (PBE) for annual periods beginning after 15 December 2018, and interim periods within those years. For all other entities, it is effective for annual periods beginning after 15 December 2019, and interim periods the following year. Early adoption is permitted for all entities. Entities are required to use a modified retrospective approach for leases that exist or are entered into after the beginning of the earliest comparative period presented in the financial statements. For example, for a calendar-year PBE that presents three years of financial statements, the effective date will be 1 January 2019 and the transition provisions must be applied beginning 1 January 2017. Full retrospective application is prohibited.

This publication summarizes the new standard and describes some industry-specific issues you may want to start working on. Like all other entities, you'll also need to apply the new standard to leases of office space, office equipment and all other leased assets.

This publication is intended to complement our Financial reporting developments (FRD) publication, *Lease accounting — Accounting Standards Codification 842, Leases* (SCORE No. 00195-171US), which provides an in-depth discussion of ASC 842. We refer to that publication as our Leases FRD. Engineering & construction entities should refer to our Technical Line, *How the FASB's new leases standard will affect the engineering and construction entities* (SCORE No. 00525-161US).

The views we express in this publication are preliminary as of April 14, 2016. We may identify additional issues as we analyze ASC 842 and entities begin to interpret it, and our views may evolve during that process.

Key considerations

Scope and scope exceptions

Consistent with ASC 840, the scope of ASC 842 is limited to leases of property, plant and equipment (i.e., land and depreciable assets), including subleases of those assets. ASC 842 does not apply to any of the following:

- Leases of intangible assets

- Leases to explore for or use minerals, oil, natural gas and similar non-regenerative resources, including the intangible rights to explore for those natural resources and rights to use the land in which those natural resources are contained
- Leases of biological assets, including timber
- Leases of inventory
- Leases of assets under construction

Definition of a lease

A lease is a contract (i.e., an agreement between two or more parties that creates enforceable rights and obligations), or part of a contract, that conveys the right to control the use of identified property, plant or equipment (i.e., an identified asset) for a period of time in exchange for consideration.

The concept of an identified asset is generally consistent with the "specified asset" concept in ASC 840. Under ASC 842, an identified asset could be either implicitly or explicitly specified in a contract and can be a physically distinct portion of a larger asset (e.g., a floor of a building). Even if an asset is specified, a customer does not have the right to use an identified asset if, at inception of the contract, a supplier has the substantive right to substitute the asset throughout the period of use. A substitution right is substantive if the supplier has the practical ability to substitute alternative assets throughout the period of use and the supplier would benefit economically from the exercise of its right to substitute the asset.

While the lessor accounting model isn't changing as much as the lessee model, real estate entities still need to modify aspects of their accounting.

A contract conveys the right to control the use of an identified asset for a period of time if, throughout the period of use, the customer has both of the following:

- The right to obtain substantially all of the economic benefits from the use of the identified asset
- The right to direct the use of the identified asset

A customer can obtain economic benefits either directly or indirectly (e.g., by using, holding or subleasing the asset). Economic benefits include the asset's primary outputs (i.e., goods or services) and any byproducts (e.g., renewable energy credits that are generated through use of the asset), including potential cash flows derived from these items. Economic benefits also include benefits from using the asset that could be realized from a commercial transaction with a third party. However, economic benefits arising from ownership of the identified asset (e.g., tax benefits related to excess tax depreciation and investment tax credits) are not considered economic benefits derived from the use of the asset.

A customer has the right to direct the use of an identified asset throughout the period of use when either:

- The customer has the right to direct how and for what purpose the asset is used throughout the period of use.
- The relevant decisions about how and for what purpose the asset is used are predetermined and the customer either (1) has the right to operate the asset, or direct others to operate the asset in a manner it determines, throughout the period of use without the supplier having the right to change the operating instructions or (2) designed the asset, or specific aspects of the asset, in a way that predetermines how and for what purpose the asset will be used throughout the period of use.

When evaluating whether a customer has the right to direct how and for what purpose the asset is used throughout the period of use, the focus should be on whether the customer has the decision-making rights that will most affect the economic benefits that will be derived from the use of the asset. The decision-making rights that are most relevant are likely to depend on the nature of the asset and the terms and conditions of the contract. The standard also says that if the customer has the right to control the use of an identified asset for only a portion of the term of the contract, the contract contains a lease for that portion of the term.

For most real estate contracts, the landlord does not have a substantive substitution right. Further, the tenant generally has exclusive use of the leased property and therefore has the right to substantially all of the economic benefits from its use. The tenant also generally has the right to direct the use of the underlying property because the tenant decides how and for what purpose the property will be used. For example, in a lease of a retail unit, the tenant generally decides the mix of products that will be sold and the sales price for those products, and has the sole discretion to change such decisions.

Property leases often contain clauses requiring the tenant to maintain the property and/or allowing the landlord to inspect the condition of the property. Such clauses are designed to protect the landlord's interest in the property and are examples of protective rights, which do not, by themselves, prevent the tenant from having the right to direct the use of the property.

If a lease involves land and other assets, the right to use land is accounted for as a separate component unless the effect of doing so is insignificant.

How we see it

We believe that the assessment of whether a real estate contract is or contains a lease will be straightforward in most arrangements and real estate entities will generally reach conclusions that are similar to those they reach today.

Identifying and separating components of a contract and allocating contract consideration

Identifying and separating lease components

For contracts that contain the rights to use multiple assets but not land (e.g., a building and equipment, multiple buildings), the right to use each asset is considered a separate lease component if both of these conditions are met: (1) the lessee can benefit from the right of use either on its own or together with other resources that are readily available to the lessee and (2) the right of use is neither dependent on, nor highly interrelated with, the other right(s) to use the underlying assets in the contract. However, for contracts that involve the right to use land and other assets (e.g., land and a building), ASC 842 requires an entity to classify and account for the right to use land as a separate lease component, even if the criteria above for separating lease components are not met, unless the accounting effect of not separately accounting for land is insignificant.

Identifying and separating non-lease components of a contract

Many contracts contain a lease coupled with an agreement to purchase or sell other goods or services (non-lease components). For these contracts, the non-lease components are identified and accounted for separately from the lease component, in accordance with other US GAAP. For example, the non-lease components may be accounted for as executory arrangements by lessees (customers) or as contracts subject to ASC 606, *Revenue from Contracts with Customers,* by lessors (suppliers). ASC 842 provides a practical expedient that permits lessees to make an accounting policy election (by class of underlying asset) to account for each separate lease component of a contract and its associated non-lease components as a single lease component.

Lessees that do not make an accounting policy election to use this practical expedient are required to allocate the consideration in the contract to the lease and non-lease components on a relative standalone price basis. Lessees are required to use observable standalone prices (i.e., prices at which a customer would purchase a component of a contract separately) when readily available. If observable standalone prices are not readily available, lessees estimate standalone prices, maximizing the use of observable information. A residual estimation approach may be appropriate when the standalone price for a component is highly variable or uncertain.

Lessors are generally required to apply ASC 606 to allocate the consideration in a contract between the lease and non-lease components on a relative standalone selling price basis. The standalone selling price is the price at which an entity would sell a promised good or service separately to a customer. When standalone selling prices are not directly observable, the lessor must estimate the standalone selling price. The guidance in ASC 606 also provides suitable methods for estimating the standalone selling price.

A lessor allocates any variable payment amounts specifically related to the lessor's efforts to transfer goods or services that are not a lease component entirely to the non-lease component(s) to which the variable payment specifically relates if doing so would be consistent with the transaction price allocation objective in ASC 606-10-32-28.[1] If any part of the variable payment amounts relate to the lease component, even partially, a lessor treats the entire variable payment as a variable lease payment. A lessor recognizes the variable lease payments as income in the period when the changes in facts and circumstances on which the variable payment is based occur.

Considerations for real estate lessors — tenant reimbursements

Under ASC 840, lease-related executory costs (e.g., insurance, maintenance, taxes) are considered part of the lease component (or lease element) when lease and non-lease elements are separated. Under ASC 842, payments for maintenance activities, including common area maintenance (CAM) (e.g., cleaning the lobby of a building, removing snow from a parking lot for employees and customers) and other goods or services transferred to the lessee (e.g., providing utilities or trash removal) are considered non-lease components. As a result, real estate lessors will be required to apply ASC 606 to allocate and recognize consideration related to reimbursements for CAM, maintenance activities and other goods or services provided to the lessee if doing so is consistent with the transaction price allocation objective in ASC 606, unless the consideration received is variable and relates, at least partially, to the lease component.

Lessors will evaluate the criteria in ASC 606 to determine whether the distinct services provided to the lessee are a single (or multiple) performance obligation(s). If the services meet the criteria to be considered a series of services that are "substantially the same and have the same pattern of transfer" to the lessee, they are accounted for as a single performance obligation. Any variable consideration received for performing these services may be eligible for the variable consideration "allocation exception" in ASC 606. That is, variable consideration (e.g., pro-rata reimbursement) is allocated to a specific part of the contract (e.g., a distinct month of services) and recognized, if both:

- The terms of a variable payment relate specifically to the entity's efforts to satisfy the performance obligation or transfer the distinct service.
- Allocating the variable amount of consideration entirely to the performance obligation or the distinct service is consistent with the overall allocation objective of ASC 606.

This allocation exception is only used to recognize variable consideration.

Fixed reimbursements for services provided are accounted for using the standard model in ASC 606. That is, lessors will allocate the consideration in the contract between the lease and non-lease components using the principles in ASC 606 and recognize the consideration allocated to the non-lease component(s) (i.e., the transaction price under ASC 606) as it transfers control[2] of the services (i.e., as it provides the services) to the lessee over the term of the contract.

How we see it

ASC 842 requires that lessors account for consideration related solely to services provided using the guidance in ASC 606. If the variable consideration allocation exception criteria in ASC 606 are met, the resulting pattern of revenue recognition for many arrangements may be consistent with how entities recognize such operating lease and lease related revenue today.

Lessors may allocate variable consideration they receive for services to the period in which they perform those services, if certain criteria are met.

In some leases, a lessee also may reimburse (or make certain payments on behalf of) the lessor that relate to the leased asset (e.g., insurance premiums and real estate taxes associated with the lessor's asset). Under ASC 842, insurance that protects the lessor's interest in the underlying asset and taxes related to the asset are not separate components of the contract because they do not represent payments for goods or services (i.e., the payments are for the use of the leased asset and are attributable to the lease component). Entities should evaluate whether lease payments made for insurance that protects the lessor's interest in the underlying asset and taxes relating to such asset are fixed (or in-substance fixed) lease payments or variable lease payments. See "Variable lease payments" section below for further discussion of the accounting for variable lease payments.

Considerations for real estate lessors — lease structures

As described above, real estate lease arrangements most often require that the tenant (1) provide consideration (e.g., monthly payment) to the lessor for use of the leased space and (2) separately reimburse the lessor for its share of operating costs (e.g., CAM, real estate taxes, insurance associated with the lessor's asset). However, other types of real estate structures also exist.

Certain real estate lease arrangements require the lessee to remit a single monthly payment that compensates the lessor for use of the property, including the related ownership costs of the building (e.g., taxes, insurance) and other services. Today, many lessors recognize the single payments received from these "gross lease" arrangements as lease revenue on a straight-line basis. In contrast, ASC 842 requires that entities determine whether such an arrangement contains non-lease components (e.g., maintenance or other CAM services) and allocate consideration to those components based on their standalone selling prices.

How we see it

Identifying non-lease components of contracts (e.g., CAM) may change practice for some lessors in the real estate industry. Today, entities may not focus on identifying lease and non-lease components because their accounting treatment (e.g., the accounting for variable payments from an operating lease and an executory contract) is often the same.

Lease classification

At lease commencement, a lessee classifies a lease as a finance lease and a lessor classifies a lease as a sales-type lease if the lease meets any of the following criteria:

- The lease transfers ownership of the underlying asset to the lessee by the end of the lease term.
- The lease grants the lessee an option to purchase the underlying asset that the lessee is reasonably certain to exercise.
- The lease term is for a major part of the remaining economic life of the underlying asset. This criterion is not applicable for leases that commence at or near the end of the underlying asset's economic life.
- The present value of the sum of the lease payments and any residual value guaranteed by the lessee that is not already included in the lease payments equals or exceeds substantially all of the fair value of the underlying asset.
- The underlying asset is of such a specialized nature that it is expected to have no alternative use to the lessor at the end of the lease term.

A lessee classifies a lease as an operating lease when it does not meet any of the criteria above.

A lessor classifies a lease as a direct financing lease when none of the criteria above are met but the lease meets **both** of the following criteria:

- The present value of the sum of lease payments and any residual value guaranteed by the lessee and **any other third party unrelated to the lessor** equals or exceeds substantially all of the fair value of the underlying asset.
- It is probable that the lessor will collect the lease payments plus any amount necessary to satisfy a residual value guarantee.

A key difference between the sales-type lease and direct financing lease classification tests is the treatment of residual value guarantees provided by unrelated third parties other than the lessee. Those third-party guarantees are excluded from the evaluation of the "substantially all" criterion in the sales-type lease test. However, they are included in the evaluation in the direct financing lease test. In addition, the evaluation of the collectibility of lease payments and residual value guarantees affects direct financing lease classification, whereas it does not affect sales-type lease classification. However, the evaluation of collectiblity does affect sales-type lease recognition and measurement.

For lessors, all leases not classified as sales-type leases or direct financing leases are classified as operating leases.

Lessees and lessors are required to reassess lease classification upon a modification (i.e., a change to the terms and conditions of the contract that results in a change in the scope of or the consideration for the lease) that does not result in a separate contract. Lessees also are required to reassess lease classification when there is a change in their assessment of either the lease term or whether they are reasonably certain to exercise an option to purchase the underlying asset.

ASC 842 also makes the following changes to today's classification guidance that will affect real estate entities:

- ASC 842 eliminates the real estate-specific classification criteria in ASC 840. For example, under ASC 840, only the "transfer of ownership" and "bargain purchase" criteria are considered when evaluating the classification of land leases. As a result, the classification of some land lease arrangements could change under ASC 842.
- Under today's guidance, if a lease involves land and a building, an entity must separately evaluate the classification of the land and building if the fair value of the land is 25% or more of the total fair value of the property. ASC 842 eliminates this requirement. However, as discussed above, an entity is still required to assess classification of separate lease components if a lease involves land and other assets unless the accounting effect of doing so would be insignificant.
- ASC 842 eliminates today's requirement that, in order for a lease of real estate to be classified as a sales-type lease, the lessor must transfer title to the lessee prior to the end of the lease term.
- ASC 842 eliminates today's requirement for lessors to classify leases of part of a building as operating leases when the cost and fair value of the leased portion is not objectively determinable. Under ASC 842, entities do not have to apply the "lease payments" criterion if the fair value of the underlying asset cannot be practicably determined (i.e., without undue cost or effort) but do have to apply the other classification criteria. As a result, a lease of part of a building could be a sales-type or direct financing lease if any other criteria are met.

How we see it

An entity that leases an entire building (i.e., 100% of the building) is inherently leasing the land underneath the building and would potentially account for the land and the building as separate lease components. However, this would not necessarily be the case when an entity only leases part of the building (e.g., one floor of a multi-story building).

Lessor accounting

Operating leases

ASC 842 requires lessors to account for operating leases in a manner similar to how they account for operating leases under ASC 840. That is, lessors continue to recognize the underlying asset, and lease payments for which collectibility is probable at lease commencement are recognized over the lease term on a straight-line basis unless another systematic and rational basis better represents the pattern in which benefit is expected to be derived from the use of the underlying asset. However, when collectibility of lease payments is not probable at the commencement date for an operating lease (including a lease that would otherwise have qualified as a direct financing lease if it had met the related collectibility requirements), lease income is limited to the lesser of (1) the straight-line amount and (2) the lease payments, including any variable lease payments, that have been collected from the lessee.

The FASB said in the Basis for Conclusions for operating leases (BC 326–327) that "recognizing rental income on a straight-line basis often will reflect the pattern in which income is earned from the underlying asset." However, the FASB said "that will not always be the case" and decided that a lessor can recognize rental income on another systematic and rational basis if it is more representative of the pattern in which benefit is expected to be derived from the use of the underlying asset. The FASB further said 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)."

How we see it

Determining that lease payments in an operating lease should be recognized on a basis other than straight line will likely require judgment. There might not be a clear distinction between increases in scheduled lease payments that reflect the pattern in which lease income is earned (e.g., "stepped" increases to compensate the lessor for changes in the market rentals) and other scheduled increases that do not.

Sales-type leases

Under ASC 842, lessors account for sales-type leases using an approach that is similar to ASC 840's sales-type lease accounting. That is, lessors derecognize the carrying amount of the underlying asset, recognize the net investment in the lease and recognize any selling profit or selling loss[3] in net income. However, if collection of lease payments and any residual value guarantee provided by the lessee is not probable at lease commencement, a lessor does not derecognize the underlying asset and does not recognize its net investment in the lease. Instead, a lessor continues to account for the underlying asset using other GAAP and recognizes lease payments received, including variable lease payments that do not depend on an index or rate, as a deposit liability until the earlier of either of the following:

ASC 842 eliminates today's real estate-specific classification criteria.

- Collection of lease payments, plus any amounts necessary to satisfy a residual value guarantee provided by the lessee, becomes probable.
- Either (1) the contract is terminated, and the lease payments received from the lessor are nonrefundable, or (2) the lessor repossesses the underlying asset and has no further obligation to the lessee under the contract and the lease payments received from the lessee are nonrefundable.

Direct financing leases

Lessors account for direct financing leases using an approach that is similar to the accounting for sales-type leases for which collectibility is probable. However, for a direct financing lease, any selling profit is deferred at lease commencement and included in the initial measurement of the net investment in the lease. The lessor recognizes interest income over the lease term in an amount that produces a constant periodic discount on the remaining balance of the net investment in the lease.

Lessee accounting

At the commencement date of a lease, a lessee recognizes a liability to make lease payments (i.e., the lease liability) and an asset representing the right to use the underlying asset during the lease term (i.e., the right-of-use asset).

The initial recognition of the right-of-use asset and the lease liability is the same for finance leases and operating leases, as is the subsequent measurement of the lease liability. However, the subsequent measurement of the right-of-use asset for finance leases and operating leases differs under ASC 842. For finance leases, lessees are required to separately recognize the interest expense on the lease liability and the amortization expense on the right-of-use asset. This generally results in a front-loaded expense recognition pattern, which is consistent with the subsequent measurement of capital leases under ASC 840. The periodic lease expense for operating leases is generally recognized on a straight-line basis, similar to the accounting for operating leases under ASC 840.

Real estate entities that are lessees (e.g., a lessee in a ground lease arrangement) need to consider the effect of ASC 842 on their financial statements. In some circumstances, the lease liabilities and right-of-use assets recognized under ASC 842 could be significant.

How we see it

The requirement in ASC 842 that lessees recognize assets and liabilities for most leases could affect the leasing strategies of tenants of real estate entities. For example, certain tenants that today enter into net leases of single-tenant properties may make different decisions about whether to lease or buy. In addition, some tenants may seek to negotiate shorter lease terms than they currently have in order to reduce the amounts of the assets and liabilities they will need to record. Many factors will influence a tenant's decisions, including the nature of its business, its access to capital and its real estate strategy.

Refer to the appendix for examples of lessee accounting for a finance lease and an operating lease.

Initial direct costs only include costs that would not have been incurred if a lease had not been obtained (e.g., commissions).

Short-term leases recognition and measurement exemption

Lessees can make an accounting policy election (by class of underlying asset to which the right of use relates) to apply accounting similar to ASC 840's operating lease accounting to leases that, at the commencement date, have a lease term of 12 months or less and do not include an option to purchase the underlying asset that the lessee is reasonably certain to exercise (short-term leases). If an entity applies this exception, short-term leases are not recognized on the balance sheet and the related lease expense is recognized on a straight-line basis over the lease term.

Other considerations

Initial direct costs

Under ASC 842, initial direct costs are incremental costs that would not have been incurred if the lease had not been obtained (e.g., commissions, payments made to an existing tenant to incentivize that tenant to terminate its lease). Lessees and lessors apply the same definition of initial direct costs. ASC 842's guidance on initial direct costs is consistent with the concept of incremental costs of obtaining a contract in the new revenue recognition standard.

ASC 842 requires lessors to recognize initial direct costs for operating leases as expenses over the lease term on the same basis as lease income. Lessors include initial direct costs in the initial measurement of their net investments in direct financing leases and sales-type leases with no selling profit or loss. However, initial direct costs related to sales-type leases with selling profit or loss are expensed at lease commencement.

How we see it

The new standard's requirement that only costs that wouldn't be incurred if a lease hadn't been obtained qualify as initial direct costs will change practice for many real estate lessors. Lessors will no longer be able to include allocated costs (e.g., salaries) and costs that are incurred regardless of whether the lease is obtained (e.g., certain legal advice) in initial direct costs.

ASC 842 requires lease modifications that meet certain criteria to be accounted for as a separate contract.

Sale and leaseback transactions

Because lessees are required to recognize most leases on the balance sheet (i.e., all leases except for short-term leases if the lessee makes an accounting policy election to use this exemption), sale and leaseback transactions no longer provide lessees with a source of off-balance sheet financing.

ASC 842 requires seller-lessees and buyer-lessors to consider the new revenue recognition standard and other criteria in ASC 842 (e.g., a sale with a finance leaseback would not qualify as a sale) to determine whether a sale has occurred. If control of an underlying asset passes to the buyer-lessor, the transaction is accounted for as a sale (or purchase) and a lease by both parties. If not, the transaction is accounted for as a financing by both parties.

ASC 842 also eliminates today's real estate-specific guidance for sale and leaseback transactions involving real estate, including ASC 840's requirement that the seller-lessee evaluate whether the sale of real estate satisfies the criteria of ASC 360-20, *Real Estate Sales*. Under ASC 840, even when these criteria are met, up-front gain recognition is generally prohibited (i.e., deferral and amortization of the gain are required) if substantially all of the property sold is leased back.

How we see it

The elimination of today's real estate-specific guidance, including the restrictions for sale and leaseback transactions, is a significant change. We generally expect more sale and leaseback transactions involving real estate to be accounted for as sales and subsequent leasebacks under the new standard than under today's guidance. Requiring the buyer-lessor to consider the revenue recognition guidance to determine whether it has obtained control the underlying property also would be a change in practice.

Lease modifications

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

In a change from today's guidance, lessees and lessors account for a lease modification as a separate contract (i.e., separate from the original contract) when both of the following conditions are met:

- The modification grants the lessee an additional right of use not included in the original lease (e.g., a right to use an additional underlying asset).
- The lease payments increase commensurate with the standalone price for the additional right-of-use, adjusted for the circumstances of the particular contract.

If both of these conditions are met, the lease modification results in two separate contracts, the unmodified original contract and a separate contract.

Refer to our Leases FRD for more details on accounting for lease modifications, including the accounting for a lease when the modification does not result in a separate new contract.

Variable lease payments

Variable lease payments that depend on an index or a rate are included in the lease payments and are measured using the prevailing index or rate at the measurement date (e.g., lease commencement date for initial measurement). Variable lease payments that do not depend on an index or rate, such as those based on performance (e.g., a percentage of sales) or usage of the underlying asset, are not included as lease payments.

Variable payments that are not based on an index or rate and are not in substance fixed are recognized in a manner similar to today's accounting. Lessees recognize expense in the period in which the obligation for those payments is incurred.[4] Lessors recognize income in the period when the changes in facts and circumstances on which the variable lease payments are based occur.

Under ASC 842, lessees are required to reassess variable lease payments that depend on an index or rate only when the lease liability is remeasured for other reasons (e.g., due to a change in the lease term). Otherwise, lessees will recognize changes to index- and rate-based variable lease payments in profit or loss in the period of the change (i.e., similar to other variable lease payments). Lessors are required to account for changes in variable lease payments that depend on an index or rate when they occur.

Next steps

- Entities should perform a preliminary assessment as soon as possible to determine how their lease accounting will be affected. Two critical first steps include (1) identifying the sources and locations of an entity's lease data and (2) accumulating that data in a way that will facilitate the application of ASC 842. For entities with decentralized operations (e.g., an entity that is geographically dispersed), this could be a complex process, given the possibility of differences in operational, economic and legal environments. Entities will also need to make sure they have processes (including internal controls) and systems in place to collect the necessary information to implement ASC 842.
- Entities also may want to monitor the discussions of the Board and others including the Securities and Exchange Commission (SEC) staff as they consider interpretations and the application of ASC 842 to common transactions.
- Real estate entities should begin to educate personnel in their leasing and tenant coordination departments about ASC 842. An entity may want these departments to evaluate its current portfolio of leases and/or prospective targets to identify tenants that may seek to alter their leasing strategies as a result of the new guidance.

Endnotes:

1 The objective when allocating the transaction price is for an entity to allocate the transaction price to each performance obligation (or distinct good or service) in an amount that depicts the amount of consideration to which the entity expects to be entitled in exchange for transferring the promised goods or services to the customer.

2 ASC 606 includes three criteria for evaluating whether control of a good or service is transferred over time. Contracts to provide services (e.g., CAM) will generally meet the criteria that "the customer simultaneously receives and consumes the benefits provided by the entity's performance as the entity performs," but an entity will need to evaluate each arrangement to reach this conclusion. Consideration from arrangements that do not meet the criteria for over time recognition is recognized at a point in time.

3 At the commencement date, selling profit and loss is calculated as the difference between the fair value of the underlying asset or the lease receivable, if lower, and the carrying amount of the underlying asset net of any unguaranteed residual asset.

4 A lessee should recognize cost from variable lease payments before the achievement of the specified target provided the achievement of the target is probable.

SCORE No. 00529-161US

ey.com/us/accountinglink

Appendix: Lessee accounting examples

The following examples illustrate a lessee's recognition and presentation of operating and finance leases under ASC 842. We are not providing examples of lessor accounting under ASC 842 because the guidance won't significantly change a lessor's recognition or presentation for most operating leases. However, lessors should understand how they will be affected by changes ASC 842 makes to other aspects of the lessor model (e.g., classification, initial direct costs, sale and leaseback transactions, accounting for sales-type and direct financing leases). See our Leases FRD for lessor accounting examples.

Illustration 1 — Lessee accounting for an operating lease

Apartment Company V (Lessee) enters into a three-year lease of office space for a satellite field office and concludes that the agreement is an operating lease. Apartment Company V agrees to pay the following annual payments at the end of each year: $10,000 in year one, $12,000 in year two and $14,000 in year three. For simplicity, there are no purchase options, payments to the lessor before the lease commencement date, lease incentives from the lessor or initial direct costs. The initial measurement of the right-of-use asset and lease liability is $33,000 using a discount rate of approximately 4.235%. Apartment Company V uses its incremental borrowing rate because the rate implicit in the lease cannot be readily determined. Apartment Company V calculates that the annual straight-line lease expense is $12,000 per year [($10,000 + $12,000 + $14,000) ÷ 3].

Analysis: At lease commencement Apartment Company V would recognize the right-of-use asset and lease liability that it wouldn't recognize today:

Right-of-use asset	$ 33,000	
Lease liability		$ 33,000

To initially recognize the lease-related asset and liability

- The following journal entries would be recorded in the first year:

Lease expense	$ 12,000	
Right-of-use asset		$ 2,000
Cash		$ 10,000
Lease liability	$ 8,602	
Right-of-use asset		$ 8,602

- To record lease expense and adjust the right-of-use asset for the difference between cash paid and straight-line lease expense (i.e., accrued rent). To adjust the lease liability to the present value of the remaining lease payments with an offset to the right-of-use asset. The adjustment of $8,602 is calculated as the initially recognized lease liability ($33,000) less the present value of remaining lease payments ($24,398) at the end of year one.

- A summary of the lease contract's accounting (assuming no changes due to reassessment) is as follows:

	Initial	Year 1	Year 2	Year 3
Cash lease payments:		$ 10,000	$ 12,000	$ 14,000
Income statement:				
Periodic lease expense (straight-line)		12,000	12,000	12,000
Prepaid (accrued) rent for period		$ (2,000)	$ –	$ 2,000
Balance sheet:				
Lease liability	$ (33,000)	$ (24,398)	$ (13,431)	$ –
Right-of-use asset				
Lease liability	$ 33,000	$ 24,398	$ 13,431	$ –
Adjust: prepaid/(accrued) rent (cumulative)	–	(2,000)	(2,000)	–
Right-of-use asset	$ 33,000	$ 22,398	$ 11,431	$ –

- Immaterial differences may arise in the re-computation of amounts in the example above due to rounding.

Illustration 2 — Lessee accounting for a finance lease

Office Owner D (Lessee) enters into a three-year ground lease for a parking lot adjacent to an office building it owns and concludes that the agreement is a finance lease because it contains a purchase option that the lessee is reasonably certain to exercise. Office Owner D agrees to make the following annual payments at the end of each year: $10,000 in year one, $12,000 in year two and $14,000 in year three. For simplicity, there are no purchase options, payments to the lessor before the lease commencement date, lease incentives from the lessor or initial direct costs. The initial measurement of the right-of-use asset and lease liability is $33,000 (present value of lease payments using a discount rate of 4.235%). Office Owner D uses its incremental borrowing rate because the rate implicit in the lease cannot be readily determined. Office Owner D amortizes the right-of-use asset on a straight-line basis over the lease term.

Analysis: At lease commencement, Office Owner D would recognize the right-of-use asset and lease liability in a manner similar to what it would do today:

Right-of-use asset	$ 33,000	
Lease liability		$ 33,000

To initially recognize the lease-related asset and liability

- The following journal entries would be recorded in the first year:

Interest expense	$ 1,398	
Lease liability		$ 1,398

To record interest expense and accrete the lease liability using the interest method ($33,000 x 4.235%)

Amortization expense	$ 11,000	
Right-of-use asset		$ 11,000

To record amortization expense on the right-of-use asset ($33,000 ÷ 3 years)

Lease liability	$ 10,000	
Cash		$ 10,000

To record lease payment

A summary of the lease contract's accounting (assuming no changes due to reassessment) is as follows:

	Initial	Year 1	Year 2	Year 3
Cash lease payments		$ 10,000	$ 12,000	$ 14,000
Lease expense recognized				
Interest expense		$ 1,398	$ 1,033	$ 569
Amortization expense		11,000	11,000	11,000
Total periodic expense		$ 12,398	$ 12,033	$ 11,569
Balance sheet				
Right-of-use asset	$ 33,000	$ 22,000	$ 11,000	$ –
Lease liability	$ (33,000)	$ (24,398)	$ (13,431)	$ –

Immaterial differences may arise in the re-computation of amounts in the example above due to rounding.

Illustration 3 — Comparing the two types of leases for lessees

This table illustrates the similarities and differences in accounting for the finance lease (see illustration 2) and the operating lease (see illustration 1):

Finance lease:

Time	Lease liability	Right-of-use (ROU) asset	Interest expense	Amortization expense	Total expense
Initial	$ 33,000	$ 33,000			
Year 1	$ 24,398	$ 22,000	$ 1,398	$ 11,000	$ 12,398
Year 2	$ 13,431	$ 11,000	1,033	11,000	12,033
Year 3	$ –	$ –	569	11,000	11,569
			$ 3,000	$ 33,000	$ 36,000

Operating lease:

Time	Lease liability	Cumulative prepaid (accrued) rent[1]	ROU asset	Lease expense
Initial	$ 33,000	$ –	$ 33,000	
Year 1	$ 24,398	$ (2,000)	$ 22,398	$ 12,000
Year 2	$ 13,431	$ (2,000)	$ 11,431	12,000
Year 3	$ –	$ –	$ –	12,000
				$ 36,000

[1] Prepaid and accrued rent amounts would not be presented separately on the balance sheet. Instead, the ROU asset would be presented on the balance sheet net of cumulative prepaid or accrued amounts (if any).

The initial measurement of the right-of-use asset and the lease liability is the same for finance and operating leases. Also, the same total lease expense is recognized over the life of the arrangement but with different income statement classification and timing of recognition. However, a lessee generally recognizes higher periodic lease expense in the earlier periods of a finance lease than it does for an operating lease.