Leases - Issues In-Depth

US GAAP

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A step closer to understanding

The FASB's new lease accounting standard ushers in a new era. Lessees will recognize most leases on-balance sheet, increasing their reported assets and liabilities – sometimes very significantly. And while lessor accounting remains substantially similar, there are some important changes. For both lessees and lessors, the details of the standard won't always match your expectations based on summary-level descriptions that you've heard, and in some cases will be surprisingly different.

The new standard impacts organizations across all industries that use leases for real estate, equipment, fleet, and automobiles, among others. Although implementation in 2019 seems a long way off, assessing the standard's impact now will allow you to develop an efficient and timely adoption plan – especially important given concurrent revenue recognition accounting change implementation efforts.

For many of you, implementation of the new standard will have broad organizational impacts beyond general accounting and financial reporting, including in areas such as legal, real estate, treasury, internal audit, IT, tax, budgeting, training, regulatory, contract management, and forecasting functions.

We trust that this edition of Issues In-Depth will give you an advantage in understanding the new standard. We take you through the standard step by step, explaining what the requirements really mean, providing examples, and giving our own observations about the requirements.

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About this publication

The purpose of this edition of Issues In-Depth is to assist you in understanding the requirements of FASB ASC Topic 842, *Leases*, which was created by the issuance of FASB Accounting Standards Update No. 2016-02, *Leases*, in February 2016.

Organization of the text

Step by step, we take you through Topic 842, using our knowledge of the FASB's leases project to provide in-depth analysis and our perspective on the requirements. We have also included a chapter on your next steps toward eventual implementation of the new requirements.

The discussion includes references to the FASB ASC (or Codification). For example, *842-10-25-1* is paragraph 25-1 of ASC Subtopic 842-10, and *ASU 2016-02.BC160* is paragraph 160 of the basis for conclusions to ASU 2016-02.

Interaction with the new revenue recognition standard, Topic 606

As you read this Issues In-Depth, you may be surprised by the level of interaction between the requirements for lessors and the requirements for suppliers under FASB ASC Topic 606, *Revenue from Contracts with Customers*. This link between the two standards acknowledges the FASB's view that leasing is, in effect, a revenue-generating activity for lessors.

For a deeper understanding of the requirements of Topic 606, see the latest news on KPMG's Financial Reporting Network.

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Comparison with current US GAAP

Throughout this Issues In-Depth, we highlight differences between Topic 842 and the current lease accounting requirements in FASB ASC Topic 840, *Leases*, and we include references to Topic 840. The significance of many of these differences will vary by entity, but this comparison provides a starting point for your analysis.

Comparison with the new International leasing standard, IFRS 16

Throughout this Issues In-Depth, we highlight what we regard as significant differences between Topic 842 and IFRS 16, *Leases*, and we include references to IFRS 16. We do not attempt to identify every difference, and we generally do not include differences that exist between the current literature, Topic 840 and IAS 17, *Leases*. To understand the differences between Topic 840 and IAS 17, see our publication, *IFRS compared to US GAAP* on KPMG's Financial Reporting Network.

Abbreviations

We use the following abbreviations in the charts and diagrams throughout this Issues In-Depth:

FV	Fair value
PV	Present value
ROU	Right-of-use (asset)
RVG	Residual value guarantee

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1 Executive summary

Transparency and comparability

Topic 842 was developed to provide financial statement users with more information about an entity's leasing activities.

– Lessees will recognize all leases, including operating leases, with a term greater than 12 months on-balance sheet
– Lessees and lessors will disclose key information about their leasing transactions.

Effective in 2019

Public business entities apply Topic 842 for interim and annual periods in fiscal years beginning after December 15, 2018.

All other entities apply Topic 842 for fiscal years beginning after December 15, 2019, and interim periods in fiscal years beginning one year later.

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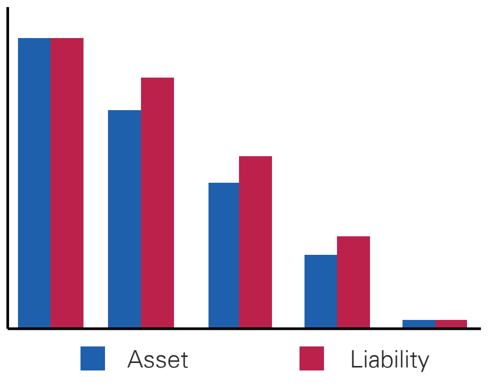
This could affect your business

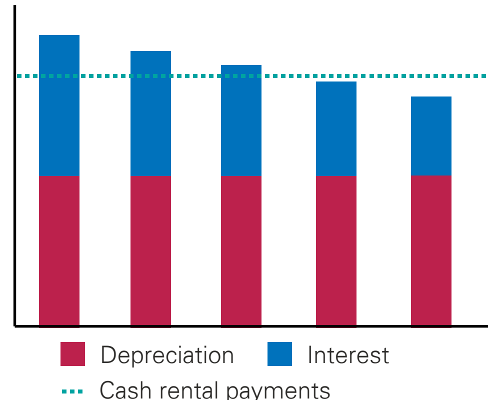
Key balance sheet measures and ratios

The effect on **lessees** will be direct, affecting investor and analyst expectations and potentially compliance with contractual covenants. For **lessors**, this may lead your customers to request shorter lease periods or different terms and conditions.

Entities with operating leases will increase their reported assets and liabilities, sometimes significantly.



Total lease expense will be front-loaded, even when rent payments are constant.



Systems, processes, and internal controls

Lessee accounting will require new significant judgments and reassessments during the lease term, which will require changes in processes and internal controls. In addition, IT systems may need to be upgraded or modified to ensure all leases are captured and the lease data necessary to apply Topic 842 are accumulated.

While **lessor** accounting will be substantially unchanged, some systems, processes, and control changes will likely be necessary as a result of the accounting changes that will result from Topic 842 and the increased disclosure requirements.

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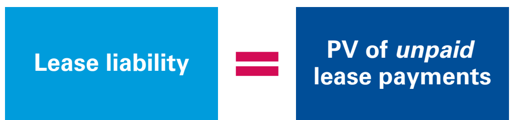
A lessee's perspective – Leases on balance sheet

The debits and credits

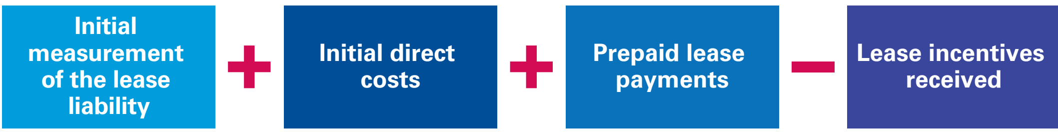
A lessee will recognize a lease liability and a right-of-use asset for all leases, including operating leases, with a term greater than 12 months, which may significantly increase reported assets and liabilities for some lessees.

The critical accounting determination will be whether a contract is or contains a lease. The lease classification distinction (which is broadly consistent with current US GAAP) will affect how lessees measure and present lease expense and cash flows – not whether the lease is on- or off-balance sheet as it does under current US GAAP.

For all leases, the lease liability is measured as follows, both initially and subsequently. Lease payments exclude contingent payments other than those that are in-substance fixed. The discount rate is the lessor's implicit rate if that rate is readily determinable; otherwise the lessee's incremental borrowing rate.

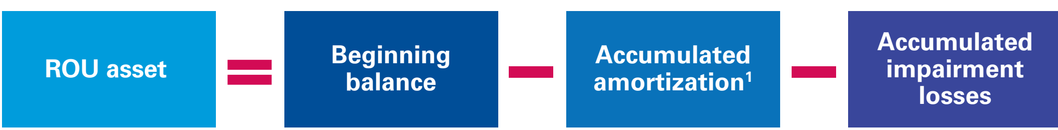


For all leases, on initial recognition the right-of-use asset is derived from the calculation of the lease liability. Topic 842 has a narrow definition of initial direct costs. Some costs incurred in negotiating and arranging a lease that are capitalized under current US GAAP will now be expensed when incurred.



The measurement of the right-of-use asset subsequent to initial recognition depends on whether the lease is a finance or an operating lease.

For **finance leases**:



Note 1:

Amortization will generally be on a straight-line basis over the lease term.

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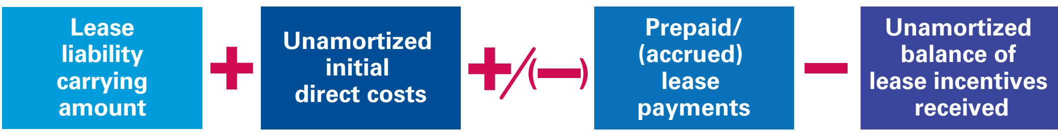
For **operating leases**, there are two possible approaches to subsequent measurement (which will yield the same result).

Method 1 derives the carrying amount of the right-of-use asset from the measurement of the lease liability at each reporting date.



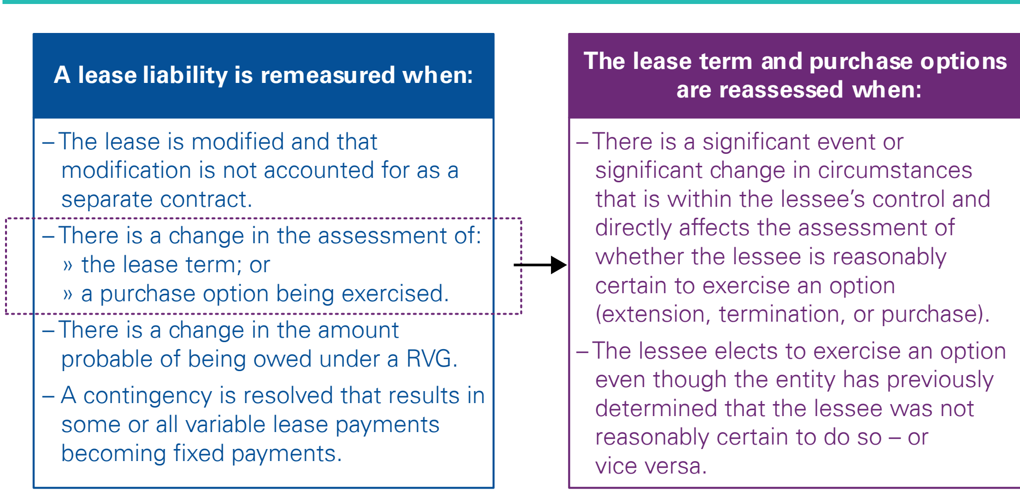
Method 2 amortizes the right-of-use asset, and the periodic amortization is a balancing figure.

Note 1:

The amortization of the right-of-use asset each period is calculated as the difference between the straight-line lease cost for the period (including amortization of initial direct costs) and the periodic accretion of the lease liability using the effective interest method.

The right-of-use asset is subject to impairment testing under Topic 360 (property, plant, and equipment). Once an operating lease right-of-use asset is impaired, the two methods above no longer apply. Instead, subsequent amortization of the right-of-use asset is calculated in the same way as for finance lease right-of-use assets – generally on a straight-line basis over the remaining lease term.

More frequent revisions to lease accounting will require new processes and controls



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Build-to-suit guidance eliminated

Topic 842 eliminates the current build-to-suit lease accounting guidance, and instead stipulates that a lessee is the accounting owner of an asset under construction when it *controls* that asset before the lease commencement date.

The new guidance on determining when a lessee controls an underlying asset before lease commencement probably will result in fewer transactions where the lessee is considered the accounting owner of an asset during the construction period. This means that fewer build-to-suit lease arrangements will become subject to the sale-leaseback guidance.

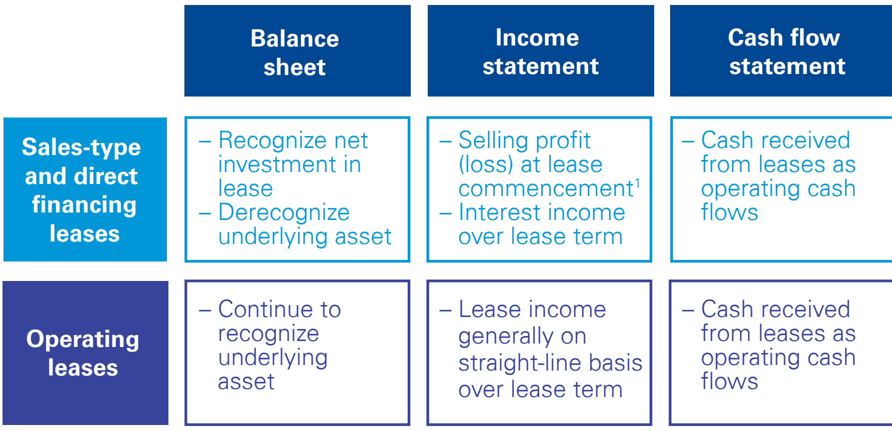
The changes to the sale-leaseback guidance make it easier for lessees to remove real estate assets recognized during the construction period from their books.

The transition provisions of Topic 842 will permit many entities to derecognize build-to-suit assets and liabilities that have remained on the balance sheet after the end of the construction period under current US GAAP.

A lessor's perspective – The devil is in the detail

Overall model substantially unchanged

A lessor will classify leases using criteria similar to current US GAAP, as (1) sales-type, (2) direct financing, or (3) operating leases. Leveraged lease classification is eliminated prospectively. Once classified, the accounting model applied to each type of lease is also substantially similar to the lessor accounting model under current US GAAP.



	Balance sheet	Income statement	Cash flow statement
Sales-type and direct financing leases	– Recognize net investment in lease – Derecognize underlying asset	– Selling profit (loss) at lease commencement[1] – Interest income over lease term	– Cash received from leases as operating cash flows
Operating leases	– Continue to recognize underlying asset	– Lease income generally on straight-line basis over lease term	– Cash received from leases as operating cash flows

Note 1:

Selling profit is recognized over the lease term for direct financing leases.

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Key concepts and definitions mostly consistent with current US GAAP

Along with the basic lessor accounting model remaining substantially unchanged, most of the key definitions and concepts relevant to lessor accounting are also consistent with current US GAAP. The following are examples.

Term	Equals
Net investment in the lease:	Lease receivable + unguaranteed residual asset
Lease receivable:	PV of lease payments + PV of guaranteed portion of estimated residual value
Unguaranteed residual asset:	PV of unguaranteed portion of estimated residual value
Lease payments:	Undiscounted fixed (including in-substance fixed) payments + optional payments (e.g. for purchase options, optional renewal periods, periods subsequent to a termination option) that are 'reasonably certain' to be owed
Discount rate for the lease:	Rate implicit in the lease, which is… The rate that causes the PV of lease payments + PV of estimated residual value = FV of the underlying asset (net of related investment tax credits) + capitalizable initial direct costs

But a change in the treatment of collectibility uncertainties

Unlike current US GAAP, a lease with collectibility uncertainties can be classified as a sales-type lease. If collectibility of the lease payments, plus any amount necessary to satisfy a lessee residual value guarantee, is not probable for a sales-type lease, lease payments received are recognized as a deposit liability (i.e. not recognized as lease income) and the underlying asset is not derecognized generally until collectibility of the remaining amounts becomes probable.

Collectibility uncertainties for a lease that otherwise would be a direct financing lease result in operating lease classification. Lease income recognized for operating leases when collectibility is not probable is limited to cash received from the lessee until collectibility of the remaining lease payments becomes probable.

Issues arising from significant lease payments

Unlike current US GAAP, leases with predominantly variable payments may be classified as sales-type or direct financing leases. Because variable lease payments are excluded from the net investment in the lease, this may result in either:

- a negative discount rate for the lease based on the definition of 'rate implicit in the lease' in Topic 842; or
- loss recognition at lease commencement.

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And a narrower definition of initial direct costs

The new definition of initial direct costs includes only those incremental costs of a lease that would not have been incurred if the lease had not been obtained, which is narrower than current US GAAP. Some costs (e.g. legal fees and allocated internal costs) that an entity is permitted to capitalize as initial direct costs under current US GAAP will be expensed when incurred under Topic 842. For some lessors, this may result in recognizing more expenses prior to the start of a lease and higher margins on lease income earned over the lease term.

Typical initial direct costs	
Include	**Exclude**
– Commissions – Payments made to an existing tenant to incentivize that tenant to terminate the lease	– Legal fees – Costs of evaluating the prospective lessee's financial condition – Costs of negotiating lease terms and conditions – General overheads

Applicable to both lessees and lessors

Allocating consideration to lease and non-lease components

Topic 842 only governs the accounting for leases. If there are lease and non-lease components (e.g. services), an entity applies Topic 842 to the lease components and other US GAAP to the non-lease components, unless a lessee elects (by class of underlying asset) to account for non-lease components as part of the lease component to which they relate.

Contract		
Lease components	Non-lease components	Not a component
Allocate consideration in the contract		Activities (or lessor costs) that do not transfer a good or service to the lessee

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The consideration in the contract is allocated in a way that maximizes the use of observable information. The **lessee** performs the allocation on a relative stand-alone price basis. The **lessor** follows the transaction price allocation guidance in the new revenue recognition standard (Topic 606).

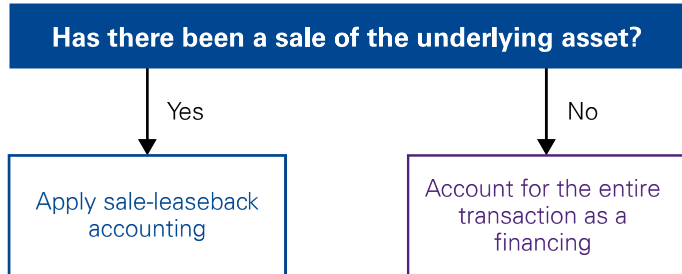
As the diagram shows, executory costs that do not represent payments for a good or service (e.g. payments to cover the lessor's costs of ownership, such as property taxes or insurance) are *not* non-lease components, and therefore payments for those costs are allocated to the lease and non-lease components in the same manner as all other payments in the contract. The result of this is that those payments will not be excluded from lease accounting as they are under current US GAAP.

Sale-leaseback accounting substantially changed

Topic 842 eliminates sale-leaseback transactions as an off-balance sheet financing proposition for **lessees**. This is because seller-lessees will recognize a right-of-use asset and lease liability in place of the underlying asset (and any asset financing repaid with the sale proceeds). Unlike current US GAAP, the sale-leaseback guidance is the same for real estate assets as it is for all other assets (e.g. equipment).

Topic 606 is used by *both* the seller-lessee and the buyer-lessor to assess whether a sale of the asset from the seller-lessee to the buyer-lessor has occurred. Purchase options will generally preclude sale accounting, unless (1) the strike price of the repurchase option is the fair value of the asset at the option exercise date, and (2) assets that are substantially the same as the underlying asset are readily available in the marketplace. This is expected to eliminate real estate sale-leaseback transactions with purchase options from qualifying for sale accounting.

In addition, sale and capital (finance) leasebacks will no longer exist; a conclusion that a leaseback is a finance (sales-type) lease will result in a conclusion that the sale-leaseback transaction does not qualify as a sale.



If the sale-leaseback transaction does not qualify as a sale, *both* the seller-lessee and the buyer-lessor account for the transaction as a financing arrangement. The seller-lessee recognizes a financial liability and continues to recognize (and depreciate) the asset, while the buyer-lessor recognizes a financial asset (i.e. a receivable).

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If the sale-leaseback transaction does qualify as a sale of the underlying asset, the seller-lessee recognizes the entire gain from the sale (subject to adjustment for off-market terms) at the time of sale rather than over the leaseback term, as is typically the result under current US GAAP. The buyer-lessor accounts for the purchase of the underlying asset in the same manner as any other purchase of a nonfinancial asset (subject to a requirement to adjust the purchase price of the underlying asset for off-market terms).

Expanded qualitative and quantitative disclosures

Topic 842 requires lessees and lessors to disclose more qualitative and quantitative information about their leases than current US GAAP. Entities will need to consider whether they have appropriate systems, processes, and internal controls to capture completely and accurately the lease data necessary to provide those expanded disclosures.

The following are examples.

Lessees	Lessors
Qualitative disclosures	
– Significant judgments and assumptions made, such as whether a contract contains a lease, stand-alone prices for lease and non-lease components, and the discount rate for the entity's leases. – Information about the nature of leases, such as the terms and conditions of variable lease payments, extension and termination options, purchase options, and residual value guarantees.	– Significant accounting judgments and estimates. – Information about the nature of leases, such as the nature of variable payment arrangements, and termination, renewal, and purchase options. – Information about how the lessor manages residual asset risk, including information about residual value guarantees and other means of limiting that risk.
Quantitative disclosures	
– Operating lease cost. – Amortization of finance lease right-of-use assets and interest on finance lease liabilities. – Variable lease cost. – Weighted-average remaining lease term, and weighted-average discount rate. – Maturity analysis of lease liabilities.	– Maturity analysis of lease receivables for sales-type/direct financing leases and of lease payments for operating leases. – Selling profit (or loss) recognized at lease commencement and interest income for sales-type/direct financing leases. – Operating lease income. – Variable lease income.

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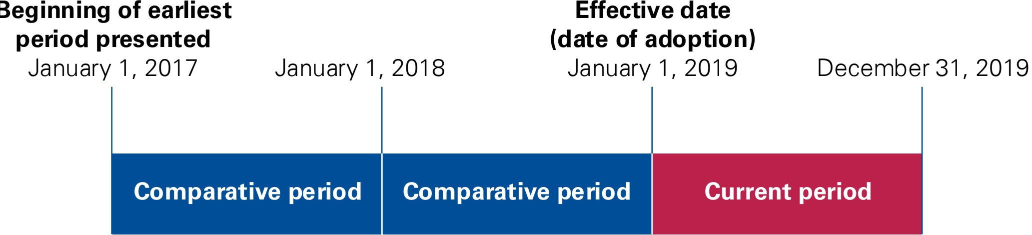
A modified retrospective transition approach, with relief

Topic 842 requires a modified retrospective transition approach, with application in all comparative periods presented. Entities will apply the new guidance at the beginning of the earliest period presented in the financial statements in which they first apply Topic 842.

If a calendar year-end public business entity adopts Topic 842 in accordance with the mandatory effective date, then the following are the relevant dates.



The standard includes certain practical expedients to ease the burden of adoption on preparers.

Package of practical expedients (all or nothing)	**Use of hindsight (elect on its own or with the package of practical expedients)**
An entity may elect not to reassess: – whether expired or existing contracts contain leases under the new definition of a lease; – lease classification for expired or existing leases; and – whether previously capitalized initial direct costs would qualify for capitalization under Topic 842.	An entity may use hindsight: – in determining the lease term, and in assessing the likelihood that a lessee purchase option will be exercised; and – for lessees, in assessing the impairment of right-of-use assets.

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2 Scope

How the standard works

- Topic 842 applies to arrangements that meet the definition of a lease except for leases of/to:
  - intangible assets;
  - explore for or use non-regenerative resources (e.g. minerals, oil, or natural gas);
  - biological assets (e.g. crops);
  - inventory; and
  - assets under construction.
- In addition, the right to use the grantor's infrastructure under a service concession arrangement is outside the scope of Topic 842.
- Leases of the following are in the scope of Topic 842:
  - non-core assets;
  - long-term leases of land; and
  - certain sales with repurchase rights (from the supplier's perspective).

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2.1 Explicit scope exclusions

2.1.10 Topic 842 is an inclusive standard, and applies to all leases (including subleases) unless there is a specific scope exclusion. The following are the specific scope exclusions from Topic 842. [842-10-15-1]

Excludes leases of/to…	Commentary
Intangible assets	Intangible assets and rights to use intangible assets continue to be accounted for under Topic 350 (intangibles – goodwill and other).
Explore for or use non-regenerative resources (e.g. minerals, oil, or natural gas)	– The scope exclusion includes the *intangible right* to explore for those natural resources, and rights to use the land in which those natural resources are contained. However, the scope exclusion does not apply if those rights of use include more than the right to explore for natural resources. – Rights to use *equipment* used to explore for natural resources are in the scope of Topic 842.
Biological assets (e.g. crops)	The scope exclusion includes leases of timber to be consistent with current US GAAP.
Inventory	Inventory is a defined term in US GAAP; only leases of assets that meet that definition are excluded from the scope of Topic 842. Therefore, the description of an asset as 'inventory' alone does not necessarily mean that a lease of that asset is outside the scope of Topic 842. – For example, sometimes entities refer to a collection of assets, such as spare parts, as inventory. If those spare parts are depreciable assets under other accounting guidance, a right to use those assets is in the scope of Topic 842.
Assets under construction	– If a lessee controls the asset under construction before the commencement date of the lease, the transaction is in the scope of the sale-leaseback guidance. – Topic 842 includes guidance (and examples) about when a lessee controls an asset that is under construction before lease commencement, and guidance on accounting for costs associated with the construction or design of the underlying asset in a lease. Section 9.4 discusses the accounting.

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KPMG observation – Assets under construction are outside scope of Topic 842

2.1.20 The Board observed that there was no clear conceptual basis for stipulating that an entity cannot lease an asset that is under construction. However, the Board concluded that the additional complexity that this concept would introduce into lease accounting was not justified by the relatively few situations (in relation to the overall volume of leases in the scope of Topic 842) in which those leases would exist. In reaching its conclusion, the Board further noted that in many cases it might be difficult to distinguish when a lessee controls the asset that is under construction itself, or controls *the right to use* that asset before construction is complete. [ASU 2016-02.BC110E]

2.2 Interaction with other standards

Derivative instruments

2.2.10 Leases that are within the scope of Topic 842 are not derivative instruments. Residual value guarantees that are subject to the guidance in Topic 842 are not subject to the guidance in Topic 815; residual value guarantees are discussed in section 5.4.6. [842-10-15-43]

2.2.20 However, a derivative instrument embedded in a lease may be subject to the requirements of Topic 815 (derivatives and hedging). For example, a third-party residual value guarantor is required to consider the guidance in Subtopic 815-10 for all residual value guarantees that it provides to determine whether they (1) are derivative instruments, and (2) qualify for any of the scope exceptions under Subtopic 815-10. [815-10-15-81]

Service concession arrangements

2.2.30 A service concession arrangement is an arrangement between a public-sector entity grantor and an operating entity under which the operating entity operates the grantor's infrastructure (e.g. airports, roads, and bridges) and may also provide construction, upgrading, or maintenance services. [853-10-15-2]

2.2.40 Although there is no explicit scope exclusion for service concession arrangements in Topic 842 itself, the consequential amendments to Topic 853 are explicit that the right to use the infrastructure in a service concession arrangement is not in the scope of Topic 842. [853-10-25-2]

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2.3 In the scope of Topic 842

Non-core assets

2.3.10 Non-core assets, such as a corporate jet or an administrative office, are not used in an entity's primary operations. Leases of non-core assets are not excluded from the scope of Topic 842. The Board's reasons included the following.

- US GAAP does not distinguish core and non-core assets that are purchases (or otherwise acquired) for purposes of recognition and measurement; therefore, it would be inconsistent to create such a distinction for leased assets.
- Conceptually, the lease of a non-core asset creates no less of a right-of-use asset or lease liability than the lease of a core asset; the same thinking applies to non-core assets that an organization purchases on a financed basis. Excluding leases of non-core assets from the scope of Topic 842 would have left material right-of-use assets and lease liabilities unrecognized. [ASU 2016-02.BC111–BC112]

Long-term leases of land

2.3.20 The scope of Topic 842 does not exclude long-term leases of land (e.g. 99- or 999-year leases). Although there is an argument that such long-term leases are economically similar to the purchase or sale of land, the Board decided against a scope exclusion. This was principally because there is no conceptual basis for differentiating long-term leases of land from leases of other assets, and inevitably any definition of a long-term lease of land would be arbitrary. [ASU 2016-02.BC113]

Certain sales with repurchase rights – supplier's perspective

2.3.30 In addition to those transactions within the scope of Topic 842, some arrangements within the scope of Topic 606 or Topic 610 (other income) in which an entity sells a nonfinancial asset to another party, but with the right or obligation to repurchase that asset from the customer, will be accounted for as leases by the supplier. [606-10-55-66 – 55-78, ASU 2014-09.BC427]

- If an entity sells an asset and also has an obligation or a right to repurchase the asset (i.e. a forward or a call option), the entity accounts for the arrangement as a lease if it can or must repurchase the asset for an amount that is less than the original selling price of the asset. If a call option is non-substantive, it should be ignored (for consistency with the general requirement for any non-substantive term in a contract). [606-10-55-68, ASU 2014-09.BC427]
- If an entity sells an asset and also has an obligation to repurchase the asset at the customer's request (i.e. a put option), the entity accounts for the arrangement as a lease if the customer has a 'significant economic incentive' to require the entity to repurchase the asset. [606-10-55-72]

2.3.40 The Board's rationale for requiring these arrangements to be accounted for as leases by the supplier is that the combined effect of the sale and repurchase agreement in each case is that the entity does not transfer control of the asset to the customer. Instead, the arrangement merely permits the customer to control the use of the asset for a period of time (which may not be defined) in exchange for consideration. [ASU 2014-09.BC424–BC431]

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KPMG observation – Unclear whether sales with repurchase rights are leases by analogy

2.3.50 The repurchase agreements guidance in Topic 606 refers to the sale of any nonfinancial asset, which includes assets that, if leased, are outside the scope of Topic 842 (e.g. intangible assets). Therefore, it is unclear whether the Board intends for entities in this scenario to analogize to the leases guidance for sales of such assets or whether those requirements do not apply to arrangements for the sale of such assets.

KPMG observation – Suppliers and customers may account for sales with repurchase rights differently

2.3.60 Topic 606 and Topic 610 (other income) do not apply to the *customers* in sale transactions. Consequently, the customer in a sale transaction that will be accounted for as a lease by the supplier will not necessarily account for that transaction as a lease unless the arrangement meets the definition of a lease in Topic 842 (see chapter 3).

2.3.70 Customers will generally apply other guidance – (e.g. Topic 360 (property, plant, and equipment) or Topic 330 (inventory) – in determining whether, and how, to account for, the purchase. Because there is limited guidance in US GAAP about whether a purchase of an asset has occurred, we believe that customers in these arrangements with repurchase provisions may still conclude that they have purchased the asset even if Topic 606 or Topic 610 requires the supplier to account for the transaction as a lease.

2.4 Differences/changes in scope

2.4.10 The Board decided to fundamentally retain the scope of its current leasing guidance in its new leasing guidance, which means that there are only minor differences in scope between Topic 842 and current US GAAP (Topic 840). [ASU 2016-02.BC110]

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The scope of IFRS 16

GAAP differences largely carried forward

2.4.20 Like the FASB, the IASB decided to broadly retain the scope of the current standard (IAS 17) for IFRS 16. Therefore, it is largely differences between the scope of current US GAAP and current IFRS that have resulted in scope divergence between Topic 842 and IFRS 16. [IFRS 16.BC67]

Leases of intangible assets, inventory, and assets under construction

2.4.30 Unlike Topic 842, IFRS 16 does not exclude from its scope leases of intangible assets (other than licenses of intellectual property granted by a lessor within the scope of IFRS 15, and rights held by a lessee under licensing arrangements within the scope of IAS 38 (intangible assets) for such items as motion picture films, video recordings, etc.), inventory, or assets under construction. The current IFRS leases guidance (IAS 17) similarly differs from the scope of the current US GAAP leases guidance (Topic 840) with respect to those leases. [IFRS 16.3, BC68]

Comparison with current US GAAP

2.4.40 In general, the scope of Topic 842 is consistent with the scope of the current US GAAP leases guidance in Topic 840, with only a couple of relatively minor differences.

Sale of an asset with a seller-provided residual value guarantee

2.4.50 Before the adoption of Topic 606, which is not yet effective, arrangements in which the seller of an asset provides a guarantee of the asset's future residual value to the buyer are accounted for as leases by the seller under US GAAP, regardless of whether the buyer has to return the asset to the seller to receive a guarantee payment. [840-10-55-14 (before ASU 2014-09)]

2.4.60 On the adoption of Topic 606, a seller residual value guarantee will not necessarily preclude sale accounting by the seller and, therefore, require the seller to account for the transaction as a lease. As a result, some arrangements involving seller residual value guarantees that are accounted for as leases under current US GAAP will not be accounted for as leases once the guidance in Topic 606 becomes effective. An arrangement in which the seller has the right or the obligation (i.e. call option or forward) to reacquire the asset *may* be accounted for as a lease by the seller depending on the terms of the repurchase agreement. [606-10-55-66 – 55-78]

2.4.70 The arrangement would be accounted for as a lease if the seller can or must repurchase the asset for an amount that is less than the price at which the asset was sold (unless the contract is part of a sale and leaseback transaction). A vendor (or supplier) with an arrangement of this nature will need to consider the guidance in Topic 842 and the repurchase agreements guidance in Topic 606.

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No mention of heat supply contracts for nuclear fuel

2.4.80 Current US GAAP explicitly *includes* heat supply contracts for nuclear fuel that meet the definition of a lease within the scope of the lease accounting requirements, while the guidance in Topic 842 does not. Entities will need to apply the general requirements of Topic 842 to determine whether those types of contracts are within its scope. In addition, because nuclear fuel leases are not explicitly excluded from the scope of Topic 842, entities will have to consider whether such arrangements meet the definition of a lease (see chapter 3). [840-10-15-9, 55-7]

The scope of IFRS 16 – Summary comparison table

2.4.90 The following table:

- identifies arrangements that do and do not fall within the scope of IFRS 16 and Topic 842; and
- compares the scope of IFRS 16 and Topic 842 with the scope of current IFRS and current US GAAP.

	In Scope?			
Arrangement	**IAS 17[1]** (legacy)	**IFRS 16** (new)	**ASC 840** (legacy)	**ASC 842** (new)
Leases of tangible assets	✔	✔	✔	✔
Long-term leases of land	✔	✔	✔	✔
Sale-leaseback transactions	✔	✔	✔	✔
Subleases	✔	✔	✔	✔
Leases of inventory	✔	✔	✘	✘
Leases of intangible assets	W/E	W/E	✘	✘
Leases of biological assets[2]	NBM	✘	✘	✘
Investment property[3]	NBM	NBM	N/A	N/A
Right-of-use assets of property, plant and equipment that are measured at a revalued amount in accordance with IAS 16	N/A	NBM	N/A	N/A
Leases to explore for or use minerals, oil, natural gas, etc.	✘	✘	✘	✘
Service concession arrangements	✘	✘	✘	✘
Leases of assets under construction	✔	✔	✘	✘

✔ In-scope

✘ Not in-scope

W/E – In scope, but with exceptions (see 2.4.30)

NBM – In scope, but standard not applied as the basis for measurement

N/A – Not applicable (i.e. no existing guidance for this specific type of arrangement)

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Notes:

1. Including IFRIC 4 (arrangements containing leases).
2. IAS 41 (agriculture) applies to biological assets held by lessees under finance leases and biological assets provided by lessors under operating leases. The requirements of IAS 17 apply to all other aspects of lease accounting for these assets.
3. IAS 40 (investment property) applies to the measurement of investment property provided by lessors under operating leases and for property held by lessees that is accounted for as investment property. The requirements of IAS 17 apply to all other aspects of lease accounting for these assets.

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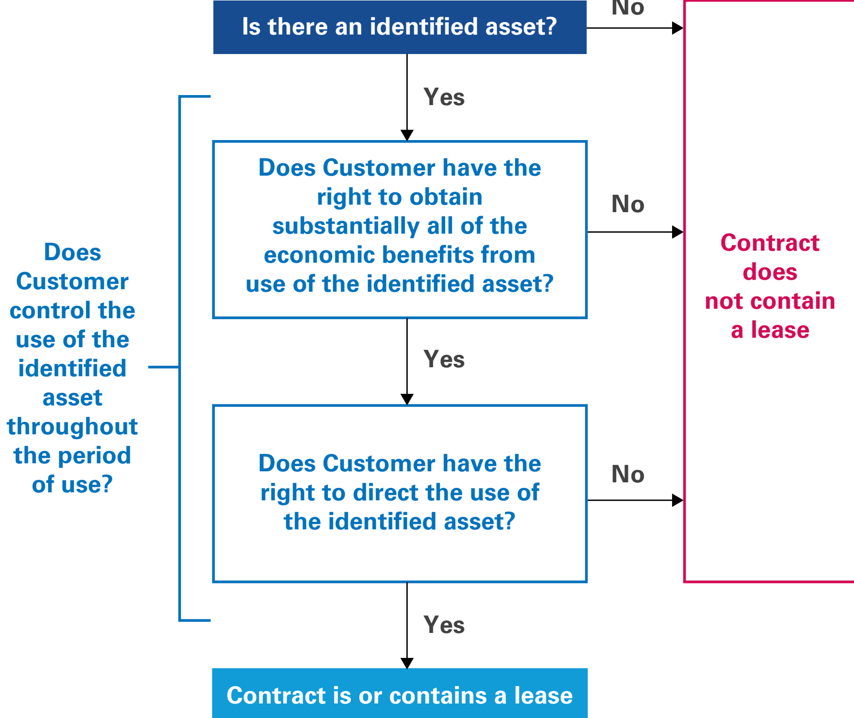
3 Definition of a lease

How the standard works

An entity assesses at contract inception whether that contract is, or contains, a lease. A contract is, or contains, a lease if the contract conveys the right to control the use of an identified asset (land or a depreciable asset) for a period of time in exchange for consideration.

The key elements of the definition are:



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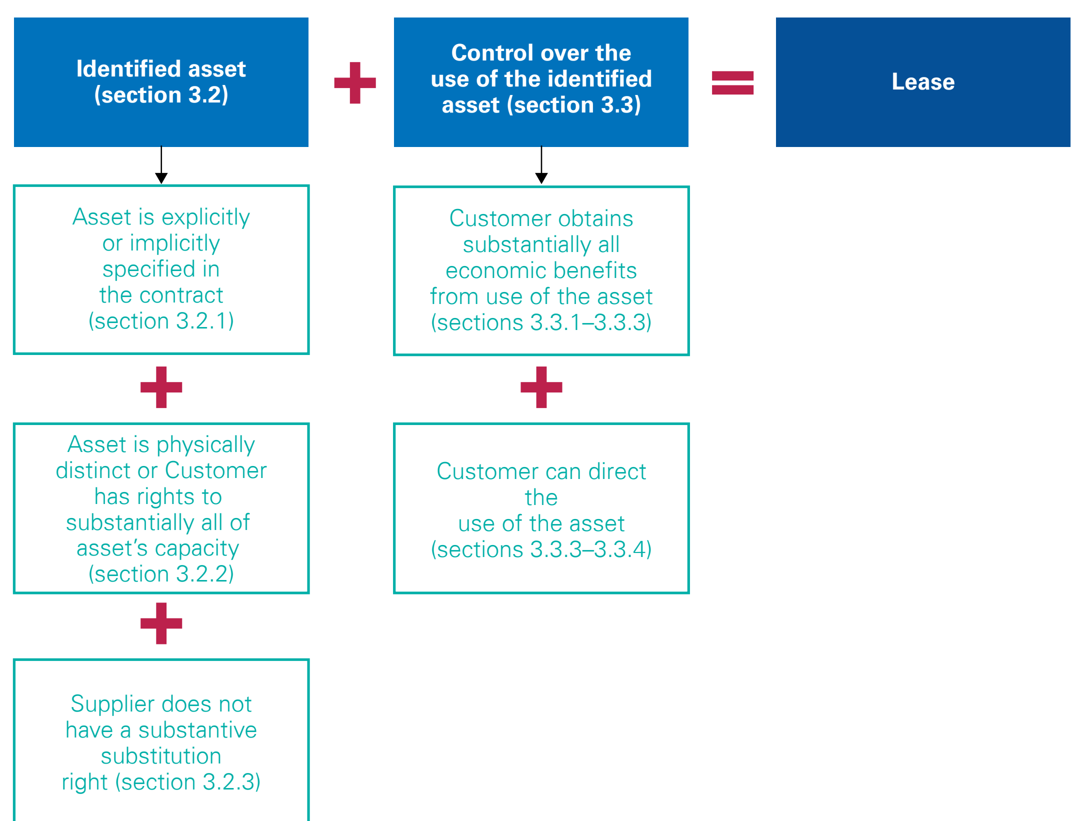
3.1 An overview

3.1.10 A lease is a contract (or part of a contract) that conveys the right to control the use of identified property, plant, or equipment (an identified asset) for a period of time in exchange for consideration. A period of time may be described in terms of a specified amount of use of an identified asset – e.g. the number of production units an item of equipment will be used to produce. [842-10-15-3]

3.1.20 Both parties to a contract (the customer and the supplier) evaluate at inception of the contract whether it is or contains a lease. An entity does not reassess whether a contract is or contains a lease unless the terms and conditions of the contract are changed. [842-10-15-2, 15-6 – 15-7]

3.1.30 The following diagram highlights the two conditions required to meet the definition of a lease, plus the specific tests that must be passed to meet those conditions, which are discussed in this chapter.



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3.1.40 The definition of a lease is converged between Topic 842 and IFRS 16, and the two conditions necessary to meet that definition are familiar under current US GAAP:

- there is an identified asset in the contract that is land or a depreciable asset (i.e. property, plant, or equipment); and
- the customer has the right to control the use of the identified asset.

3.1.50 While those two conditions appear similar to the requirements for identifying a lease under current US GAAP, important details have changed. Most notably, the second condition (i.e. the customer must have the right to control the use of the identified asset) is now more closely aligned with how control is defined and applied in the consolidation guidance (Topic 810) and the new revenue recognition standard (Topic 606). This is because, while an entity has to consider the customer's right to obtain the output or other utility from use of the identified asset under current US GAAP (which is similar to evaluating the customer's right to obtain the economic benefits from use of the underlying asset under Topic 842), the concept of evaluating whether the customer has the right to direct the use of the identified asset (a 'power' element of control) is new to the leases guidance.

3.1.60 In most cases, a customer will have the right to direct the use of an identified asset if it can direct (and change) 'how and for what purpose' the asset will be used throughout the 'period of use' (see section 3.3.5). However, if how and for what purpose the asset will be used is determined before the beginning of the period of use (e.g. predetermined in the contract or by the design of the asset), a customer still directs the use of the asset if it has either (1) operational control over the asset, or (2) had control over the design of those aspects of the asset that predetermine how and for what purpose it will be used.

3.1.70 Determining whether a contract contains a lease is an important step under Topic 842. When a contract contains a lease, the core principle of Topic 842 is that the customer (lessee) should recognize both a lease liability for its obligation to make lease payments to the supplier (lessor) and a right-of-use asset reflecting its right to use the underlying asset during the lease term. Whether a contract is or contains a lease also triggers specific disclosure requirements for lessees *and* lessors. Consequently, properly identifying leases is important to all entities, regardless of their role as customer or supplier in the arrangement.

3.1.80 Throughout this chapter, the 'period of use' is referred to in looking at the economic benefits to which the customer has rights, and the power that the customer has to control the use of the asset. The period of use is the total period of time that an asset is used to fulfill a contract with a customer, including the sum of any non-consecutive periods of time. [842 Glossary]

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KPMG observation – Lease definition is the new on/off-balance sheet test

3.1.90 Under current US GAAP, the critical determination in lessee accounting is lease classification, because lease assets and lease liabilities are recognized only for capital leases. In contrast, under Topic 842 a lessee will recognize lease assets and lease liabilities for all leases other than 'short-term leases' (see section 6.3.1), whether classified as operating or finance leases. It is therefore effectively the new test to determine whether an arrangement is on- or off-balance sheet for the customer. While the lease classification distinction continues to exist in Topic 842, it now affects how lessees measure and present lease expense and cash flows – not whether the lease is on- or off-balance sheet.

3.1.100 This change will require lessees to implement new or more robust processes and controls over the identification of leases because of the critical shift in risk points (see chapter 14).

KPMG observation – Lease identification occurs at contract inception

3.1.110 An entity determines whether a contract is or contains a lease at inception of the contract under Topic 842. When a lease exists, an entity applies the recognition and measurement provisions at the 'commencement date of the lease'.

3.1.120 Determining whether a contract is or contains a lease occurs at inception for practical reasons. Because Topic 842 establishes the lease commencement date for recognition and measurement items, while other Topics use different dates (e.g. Topic 606 measures and allocates the transaction price to performance obligations at contract inception), it is necessary to identify whether a contract includes one or more leases at contract inception to know whether the leases recognition and measurement guidance applies and, if so, which guidance (i.e. Topic 842 and/or another Topic) governs.

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KPMG observation – A straightforward analysis in most cases

3.1.130 In the Board's view, assessing whether a lease exists will be straightforward in most cases. A contract will either fail to meet, or will clearly meet, the definition of a lease without the need for significant judgment. The new definition will likely continue to easily capture most common lease arrangements (e.g. leases of vehicles, office equipment, and real estate). However, for more complicated scenarios, the Board added guidance to assist entities in their evaluations. Examples of more complicated lease identification scenarios may include some outsourcing arrangements, as well as other arrangements in which both the customer and the supplier have decision-making rights about the use of an asset; this includes some equipment arrangements where the customer makes most or all of the decisions about how and for what purpose the asset will be used (see section 3.3.4), but the supplier retains the decision-making rights over operations and/or maintenance of the equipment. [ASU 2016-02.BC127]

KPMG observation – Meaning of *period of time*

3.1.140 A lease conveys the right to control the use of an identified asset for a *period of time* in exchange for consideration. The use of the phrase 'period of time' is not intended to suggest that a lease does not exist solely because there is not an explicit period of time assigned to the customer's right to control the use of the identified asset. A period of time, for purposes of identifying a lease, may be described in terms of the amount of use of the identified asset. For example, a customer may control the use of an identified asset for the period of time it takes to produce a specified number of units, or to complete a specific task, using the identified asset. [ASU 2016-02.BC123]

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3.2 Is there an identified asset?

3.2.10 The following flowchart takes the diagram in section 3.1, and highlights in greater detail the key considerations in determining whether there is an identified asset – i.e. whether the first requirement for there being a lease is met. [842-10-15-9 – 15-16]

Is the asset specified in the contract (explicitly or implicitly)?

No → STOP – Contract does not contain a lease. Apply other GAAP.

Yes ↓

Is the asset physically distinct or does the customer have the right to receive substantially all of the capacity of that asset?

No → STOP – Contract does not contain a lease. Apply other GAAP.

Yes ↓

Does the supplier have substitution rights?

No → There is an identified asset. → Go to section 3.3

Yes ↓

Can the customer prevent the supplier from substituting the asset?

Yes → Supplier does not have a substantive substitution right. Contract depends on an identified asset.

No → Are alternative assets readily available or could they be sourced by the supplier within a reasonable period of time?

No[1] → Supplier does not have a substantive substitution right. Contract depends on an identified asset.

Yes → Would the supplier benefit economically from exercising its right of substitution (i.e. economic benefits exceed costs)?

No[1] → Supplier does not have a substantive substitution right. Contract depends on an identified asset.

Yes → STOP – Supplier has a substantive substitution right. Contract does not contain a lease. Apply other GAAP.

Supplier does not have a substantive substitution right. Contract depends on an identified asset. → Go to section 3.3

Note 1:

Or it is impractical for the customer to make this determination.

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3.2.1 Is the asset specified in the contract?

3.2.20 An identified asset may be explicitly or implicitly specified in a contract. In most cases, the asset that is the subject of the lease will be *explicitly* specified in a contract (e.g. by serial number, or a specified floor of a building). However, consistent with current US GAAP, an identified asset can be one that is *implicitly* specified. An asset is implicitly specified if the supplier does not have a substantive right to substitute alternative assets to fulfill the contract (e.g. the supplier has only one asset to fulfill the contract). [842-10-15-9, ASU 2016-02.BC128]

3.2.30 An asset can be implicitly specified even if the customer does not know whether the supplier has multiple assets or only one asset to fulfill the contract – i.e. whether the supplier has the practical ability to substitute an alternative asset. All an entity must conclude for there to be an identified asset is that fulfillment of the contract depends on an item of property, plant, or equipment (e.g. a piece of equipment) and that substitution of that asset would not be economically beneficial to the supplier. [ASU 2016-02.BC128]

3.2.40 If the customer cannot readily determine whether substitution would be economically beneficial to the supplier, the customer should assume it is *not* economically beneficial. This is discussed in section 3.2.3. [842-10-15-15]

3.2.2 Is the asset physically distinct?

3.2.50 In most cases, the asset will be a complete asset and therefore easy to identify (e.g. a building or a piece of equipment). However, a capacity portion of an asset can also be an identified asset if: [842-10-15-16]

- it is physically distinct (e.g. the floor of a building, a specified strand of a fiber-optic cable, or a distinct segment of a pipeline); or
- it is not physically distinct, but the customer has the right to receive substantially all (see 3.3.300–310) of the capacity of the asset (e.g. substantially all of the data capacity of a fiber-optic cable).

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Example 3.1
Assessing whether the asset is physically distinct

Scenario 1: Rights to a capacity portion – Not physically distinct

3.2.60 Customer enters into an arrangement with Supplier for the right to store its products in a specified climate-controlled storage warehouse (storage warehouse 3C).

3.2.70 Supplier has no substitution rights. However, the arrangement allows Supplier to store products from other customers in storage warehouse 3C. The exact space to be used by Customer within storage warehouse 3C is not specified. Instead, Supplier decides where each customer's products are stored within storage warehouse 3C and can relocate them at its sole discretion.

3.2.80 At inception of the contract, Customer has storage rights that permit Customer to use up to 60% of the capacity of storage warehouse 3C throughout the term of the contract. Supplier can use the other 40% of the warehouse as it sees fit.

Warehouse 3C

Storage rights of Customer	Storage rights of other customers

3.2.90 In this scenario, there is not an identified asset because Customer only has rights to a capacity portion of storage warehouse 3C that is not physically distinct from the remainder of the warehouse. In addition, the capacity of the storage warehouse that Customer has the right to use does not represent substantially all of the capacity of storage warehouse 3C. Because there is not an identified asset, the contract does not contain a lease.

Scenario 2: Rights to a capacity portion – Physically distinct

3.2.100 Changing the facts of Scenario 1, the contract provides Customer the right to use rooms A, B, and C within storage warehouse 3C, and Supplier has no substantive right to substitute alternative space in place of rooms A, B, and C. Rooms A, B, and C represent only 60% of storage warehouse 3C's total capacity.

Warehouse 3C

Room A	Room B	Room C	Room D	Room E
Reserved for usage by Customer				

3.2.110 In this scenario, there is an identified asset even though rooms A, B, and C represent only 60% of storage warehouse 3C's total capacity. This is because the rooms are specified in the contract, are physically distinct from other storage locations within the warehouse, and Supplier has no substantive substitution right.

3.2.120 Accordingly, the next step is for Customer to determine whether it has the right to control the use of rooms A, B, and C (see section 3.3) to determine if there is a lease.

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KPMG observation – Board decided against including all capacity portions

3.2.130 In deciding on the requirements in 3.2.50, the Board reasoned that a customer is unlikely to have the right to control the use of a capacity portion of an asset that is not physically distinct or that is less than substantially all of the capacity of the asset, because the relevant decisions about an asset's use are generally made at the whole asset level. That is, having rights to only a capacity portion of an asset (that is not substantially all of the asset's capacity), a customer will generally not have decision-making rights as to how the asset is used. [ASU 2016-02.BC133]

3.2.140 Therefore, the Board decided not to broaden the concept of an identified asset to the use of *any* capacity portion of a larger asset, because it may have forced entities to analyze all contracts for goods or services in which a customer obtains some amount of capacity from an asset as possible leases, only to then conclude that they were not leases because the customer does not have the relevant decision-making rights about the asset's use. [ASU 2016-02.BC133]

3.2.3 Does the supplier have a substantive substitution right?

3.2.150 Even if an asset is specified, there is not an identified asset (and therefore the contract does not contain a lease) if the supplier has a *substantive* right to substitute the asset throughout the period of use. A substitution right is substantive when the supplier: [842-10-15-10]

- has the practical ability to substitute alternative assets throughout the period of use; and
- would benefit economically from the exercise of its substitution right – i.e. the economic benefits that will be derived from substituting the asset exceed the costs of the substitution; for example, costs to transport/relocate the original and the alternative asset, and associated labor costs.

3.2.160 In considering whether the supplier has the practical ability to substitute alternative assets, an entity considers whether the customer can prevent substitution, and whether the supplier has ready access to an alternative asset or could source an alternative asset within a reasonable period. [842-10-15-10(a)]

3.2.170 An entity evaluates whether a supplier substitution right is substantive based on the facts and circumstances at inception of the contract. This evaluation excludes consideration of future events that, at inception, are not likely to occur.[1, 2] For example: [842-10-15-11, 55-64]

- an agreement by a future customer to pay an above-market rate for use of the asset;
- the introduction of new technology not substantially developed at contract inception;

Notes:

1. Under US GAAP, 'probable' is defined as "the future event or events are likely to occur." Therefore, we believe that 'likely to occur' is effectively the same threshold as 'probable' in Topic 405 (liabilities).
2. Example 4 in Subtopic 842-10 suggests that the Board views facts and circumstances that are "highly susceptible to factors outside of the supplier's influence" as not likely to occur. [842-10-55-63 – 55-71]

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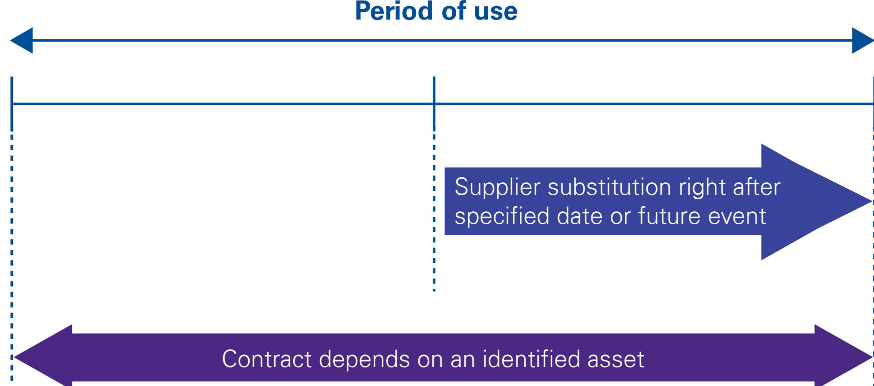
– a substantial difference between the customer's use of the asset, or the performance of the asset, and the use or performance considered likely at inception of the contract; and/or

– a substantial difference between the market price of the asset during the period of use, and the market price considered likely at inception of the contract.

3.2.180 Topic 842 provides additional guidance to assist entities in determining whether a supplier substitution right is substantive, including the following.

– When the asset is located at the customer's premises (or someplace other than the supplier's premises), the costs of substituting the asset are generally higher than when located at the supplier's premises. Accordingly, those costs are more likely to exceed the economic benefits of substitution. [842-10-15-12]

– When a supplier has a right or an obligation to substitute the asset only on or after either (1) a particular date or (2) the occurrence of a specified event, the supplier does not have the practical ability to substitute alternative assets throughout the period of use. The substitution right is not substantive because the contract restricts when the supplier can substitute the asset. As a result, there is an identified asset for the entire period of use (as illustrated in the diagram), unless or until the identified asset is actually substituted by the supplier. [842-10-15-13, ASU 2016-02.BC131]



– A supplier right or obligation to substitute the asset for repairs and maintenance, because the asset is not operating properly, or because a technical upgrade becomes available, does not preclude the customer from having the right to use an identified asset. [842-10-15-14]

3.2.190 To the extent a customer cannot readily determine whether a supplier substitution right is substantive, it should presume that the substitution right is *not* substantive. [842-10-15-15]

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Example 3.2
Substitution rights

Scenario 1: Supplier has substantive substitution right

3.2.200 Customer enters into an arrangement with Supplier for a climate-controlled storage warehouse to store its coffee beans.

3.2.210 Supplier has the right to substitute the storage warehouse without Customer's consent throughout the term of the contract. The following additional facts are relevant.

- Supplier has many identical storage warehouses that are maintained in a single, accessible location and Supplier could easily substitute another storage warehouse for the one specified in the contract at a nominal cost.
- Supplier would benefit economically from substituting the storage warehouse because substitution allows it to make the most effective use of its storage warehouse portfolio to meet regularly changing circumstances, which are likely to continue throughout the period of use.

3.2.220 In this scenario, there is *not* an identified asset, because Supplier's substitution right is substantive. Accordingly, the contract does not contain a lease.

Scenario 2: Supplier has substitution right but the underlying asset is significantly customized

3.2.230 Changing the facts of Scenario 1, although Supplier has the right to substitute the storage warehouse without Customer's consent throughout the period of use, there are no other similarly customized warehouses in Supplier's portfolio or readily available from other suppliers.

3.2.240 In this scenario, the substitution right is not substantive because a similarly customized storage warehouse is not readily available – i.e. Supplier does not have the practical ability to substitute the storage warehouse.[1] Therefore, there is an identified asset. The next step is for the entity to determine whether Customer has the right to control the use of the warehouse (see section 3.3) to determine if there is a lease.

Note 1:

Even if Supplier could customize an alternative warehouse in its portfolio within a reasonable period of time, the cost of customizing and providing a similar alternative storage warehouse would likely exceed the economic benefits that would be realized from substitution – i.e. while Supplier would not obtain additional payments from Customer for the substitution, Supplier would incur potentially significant costs to customize an alternative warehouse to Customer's needs and to relocate Customer's inventory to the alternative warehouse. In that case, Supplier's substitution right would still not be substantive because it would not benefit economically from the exercise of its substitution right.

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Scenario 3: Customer unable to determine whether substitution rights are substantive – Customer assumes substitution right is not substantive

3.2.250 Changing the facts of Scenario 2, Customer is unable to determine whether the substitution right is substantive. In particular, Customer is unable to determine whether a similarly customized storage warehouse is readily available, or whether the economic benefits that would result from substitution exceed the expected costs of making the substitution. In this scenario, Customer does not know whether Supplier has alternative warehouses or could source one in a reasonable period of time, and also does not know if Supplier would economically benefit from substituting the warehouse.

3.2.260 In this scenario, Customer presumes that the substitution right is *not* substantive, and therefore that there is an identified asset. The next step is for Customer to determine whether it has the right to control the use of the warehouse (see section 3.3) to determine if there is a lease.

Example 3.3

Supplier substitution right – Evaluation of economic benefits

3.2.270 Customer enters into a three-year lease of a multi-function copier/printer. The contract provides Customer with the right to determine how to use the machine during the three-year term (subject to the limitations of its design and capabilities).

3.2.280 Supplier is required to provide an equivalent machine to the extent the one originally delivered ceases to operate properly. Supplier may also substitute an equivalent machine at any time during the period of use at its expense and without Customer's approval.

3.2.290 Regarding Supplier's right of substitution, Supplier has other equivalent machines readily available. However, it is not likely that events or circumstances will arise from which Supplier would be able to generate more rental income by substituting an equivalent machine for the original machine than it would by leaving the original machine in place. Supplier would incur costs both to transport and install an equivalent machine at Customer's location, and to remove and transport the original machine to storage or to another customer's location.

3.2.300 In this example, Supplier's substitution right is not substantive, because the economic benefits from substituting the original machine for an alternate machine would not exceed the costs of the substitution. Therefore, there is an identified asset. The next step is for the entity to determine whether Customer has the right to control the use of the machine (see section 3.3) to determine if there is a lease.

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KPMG observation – Substantive substitution rights change the substance of the arrangement

3.2.310 Evaluating whether a supplier substitution right is substantive is effectively a test to determine whether the supplier (rather than the customer) controls the use of the asset because it can substitute that asset *throughout the period of use*. When a substitution right is substantive, meaning that the supplier can substitute and redeploy that asset as it sees fit, the supplier has the right to decide how and for what purpose the asset is used, and therefore directs its use. A substantive substitution right changes the substance of the arrangement (i.e. there is not an identified asset). [ASU 2016-02.BC128–BC129]

3.2.320 The Board believes that it will be clear in many situations whether a substitution right is substantive. However it may sometimes be difficult for a customer to make that determination. For example, a customer may not have sufficient information to perform the evaluation – e.g. assessing the supplier's costs and potential economic benefits from substituting the asset may be particularly difficult in many cases. This is why the Board included the presumption that substitution rights are *not* substantive when the customer cannot readily make that determination. Accordingly, a customer does not have to exert undue effort to prove that a substitution right is not substantive. [ASU 2016-02.BC130–BC132]

3.2.330 The specific guidance provided in Topic 842 on substitution rights, especially the condition that the supplier must benefit economically from substituting the asset in order for a substitution right to be substantive (see 3.2.150), may mitigate structuring opportunities to include substitution clauses solely to avoid there being an identified asset in the contract.

KPMG observation – Interaction between paragraphs 842-10-15-13 and 842-10-15-11

3.2.340 Paragraph 842-10-15-13 addresses whether a supplier has the practical ability to substitute alternative assets throughout the period of use. As discussed in 3.2.180, if the supplier has the right or obligation to substitute an alternative asset only on or after a specified date, or after the occurrence of a specified event, the supplier does not have the practical ability to substitute alternative assets; therefore, the substitution right is not substantive. [842-10-15-13]

3.2.350 Paragraph 842-10-15-11 applies when the supplier *has* the practical ability to substitute an alternative asset throughout the period of use and the entity (customer or supplier) is considering whether exercising that right will economically benefit the supplier. If a supplier with the practical ability to exercise a substitution right will only benefit economically from exercising that right under circumstances that are not 'likely to occur', that substitution right is not substantive. [842-10-15-11]

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3.2.360 Consider the following contrasting scenarios.

- A supplier leases a group of similar assets maintained at its premises to a customer. The supplier has the right, throughout the period of use, to substitute the leased assets and has a pool of readily available alternative assets. Relevant experience demonstrates that (1) the supplier benefits economically from being able to deploy alternative assets as necessary to fulfill customer needs, and (2) that the conditions that make substitution economically beneficial (e.g. the nature and mix of different customer needs for the supplier's assets) are likely to continue throughout the period of use. In this scenario, the supplier's substitution right is substantive.
- A supplier leases a piece of equipment to a customer. The supplier has the substantive right at any time to substitute an alternative, but generally equivalent, piece of equipment and has readily available alternative assets. However, the supplier will only benefit economically from doing so if events and circumstances change from those at lease commencement; for example, a new customer wants to lease or buy the specific piece of equipment being leased in this example and is willing to pay a premium to get it. The necessary circumstance in this case is not 'likely to occur' because it depends on factors substantially outside of the supplier's control and there is not relevant history to suggest this is likely to occur.

Comparison with current US GAAP

Identified asset concept aligns with current guidance

3.2.370 The concept of an identified asset is generally consistent with the concept of a specified asset under current US GAAP. This includes the concept that an asset is implicitly identified if the supplier does not have a substantive substitution right. The Board decided not to revise this concept because it works well in practice. However, because concluding that a contract is or contains a lease will have a more significant effect on customers' accounting compared to the current guidance, the Board also decided to provide additional guidance about when there is, or is not, an identified asset; in particular, providing significant new guidance about whether a substitution right is substantive. [840-10-15-15]

Determining whether substitution rights are substantive

3.2.380 The requirement that a substitution right must economically benefit the supplier to be substantive is a new concept. Current US GAAP focuses only on the supplier's right and ability to substitute goods or services using other property, plant, and equipment. Therefore, entities will need to consider this additional criterion under Topic 842 to determine if a supplier has a substantive substitution right. [840-10-15-5]

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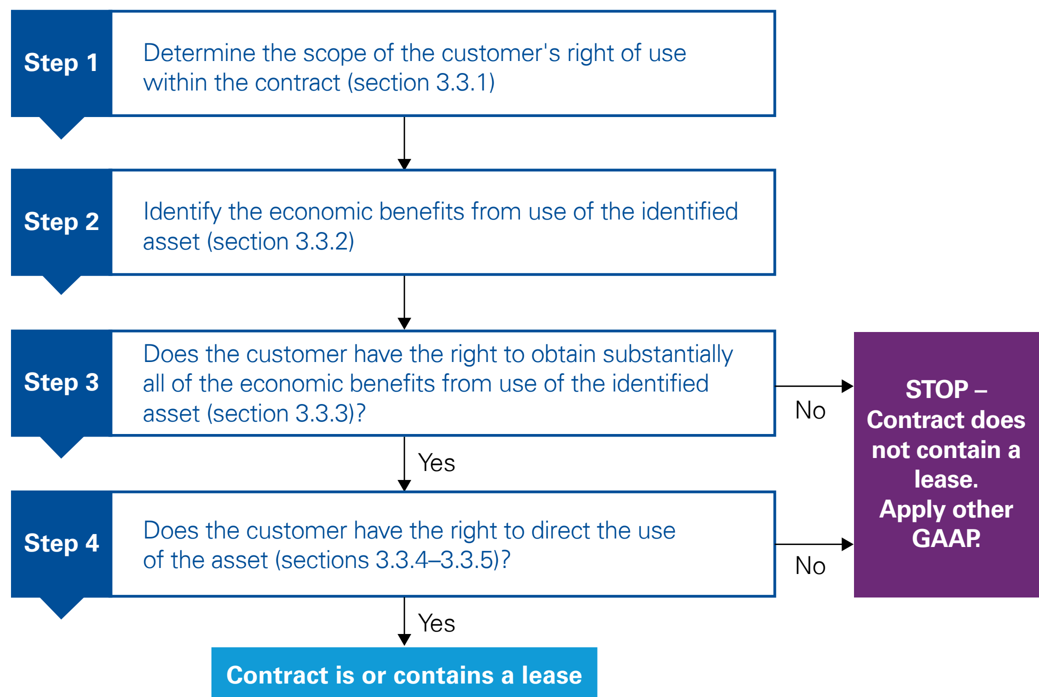
3.3 Does the customer control the use of the identified asset?

3.3.10 If an entity determines that a contract depends on the use of an identified asset (see section 3.2), it then evaluates whether the customer has the right to control the use of that asset for a period of time. This occurs when the customer has the right, *throughout the period of use*, to:

- obtain substantially all of the economic benefits from the use of the identified asset; and
- direct the use of the identified asset. [842-10-15-4]

3.3.20 Topic 842 introduces important concepts to determine whether a customer controls the use of an identified asset. The following chart depicts the decision process that an entity considers in this evaluation. [842-10-15-4, 15-20]



3.3.30 In many situations, this analysis will be straightforward and will require little to no judgment. However, for more complex situations, significant judgment may be needed.

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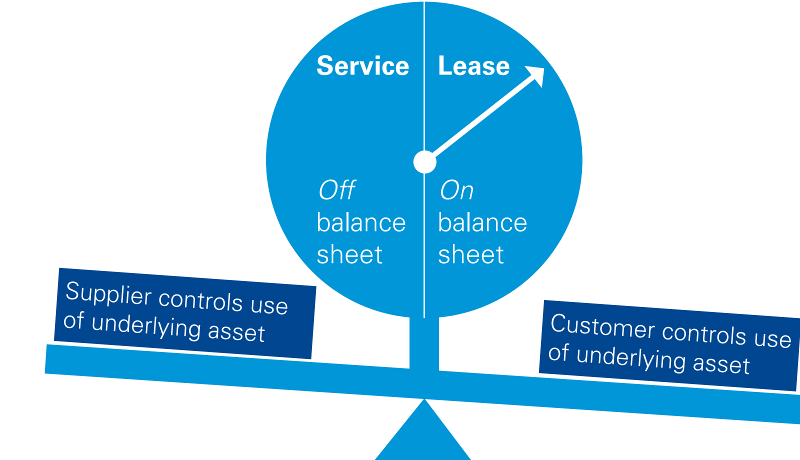
KPMG observation – Who has control over the use of an asset differentiates a lease from a service

3.3.40 A lease exists when a customer has the right to make those decisions about the use of an asset that significantly affect the economic benefits to be derived from its use in a manner similar to the way in which an entity can make decisions about its owned property, plant, and equipment. This concept of control, which is based on two elements (power over directing the use of the asset, and control of the economic benefits to be derived from use of the asset), is similar to how control is defined in Topic 606.

3.3.50 The Board observed that control of the use of the asset requires the customer to have decision-making rights over the use of the asset to influence the economic benefits derived from use of the asset – and this must be throughout the period of use. Without these rights, the Board concluded that the customer would have no more rights than if it were simply buying supplies or services, and the customer would not control the asset. This may be a change for certain arrangements that are currently accounted for as leases only because the customer obtains substantially all of the output (or other utility) from an asset. [ASU 2016-02.BC134]



KPMG observation – The control concept in Topic 810 is relevant

3.3.60 Although they are not the same, there are similarities between some aspects of the control concept in Topic 842 and the controlling financial interest concept in Topic 810 (consolidation). Both concepts comprise a power characteristic and a benefits characteristic. The power characteristic in Topic 810 is highly consistent with the power characteristic in Topic 842, but the benefits characteristics are significantly different.

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3.3.70 We believe that one of the aspects of the power characteristic in Topic 810 that is particularly relevant to Topic 842 is when some, but not all, decisions that significantly affect economic performance are shared. Topic 810 requires one party to be identified as the party with power in these situations. We believe that this is essentially the same approach that the Board decided to require in Topic 842 when *some, but not all*, of the relevant decisions that affect the economic benefits to be derived from use of the underlying asset are predetermined. [810-10-25-38E]

3.3.80 Under Topic 842, either the supplier or the customer would be identified as the party with power in those circumstances – i.e. the guidance in paragraph 842-10-15-20(b) on how to identify whether the customer has power when the relevant decisions about how and for what purpose an asset is used are predetermined in Topic 842 would not apply. For further discussion about how to determine whether the customer has control when some or all of the how and for what purpose decisions are predetermined, see section 3.3.5.

3.3.1 Step 1: What is the scope of the customer's right to use the asset?

3.3.90 A lease may not grant a customer an unlimited or unrestricted right to use an asset. For example, a contract may limit the customer's use of a motor vehicle or an aircraft to only one particular territory, or up to a particular number of miles, during the period of use. These limits or restrictions define the scope of the customer's right to use the identified asset. While limits or restrictions of this nature affect what economic benefits can be derived from use of the asset during the period of use, a lease still exists:

- if the customer has the right to obtain substantially all of those economic benefits; and
- substantive relevant decision-making rights about the use of the asset remain unrestricted that the customer controls (e.g. when and where the motor vehicle or aircraft travels within the unrestricted territory). [842-10-15-18]

3.3.100 A contract may include terms and conditions designed to protect the supplier. Protective rights are provisions in the contract that, for example, are intended to:

- protect the supplier's interest in the underlying asset (e.g. by preventing a customer from transporting particular types of goods, such as explosives) or other of its owned assets (e.g. a larger asset of which the identified asset is a physically distinct portion);
- protect its personnel (e.g. restrictions preventing the customer from sailing a ship in high risk waters when the supplier's personnel operate the asset); or
- ensure the supplier complies with laws and regulations (e.g. legal restrictions on where an aircraft can fly).

3.3.110 The Board concluded that protective rights generally define the scope of the rights that a customer obtains rather than affecting the existence of a right to use an asset. Contractual restrictions of this nature are known and agreed to by the customer and are an inherent part of the contract pricing – i.e. the contractual consideration reflects the economic substance of the right-of-use. [ASU 2016-02.BC141]

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KPMG observation – Protective rights versus decision-making rights in the scope of the contract

3.3.120 Topic 842 describes rights to specify the maximum amount of use of an asset or where or when the customer can use the asset as supplier protective rights; however, it also describes similar rights as examples of decision-making rights that grant the customer the right to direct how and for what purpose the underlying asset is used. Accordingly, at various points during the Board's project, some suggested that an entity would need to evaluate whether restrictions in a contract are merely protective in nature or whether they are so restrictive that they preclude the customer from controlling the use of the underlying asset. [842-10-15-23, 15-25]

3.3.130 It is possible that in an extreme circumstance, the restrictions imposed on the customer could be so restrictive that they leave the customer with *no* substantive decision-making authority over the use of the asset. If the customer has *no* substantive decision-making authority over the use of the asset during the period of use, there is not a lease.

3.3.140 However, in general we believe that contractual restrictions define the scope of the customer's right to use the underlying asset, and that restrictions on the use of the asset agreed to by the customer and the supplier reflect just another form of predetermined decision. Therefore, in the vast majority of arrangements, including those with significant contractual restrictions, restrictions do not prevent the customer from having the right to direct the use of the asset as long as there are substantive decisions about the use of the asset that are still available to be made and the customer controls those remaining decisions that will most significantly affect the economic benefits to be derived from use of the asset during the period of use (see sections 3.3.4 and 3.3.5).

3.3.150 The following scenarios illustrate the principle of only looking at the rights that are within the scope of the contract. [842-10-15-24 – 15-25]

- In Scenario 1, none of the possible, relevant decision-making rights in relation to the underlying asset are predetermined (e.g. by restrictions in the contract). Therefore, in assessing whether the customer controls the use of the asset, all of these rights are considered; this does not mean, however, that the customer must have *all* of those decision-making rights for there to be a lease (see section 3.3.4).
- In Scenario 2, the contract encompasses only *what* the underlying asset can be used for – i.e. what output the asset can produce. Therefore, in assessing whether the customer controls the use of the asset, only these *what* rights are considered. This scenario assumes that the 'what' decisions are substantive and significantly affect the economic benefits that can be derived from the use of the asset.

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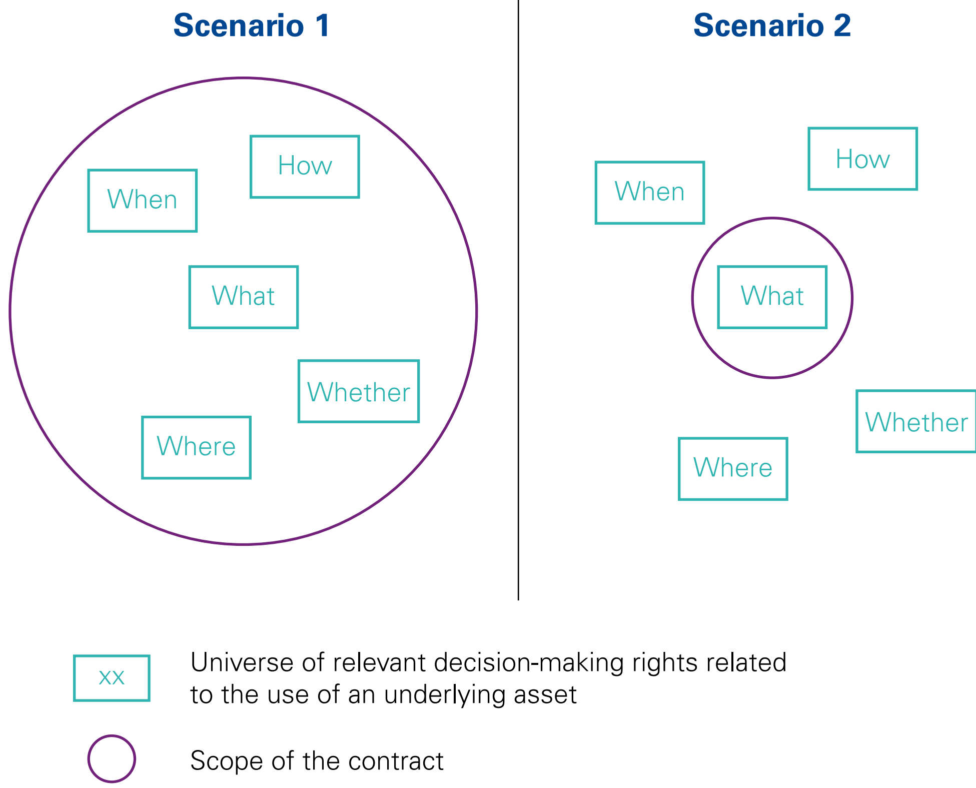

Universe of relevant decision-making rights related to the use of an underlying asset

Scope of the contract

Example 3.4
Scope of the customer's right of use

3.3.160 Customer enters into a contract with Supplier for the use of an aircraft for a specified period of time. The contract includes a number of restrictions on the use of the aircraft. It restricts:

- where the aircraft may fly – in the US only for regulatory purposes;
- what the aircraft may transport – passengers and passenger luggage only; and
- when the aircraft may fly – Customer is prohibited from operating the aircraft in certain weather conditions.

3.3.170 Notwithstanding these restrictions, there are substantive decisions about the use of the aircraft that Customer has the right to make (and change) throughout the period of use that are within the scope of its right to use the aircraft (i.e. that are not predetermined through restriction). For example, Customer can decide whether the aircraft flies, when it flies (subject to the bad weather restriction), where it flies within the US, and the passengers it carries.

3.3.180 In this example, the usage restrictions in the contract do not preclude Customer from having the right to direct the use of the aircraft.

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3.3.2 Step 2: What are the economic benefits from using the asset?

3.3.190 Once the scope of a customer's right to use an asset is determined (see section 3.3.1), an entity should only consider the *economic* benefits arising from the *use* of that asset. Topic 842 further explains that this includes direct benefits (e.g. from using, holding or subleasing the asset) and other economic benefits relating to the use of the asset (e.g. renewable energy credits received, or by-products arising from the use of an asset) that could be realized in a commercial (arm's length) transaction. [842-10-15-17]

3.3.200 The Board reasoned that a lease conveys a right to use the underlying asset; it does not convey ownership. Accordingly, benefits derived from *ownership* of the asset (e.g. income tax credits) are excluded from the evaluation. While certain tax credits may be indirectly related to the underlying asset's use (e.g. production tax credits), we believe that *all* benefits related to tax attributes should be excluded from the population of economic benefits to be considered in determining whether there is a lease. [ASU 2016-02.BC135]

KPMG observation – Government priorities can drive whether there is a lease

3.3.210 Governments establish and change incentives or subsidies, such as renewable energy credits, for reasons that may often be unrelated to the value of the output produced by an asset. These governmentally established incentives or subsidies are not a result of the underlying asset's utility and are artificial – i.e. because they can be established, revoked, or changed by governments at any time.

3.3.220 Therefore, we believe that over time, equivalent arrangements granting a customer the right to use an asset could meet or not meet the definition of a lease based solely on government priorities (e.g. whether government is currently trying to encourage one activity or another) at contract inception.

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3.3.3 Step 3: Does the customer have the right to obtain substantially all of the economic benefits?

3.3.230 Evaluating whether a customer has the right to obtain *substantially all* of the economic benefits from use of an asset throughout the period of use will be straightforward in many situations, generally because the customer in a lease frequently has exclusive use of the asset. However, in some situations, a contract may provide a party other than the customer the right to more than a minor amount of the economic benefits from use of the same asset.

3.3.240 A contract may require a customer to pay a portion of the cash flows derived from the use of an asset to the supplier (or another party) as consideration; this does not prevent the customer from obtaining substantially all of the economic benefits from use of that asset. For example, a customer may be required to pay the supplier a percentage of sales as consideration for use of the retail space. The cash flows from those sales are considered economic benefits that the customer receives, a portion of which it then pays to the supplier as consideration for the right to use the retail space. [842-10-15-19]

Example 3.5

Right to obtain the economic benefits from use – Outsourcing arrangement

Scenario 1: Supplier can use the factory to supply other customers

3.3.250 Customer enters into a 10-year agreement with Supplier to purchase a particular type and quantity of airbags. The following facts are relevant.

- Supplier has only one factory that can meet the needs of Customer.
- Supplier is unable to supply the airbags from another factory and does not have the right or ability to source the airbags from a third-party supplier.
- The capacity of the factory significantly exceeds the output for which Customer has contracted, and the factory is used to fulfill contracts with a number of Supplier's customers.
- There are no other substantive economic benefits that can be derived from use of the facility other than those that are derived from its production of airbags.

3.3.260 In this example, Customer does not control the use of the factory because it does not have the right to obtain substantially all of the economic benefits from use of the factory. This is because Supplier can obtain more than an insignificant portion of the economic benefits from use of the factory by producing parts and selling them to other customers. Therefore, the arrangement is not a lease of the factory that will produce the airbags.

Scenario 2: Supplier cannot use the factory to supply other customers

3.3.270 Changing the facts of Scenario 1, Supplier designed and constructed the factory that will produce the airbags specifically to meet Customer's demand. The factory is specified in the contract and Supplier does not have the practical ability to source the airbags from another factory. The factory's capacity to produce airbags is the only way in which the factory can produce economic benefits from its *use*.

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3.3.280 The existing capacity of the factory will be used to produce only the particular type and quantity of airbags requested by Customer, and Customer has the right to purchase all of the airbags produced by the facility – i.e. Supplier cannot use the factory to supply other customers. Supplier has the right to expand the facility in the future if it wishes to, and therefore expand its capacity; however, at contract inception it is not likely that it will do so.

3.3.290 In this example, Customer has the right to obtain substantially all of the economic benefits from use of the factory. Supplier's right to expand the facility, at which point the facility would be able to generate additional economic benefits from use that Customer might not control, is not considered in arriving at this conclusion. This is because an expanded facility would be a different asset from the one identified in the contract. Therefore, the arrangement is a lease if Customer also has the right to direct the use of the factory throughout the period of use (see section 3.3.4).

KPMG observation – No definition of 'substantially all'

3.3.300 The Board did not define what 'substantially all' means in the context of the definition of a lease. However, Topic 842 uses the same terminology in one of the criteria used to determine lease classification: whether the present value of the sum of the lease payments and residual value guaranteed by the lessee equals or exceeds substantially all of the fair value of the asset (see section 6.2). In that case, the standard includes implementation guidance that states that one reasonable approach to assessing that criterion is to conclude that 90 percent or more of the fair value of the underlying asset amounts to substantially all the fair value of the underlying asset. [842-10-55-2]

3.3.310 In addition, 'substantially all' is used elsewhere in US GAAP and is interpreted on a mostly consistent basis to mean approximately 90 percent. As a result, we believe that an entity should generally use 90 percent as its benchmark in evaluating whether the customer has the right to obtain substantially all of the economic benefits from use of an asset.

KPMG observation – Contracts requiring a customer to pay a portion of the cash flows derived from use of the asset

3.3.320 As noted in 3.3.240, when a customer is required to pay a portion of the cash flows derived from the use of the asset to the supplier or another party as consideration (e.g. rent based on a percentage of retail store sales), those cash flows are considered economic benefits that the customer obtains. However, given that the concept of control in the new leases definition requires both a 'power' element (the right to direct the use of the underlying asset) and a 'benefits' element (the right to obtain substantially all of the potential economic benefits from use of the asset), some might question whether the benefits requirement is met when a customer is required to pay a significant portion of the cash flows derived from use of the asset to the supplier as additional rent.

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3.3.330 However, we believe that the Board's intent was to establish that the customer obtaining the economic benefits from use of the asset (e.g. the cash flows obtained from selling products in a leased retail store) generally is separate from its payment of a portion of those cash flows to the supplier as additional rent. Variable payments of this nature should generally not affect the identification of a lease any differently from fixed payments that are often made with cash flows generated from use of the asset. Fixed *or* variable payments may be significant compared to the economic benefits generated by use of the asset (e.g. in high rent locations), and we believe that the Board intended that the amount or significance of the payments for the right to use the asset (compared to the economic benefits to be derived from the use of that asset) generally should not affect the conclusion about whether a lease exists.

3.3.340 It is not clear, however, whether a contract contains a lease when the customer obtains a fixed rate of return and the supplier receives/absorbs all of the variability in net operating profits, particularly if the supplier also receives most of the economic benefits from use of the asset; for example, most of the cash flows from the use of the asset, such as from a casino or hotel operation. In that situation, we believe that careful consideration should be given to the substance of the contract, including the nature of the arrangement between the parties, when determining whether the customer has the right to obtain substantially all of the economic benefits from use of the identified asset; for example, whether the nature of the arrangement is that the customer is in effect an agent of the supplier rather than the principal in the operation that is using the asset.

KPMG observation – Capacity does not necessarily equal economic benefits

3.3.350 Example 3.5 considers the facility's capacity to produce airbags as the only substantive means to derive economic benefits from use of the facility. However, a facility's capacity to produce output may not always be the only means from which to derive economic benefit from its use. For example, the economic benefits that an entity can derive from a renewable energy power plant stems from more than the electricity produced; for example, the plant may also produce economic benefits in the form of renewable energy credits.

3.3.360 Another example might be a production facility such as that in Example 3.5, but where the steam from the manufacturing process is sold as a by-product to a power generation company. In that case, the economic benefits to be derived from the facility include not just those related to the facility's capacity to produce airbags, but also the facility's production of steam as a by-product.

3.3.370 In evaluating whether the customer has the right to obtain substantially all the economic benefits from use of an asset, entities will need to ensure that they appropriately capture the complete population of economic benefits that can be derived from use of the asset.

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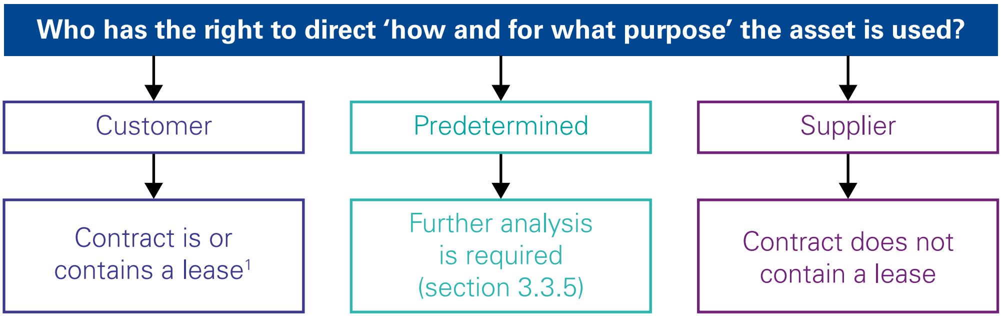
3.3.4 Does the customer have the right to direct the use of the asset?

3.3.380 This section looks at the general considerations that are relevant in determining whether the customer has the right to direct the use of the asset throughout the period of use, while section 3.3.5 looks more closely at situations in which the substantive decision making about how and for what purpose the asset will be used is predetermined.

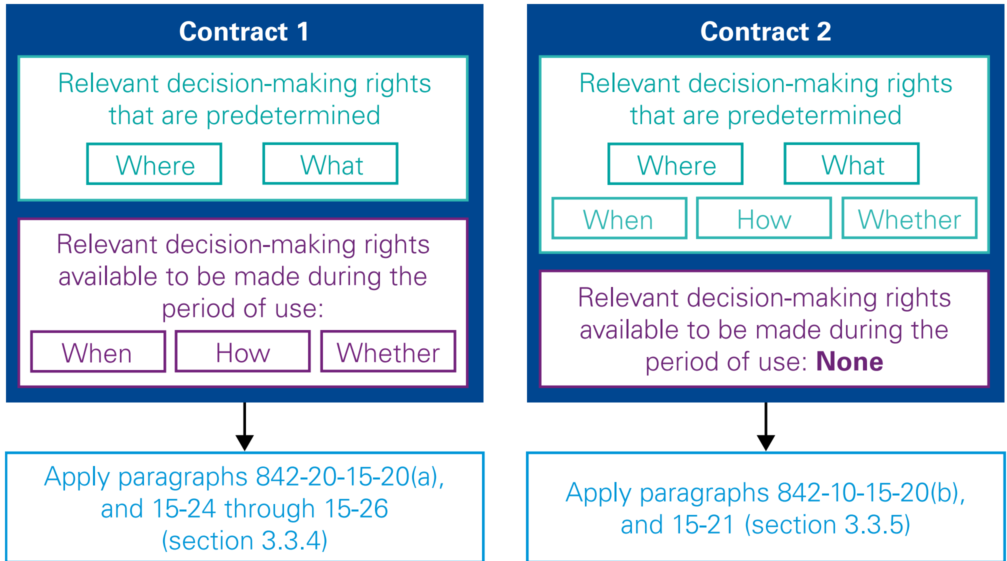
3.3.390 A customer has the right to direct the use of an identified asset when it has the right to direct (*and* change) how and for what purpose the asset is used throughout the period of use; for example, the ability to decide how leased space in a retail unit is used, or where and when a leased ship sails and what cargo it transports. [842-10-15-20, 15-24]



Note 1:

If other criteria are met (see sections 3.2 and 3.3.3).

3.3.400 When the relevant decisions about how and for what purpose the asset will be used throughout the period of use – i.e. those how and for what purpose decisions that significantly affect the economic benefits to be derived from use of the asset – are predetermined, an entity applies the guidance in section 3.3.5 to determine if the customer directs the use of the identified asset. If only some of the relevant decisions about how and for what purpose the asset will be used are predetermined, an entity considers whether the customer has the right to make those remaining, relevant 'how and for what purpose' decisions throughout the period of use. The following diagram illustrates this point.



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3.3.410 The evaluation focuses on whether the customer has control over those decision-making rights that are most relevant to (i.e. those that most significantly affect) the economic benefits to be derived from the asset's use. Topic 842 notes that the relevant decision-making rights are likely to vary by contract, depending on the nature of the asset and the terms and conditions of the contract, and that some decisions about the use of an asset may be predetermined (e.g. through restrictions or other provisions in the contract). [842-10-15-24]

3.3.420 An entity should only consider which party (i.e. the customer or the supplier) has the right to make decisions about the use of the asset *during the period of use* – i.e. in evaluating whether a lease exists or not, an entity ignores decisions that are predetermined in the contract – unless the customer designed the asset or specific aspects thereof (see section 3.3.5). [842-10-15-22]

3.3.430 Topic 842 provides examples of decision-making rights that do and do not grant an entity the right to direct how and for what purpose an identified asset is used (within the scope of its right of use). [842-10-15-25 – 15-26]

Rights in the contract			
Example rights to direct how and for what purpose asset is used throughout period of use		**Other rights**	
Right to change the type of output produced by the asset	Right to change when the output is produced	Supplier protective rights	Maintaining the asset
Right to change where the output is produced	Right to change whether output is produced and, if so, quantity produced	Insuring the asset	Operating the asset[1]

Note 1:

Except when decision-making rights are predetermined.

3.3.440 A contract may include provisions that are intended to protect the supplier's interest in the asset or other assets, protect its personnel, or comply with laws or regulations – 'supplier protective rights' in the diagram in 3.3.430. [842-10-15-23]

3.3.450 Such rights typically define the scope of the customer's right to use the asset but do not, in isolation, prevent the customer from having the right to direct the use of the asset (see section 3.3.1).

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KPMG observation – Decision-making rights are relevant when they affect the economic benefits from use of an asset

3.3.460 Relevant decisions about the use of an asset affect what and how much economic benefit is derived from the asset's use. An entity controls the use of an asset when it has the right to make those relevant decisions that most significantly affect what and how much economic benefit is derived from the asset's use. The Board concluded that decisions about how and for what purpose an asset is used are more important in determining who has control over the use of an asset than other decision-making rights (such as maintenance or operational decisions) that are dependent on, and typically subordinate to, the decisions about how and for what purpose an asset is used. [ASU 2016-02.BC137]

3.3.470 Examples of relevant decision-making rights that affect how and for what purpose an asset is used are provided in Topic 842, and include decision-making rights about whether to produce outputs from the underlying asset (e.g. whether to produce widgets from a machine or electricity from a power plant) and if so, what, when, and/or where to produce that output. Rights that give a customer the ability to specify the output of an asset at or before the beginning of the period of use (such as the amount and/or type of goods or services produced by the asset) in isolation do not give the customer the ability to direct the use of that asset. If a customer has no other decision-making rights relating to the use of the asset, the customer has the same rights as any customer that purchases similar goods or services. [842-10-15-25]

KPMG observation – Right to direct (and change) how and for what purpose an asset is used

3.3.480 The Board views the right to direct how and for what purpose an asset is used as a single right (i.e. a singular concept). That is, 'how' an asset is used is not evaluated separately from the 'purpose' for which the asset is used. 'How' in this context does not refer to purely operational decisions. As outlined in 3.3.430, the Board considers operational decisions to be subordinate to those decisions that affect how and for what purpose an asset is used. [ASU 2016-02.BC137]

3.3.490 When considering whether a customer has the right to direct how and for what purpose an asset is used, an entity would not consider whether the customer:

- has the right to make *every* decision about how and for what purpose the asset is used; or
- had the right to make those decisions that affect how and for what purpose the asset will be used that were made before the beginning of the period of use (except as discussed in section 3.3.5).

3.3.500 Instead, an entity considers the narrower population of whether the customer has the right to make (and change) those decisions about how and for what purpose the asset is used throughout the period of use that both:

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– significantly affect the economic benefits to be derived from use of the asset; and
– are available to be made during the period of use.

3.3.510 Therefore, a customer need not have *all* of the decision-making rights in 3.3.430 to have the right to direct how and for what purpose the asset is used. This principle is illustrated in Example 3.6, Scenarios 1 and 2.

3.3.520 There are also multiple examples in Subtopic 842-10 that illustrate this concept. Those include (but are not limited to):

– Example 9, Case C, illustrates a scenario in which the customer cannot change the type of output produced; the power plant can only produce electricity, which was predetermined by the design of the asset before the period of use. However, the customer directs how and for what purpose the asset is used because it controls those substantive decisions about how and for what purpose the power plant will be used (which significantly affect the economic benefits to be derived from use) that are available to be made during the period of use (i.e. whether, when, and how much output will be produced). [842-10-55-117 – 55-123]
– In contrast, Example 8 illustrates a scenario in which some decision-making rights about how and for what purpose the asset is used are unavailable to be made during the period of use – i.e. because of the contract, the supplier cannot change the type of output the factory will produce. However, the supplier, rather than the customer, directs how and for what purpose the asset is used because it has the remaining relevant decision-making rights about when and how much the factory produces, while the customer has no substantive decision-making rights during the period of use. [842-10-55-100 – 55-107]

3.3.530 Identifying not only the relevant decisions (i.e. those decisions that can significantly affect the economic benefits to be derived from use of the asset), but only those relevant decisions that are available to be made during the period of use, may prove challenging for some contracts. For example, in a contract for the use of retail space in a shopping center, many of the decision-making rights that affect how and for what purpose the retail space is used may not be readily apparent or may not be available to be made during the period of use (i.e. those decisions may be predetermined).

3.3.540 For example, the contract may stipulate what type of retail store the customer may operate (e.g. a store that sells shoes, jewelry, or video games), when the retailer may operate (e.g. by prohibiting the customer from selling when the shopping center is not open), and/or that the retailer must operate when the shopping center is open. Because those decisions are predetermined, they are not considered in determining whether there is a lease. In determining whether there is a lease, the entity considers only those relevant decisions that are available to be made during the period of use.

3.3.550 Example 4 in the standard illustrates what some of the relevant decisions available to be made during the period of use might be (e.g. deciding upon the mix of goods, and the sale prices of those goods in the store) and concludes that the customer controls those remaining substantive decisions that significantly affect the economic benefits that can be derived from use of the retail space. In contrast, the supplier has no substantive decision-making rights about how and for what purpose the retail space will be used during the period of use. [842-10-55-63 – 55-71]

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Example 3.6
Right to direct the use – Outsourcing arrangement

Scenario 1: Customer can change the mix and quantity of output during the period of use

3.3.560 Continuing Example 3.5, Scenario 2, Supplier designed and constructed the factory that will produce the airbags specifically to meet Customer's demand. The factory is specified in the contract and Supplier does not have the practical ability to source the airbags from another factory.

3.3.570 In addition, the factory is designed to manufacture various types and quality of airbags and Customer has the right to direct (and change) the mix and quantity of airbags that the factory produces during the period of use. Because Customer controls the mix and quantity of airbags produced, it also implicitly controls when the factory produces airbags.

3.3.580 Customer has the right to direct the use of the factory because it directs (and can change) how and for what purpose the factory is used – Customer can change the type and quantity of output produced by the factory. Because the factory is an identified asset and Customer also has the right to obtain substantially all of the economic benefits from the use of the factory (see Example 3.5, Scenario 2), the arrangement contains a lease.

Scenario 2: Customer can change the output quantity only during the period of use

3.3.590 Changing the facts of Scenario 1, the factory, as designed, can only produce the particular type and quality of airbag requested by Customer in the contract – i.e. the factory cannot produce other types of output. However, consistent with the facts in Scenario 1, Customer has the right to decide (and change) the quantity of airbags produced by the factory during the period of use.

3.3.600 Neither Customer nor Supplier can change *what* the factory produces, because the factory was designed to produce only the particular type and quality of airbags requested by Customer in the contract. However, Customer decides how much output the factory will produce and when, which are the relevant decisions about how and for what purpose the asset will be used that are *available to be made* during the period of use.

3.3.610 Supplier has no substantive decision-making rights about how and for what purpose the factory will be used during the period of use – i.e. it has no decision-making rights about the type, quantity, or timing of output from the factory.

3.3.620 Because Customer has the right to make the relevant decisions about how and for what purpose the factory will be used throughout the period of use that are not predetermined by the design of the factory, Customer has the right to direct the use of the factory. The factory is an identified asset and Customer controls its use – i.e. it has the right to both direct its use and obtain substantially all of the economic benefits from use; therefore, the arrangement contains a lease.

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Example 3.7
Is there a lease (storage warehouse)?

3.3.630 Continuing from Example 3.1, Customer enters into a five-year arrangement with Supplier for a climate-controlled storage warehouse to store its coffee beans and/or other products. The storage warehouse is specified in the contract (storage warehouse 3C), Customer has exclusive use of the warehouse, and Supplier has no right to substitute it. Therefore, there is an identified asset.

3.3.640 Customer determines throughout the period of use what to store in the warehouse (e.g. coffee, tea, etc., subject to a restriction on the storage of hazardous materials), the quantity to be stored (up to a maximum quantity), and how much of the warehouse it will utilize. Supplier operates and maintains the storage warehouse.

3.3.650 In this example, the contract contains a lease. Customer has the right to obtain substantially all of the economic benefits from the use of the identified storage warehouse because it has exclusive use of it. Customer also has the right to direct the use of the storage warehouse because it has the right to direct how and for what purpose it is used throughout the period of use. That is, Customer has the right to determine the type and quantity of output that the asset produces throughout the period of use, which in the case of the warehouse is what and how much it stores.

Example 3.8
Is there a lease (truck and tractor trailers)?

3.3.660 Supplier provides Customer with a truck and three trailers for its exclusive use for a period of three years. The following facts are relevant.

- Supplier cannot substitute the truck or any of the trailers except for servicing or repair.
- Customer keeps the truck and trailers at its location when not in transit or at a delivery point so that it can use the trucks and trailers that are not in transit. For example, Customer can load one of the trailers that is not in transit with cargo so that it is ready for transit upon return of the truck.
- Customer can use the truck with a trailer not provided by Supplier, and any one of the trailers with a truck not provided by Supplier.
- Customer is responsible for providing a driver for the truck and can decide when and where the truck and trailers go.
- The contract limits Customer’s use of the truck to 120,000 miles over the three-year period of use.
- The contract prohibits Customer from using any trailers with the Supplier truck larger than those provided by Supplier or hauling loads above a certain weight.

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3.3.670 In this example, the contract contains a lease of the truck and three trailers because they are specifically identified assets that cannot be substituted except for reasons of servicing or repair. Customer has the right to control the use of the truck and each of the three trailers during the contract term within the scope of its right of use defined in the contract. Customer has the right to obtain substantially all of the economic benefits from use of the truck and each of the three trailers because it has exclusive use of those assets.

3.3.680 The contractual limits on truck usage are inherent features of the usage rights conveyed by the contract (i.e. supplier protective rights). Customer has the right to direct how and for what purpose the truck and trailers are used (i.e. when and where the truck and the trailers go or what they transport) within the scope of the contractually agreed right of use (i.e. subject to the supplier's protective rights).

KPMG observation – A customer must have relevant decision-making rights throughout the period of use

3.3.690 The criteria governing whether the customer has the right to direct the use of an identified asset refer to decision-making rights that exist throughout the period of use. This requirement prevents structuring to avoid the definition of a lease by including in the contract term periods during which the customer cannot make the decisions about how and for what purpose the asset is used, and/or obtain substantially all of the economic benefits from use of the identified asset.

3.3.700 Because of how *period of use* is defined and used in the guidance on identifying a lease, we believe that an arrangement to use an identified asset would not fail the definition of a lease solely because it is either contained within a contract with a longer overall term than the period during which the customer has the right to use the asset, or contains intermittent periods during which the customer does not have the right to control the use of the asset.

3.3.710 For example, a sports team that has the right to use an identified stadium for the months of September through January each year (during its playing season) for a period of 10 years would have a lease if it has the right to control the use of the stadium during the 10 five-month periods, even though it does not have the right to control the use of the stadium during the other seven months each year of the 10-year term of the contract. The *period of use* for purposes of evaluating control is the 50 non-concurrent months.

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3.3.5 Control when the 'how and for what purpose' decisions are predetermined

3.3.720 It is possible that neither the customer, nor the supplier, controls the relevant decisions (i.e. those decisions that can significantly affect the economic benefits to be derived from use of the asset) to be made about how and for what purpose an identified asset will be used throughout the period of use (i.e. because those decisions are predetermined). In that case, the customer nevertheless has the right to direct the use of the asset if: [842-10-15-20]

- it has the right to operate the asset or direct others to operate it in a manner it determines throughout the period of use (and the supplier has no right to change those operating decisions); *or*
- it 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.

3.3.730 The relevant decisions about use of an asset can be predetermined in a number of ways – e.g. by the design of the asset or by contractual restrictions on the use of the asset. [842-10-15-21]

Example 3.9

Right to direct the use predetermined – Outsourcing arrangement

3.3.740 Assume the same facts as in Example 3.5, Scenario 2, except that the type, quantity, and quality of the airbags to be produced are specified in the contract and neither Customer, nor Supplier, has the right to change any of those decisions absent a modification to the contract. Supplier has the right to make all of the operating decisions for the factory during the period of use. Customer has no right to hire another operator or to operate the factory itself.

3.3.750 Supplier and Customer analyze Customer's rights as follows to determine if the arrangement is a lease.

- The relevant decisions about how and for what purpose the factory will be used throughout the period of use (e.g. what and how much it will produce) are predetermined by the contract. Customer has no right to make or change the relevant decisions about how and for what purpose the factory is used (e.g. Customer has no right to change what, whether, how much, or when the factory produces).
- Because how and for what purpose the factory will be used is predetermined, Supplier and Customer consider whether Customer has other rights of use that extend beyond the receipt of output (i.e. airbags) from the factory. Customer does not have the right to operate the factory or to direct Supplier (or others) to operate it in a manner that Customer determines. Customer also did not design the factory or cause it to be designed in a way that predetermines throughout the period of use the relevant decisions about how and for what purpose the factory will be used.

3.3.760 As a result of this analysis, Supplier and Customer conclude that the contract does not contain a lease.

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Example 3.10

Right to direct the use predetermined – Storage warehouse

3.3.770 Continuing Example 3.2, Customer enters into a five-year arrangement with Supplier for a climate-controlled storage warehouse to store its coffee beans. The storage warehouse is specified in the contract (storage warehouse 3C), Customer has exclusive use, and Supplier has no right to substitute it. Therefore, there is an identified asset.

3.3.780 The contract includes a list of items (coffee) agreed on by Customer and Supplier, and a specific quantity of coffee that may be stored in the warehouse. Customer is not permitted to change the types or quantity of coffee stored or use the storage warehouse for any purpose other than storing coffee during the period of use. Customer has no right to operate (or direct others to operate) the storage warehouse and did not design it.

3.3.790 In this example, the contract does not contain a lease. Although Customer has the right to obtain substantially all of the economic benefits from use of the storage warehouse (because it has exclusive use of the warehouse), it does not have the right to direct its use. Customer does not have the right to direct how and for what purpose the storage warehouse is used; instead, it is predetermined in the contract. Customer also does not have the right to operate the warehouse and did not design it.

KPMG observation – Decisions about how and for what purpose the asset is used are predetermined in the contract

3.3.800 The Board expects relatively few cases where all of the substantive decisions about how and for what purpose the asset will be used will be predetermined in the contract. During deliberations of Topic 842, some Board members observed that someone must control the use of an asset; therefore, if all of the substantive how and for what purpose decisions have been predetermined, it is reasonable to ascribe control over the use of the asset to the customer if it effectively predetermined those decisions by control over the design of the asset, or it controls the operational decisions that remain after the relevant how and for what purpose decisions have already been made. [ASU 2016-02.BC138–BC140]

3.3.810 After the Board reached this decision, some entities suggested that the supplier should be considered to control the use of the asset if its right to operate the asset more significantly affects the economic benefits to be derived from use of the asset than the customer's involvement in design. However, the final guidance is clear that the customer will be deemed to control the use of the asset if it either has the right to operate the asset *or* designed those aspects of the asset that predetermine how and for what purpose it will be used throughout the period of use (see 3.3.720). We believe that it was the Board's intent to, in effect, create a bias toward the customer in close-call situations to mitigate structuring opportunities. [842-10-15-20]

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3.3.820 We believe that all facts and circumstances should be considered in determining who controls the use of an identified asset when the substantive decision-making rights about how and for what purpose the asset will be used are predetermined. For example, a contract may stipulate that the supplier operates the asset but the customer has the right to remove the supplier *without cause* at any time during the contract term and to hire someone else to operate the asset. In this situation, we believe that the customer controls the use of the asset.

3.3.830 This is supported by several examples included as illustrations in Subtopic 842-10. For example, in Example 6, Case A, the supplier operates the asset and the example adds that the customer is prohibited from hiring another operator or operating the asset itself – i.e. the customer does not have kick-out rights and accordingly the supplier controls the use of the asset. We believe that the Board was intending to highlight that if the customer *did* have the right to replace the supplier as the operator of the asset or had the right to operate the asset itself, the contract would be a lease because how and for what purpose the asset will be used is predetermined in the contract. [842-10-55-79 – 55-84]

3.3.840 While it appears that the Board attempted to mitigate structuring opportunities (e.g. by creating an apparent bias toward the customer in close-call situations), the guidance about when rights are predetermined may still provide some structuring opportunities because an entity might be able to avoid meeting the definition of a lease by carefully specifying what is predetermined versus what is not, and who makes what decisions. The following are examples.

- When the operation of the asset will be outsourced, the decision of which party will operate could be predetermined in the contract.
- In many situations, the customer may not unilaterally design the asset (e.g. an investor might have real expertise in renewable energy and play an active role in the design). In other cases, the design may involve no significant decisions because construction of the asset is straightforward such that the customer does not need to participate in the design of the asset.
- In other contracts, there may be, or the parties may be able to create, joint decision-making rights that neither party to the contract controls.

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Comparison with current US GAAP – New control concept differs from current US GAAP

3.3.850 The concept of control over the use of the identified asset in Topic 842 is based on both a power element (the right to control the use of the identified asset) and a benefits element (the right to obtain substantially all of the economic benefits from use of that asset). While a lease could exist under current US GAAP solely on the basis of the customer having the right to obtain substantially all of the output or other utility from an identified asset, the customer will need to have decision-making rights over the use of the asset for there to be a lease under Topic 842. The Board concluded that without the right to control the use of the identified asset, the customer has no more control over the asset than any customer purchasing goods or services from the supplier. [840-10-15-6]

3.3.860 Under current US GAAP, the right to control the use of an asset is conveyed if:

1. the purchaser has the ability to operate the asset in a manner it determines while obtaining or controlling more than a minor amount of the asset's output;
2. the purchaser has the ability or right to control physical access to the asset while obtaining or controlling more than a minor amount of the asset's output; or
3. it is remote that one or more parties other than the purchaser will take more than a minor amount of the output and the price that the purchaser will pay for the output is neither contractually fixed per unit of output nor equal to the current market price per unit of output as of the time of delivery of the output. [840-10-15-6]

3.3.870 Under either criterion (2) or (3), control over the use of a specified asset does not require that the customer have the right to *direct the use of* the asset. The control concept in Topic 842 also differs from criterion (1) because the right to operate the asset is not considered relevant unless the substantive decisions about how and for what purpose the asset will be used are predetermined in the contract. In addition, not only must the customer be able to direct the use of the asset, but the customer must *also* have the right to obtain substantially all (rather than only more than a minor amount) of the economic benefits from use of the asset throughout the period of use.

3.3.880 This change to the concept of control will mean that some contracts that were previously considered to be leases will no longer meet the definition. This is most likely to be the case for arrangements where the customer receives substantially all of the output or utility of an identified asset, regardless of the price the customer pays for the output, as illustrated in Example 3.11. However, in general, we believe that most arrangements that meet the definition of a lease under current US GAAP will continue to meet the definition of a lease in Topic 842.

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Example 3.11

Outsourcing arrangement that is a lease under current US GAAP but not a lease under Topic 842

3.3.890 Customer enters into a 10-year agreement for Supplier to supply parts to Customer's manufacturing plant. Customer builds its facility adjacent to Supplier's manufacturing plant. Customer will make an equity investment in the entity formed by Supplier to own the facility but does not participate in the design of the facility.

3.3.900 The following additional facts are relevant.

- Customer and Supplier agree that the parts facility will produce constant-velocity (CV) joints for Customer.
- The initial capacity of the facility will be used to produce only CV joints and Customer will purchase all of the CV joints produced by the facility.
- The price paid by Customer will be determined based on Supplier's actual operating costs plus a profit margin.
- Supplier has the right to expand the facility in the future if it wishes to produce other parts (but does not expect to do so) and has the right to make all operating decisions for the facility.

Current US GAAP

3.3.910 Under current US GAAP, the arrangement contains a lease because Customer is expected to obtain substantially all of the facility's output during the term of the arrangement for a price that is not fixed per unit of output or equal to the market price per unit of output at the time it is delivered.

Topic 842

3.3.920 Under Topic 842, the arrangement does not contain a lease. Customer does not have the right to direct the use of the facility throughout the 10-year period of use because it cannot direct how and for what purpose the facility is used.

3.3.930 Even though Supplier built the facility for the express purpose of supplying parts to Customer, Customer has no right to change how the facility is used or to change what, how much, or when it produces. Because how and for what purpose the facility will be used is predetermined by the terms of the contract, Supplier and Customer also consider whether the arrangement meets either of the criteria for directing the use of the asset when the 'how and for what purpose' decisions are predetermined (see 3.3.720):

- Customer does not have the right to operate the facility or direct Supplier to operate it in a manner that Customer determines.
- Customer also did not design the facility (or specific aspects of the facility) in a way that predetermines how and for what purpose the facility will be used throughout the period of use.

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3.3.940 Consequently, Customer is not leasing the facility.

3.3.950 Customer will need to separately evaluate whether to consolidate the entity that owns the facility and, if it is required to consolidate the entity, the inventory acquisition accounting will be eliminated in Customer's consolidated financial statements.

3.3.960 There are a number of alternative fact patterns related to this example that would have resulted in a conclusion that Customer has the right to direct the use of the facility, and therefore that the arrangement contains a lease. The following are examples:

- If Customer had the right to change the parts produced by the facility throughout the period of use (e.g. to require that the facility produce axles rather than, or in addition to, CV joints), then Customer would have the right to direct the use of the facility. This is because it would be able to direct how and for what purpose the facility is used by virtue of being able to change what the facility produces.
- If Customer had the right to determine when and how many CV joints the facility produces throughout the period of use (i.e. Customer controls how much output the facility produces, even if it cannot change the nature of the output produced), then Customer would have the right to direct the use of the facility. This is because it would be able to direct how and for what purpose the facility is used by virtue of being able to effectively control whether, when, and how much economic benefit is derived from use of the facility.
- If Customer had designed the facility, or those specific aspects of the facility that predetermined how and for what purpose it would be used throughout the period of use, Customer would be deemed to have the right to direct the use of the facility.

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4 Separating components of a contract

How the standard works

- If a contract is, or contains, a lease, the entity follows these steps in accounting for the components of the contract:
  - **Step 1:** Identify the separate lease components. In many cases there will be a single lease component, but in some cases there will be multiple lease components.
  - **Step 2:** Identify any non-lease components – e.g. a maintenance or operating service.
  - **Step 3:** Measure the 'consideration in the contract'. This calculation is different for the lessee versus the lessor.
  - **Step 4:** Separate and allocate the consideration in the contract between the lease and non-lease components. This process differs slightly for the lessee and the lessor, but in both cases requires the entity to maximize the use of observable data.

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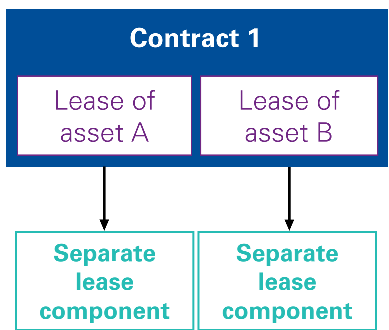
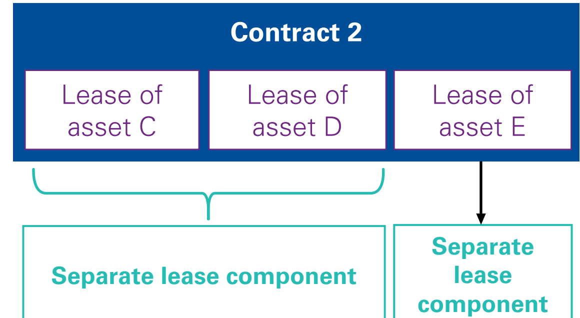
4.1 Step 1: Identify the separate lease components

4.1.10 Lessees often contract with lessors for the right to use multiple underlying assets – i.e. the contract contains multiple leases. However, the unit of account in applying Topic 842 is not each lease in the contract – it is each 'separate lease component'. A contract with multiple leases may contain many or only one separate lease component. The diagram illustrates this principle. [842-10-15-28, 15-30]





4.1.20 On the basis that the requirements of Topic 842 for lessees and lessors apply to each separate lease component, an entity:

- assesses lease classification for the separate lease component – i.e. not for each of the leases that comprise that component (see sections 6.2 and 7.2); and
- applies the recognition and measurement requirements of Topic 842 to each separate lease component (see chapters 6 and 7).

4.1.30 The guidance about what constitutes a separate lease component is the same for lessees and lessors.

Separating lease components

4.1.40 A right to use an underlying asset (i.e. a lease), or a bundle of such rights is a separate lease component if both of the following criteria are met:

- the lessee can benefit from the lease (or bundle of leases) either on its own or together with other resources that are readily available to the lessee; and
- the lease (or bundle of leases) is neither highly dependent on, nor highly interrelated with, the other leases in the contract. [842-10-15-28]

4.1.50 In interpreting the first criterion, 'readily available' resources are goods or services that are sold or leased separately by the lessor or other suppliers (e.g. office furniture), or that the lessee has already obtained from the lessor or from other transactions or events. [842-10-15-28(a)]

4.1.60 In interpreting the second criterion, a lease is highly dependent on or highly interrelated with another lease if *each* lease significantly affects the other. This is illustrated in Examples 4.1 and 4.2. [842-10-15-28(b)]

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KPMG observation – Separate lease components similar to separate performance obligations in Topic 606

4.1.70 The Board intended the separate lease components guidance in Topic 842 to align with the separation model for identifying performance obligations in Topic 606. In the Board's view, identifying separate lease components in a lease contract is similar to identifying separate performance obligations in a revenue contract. Although the separation guidance in Topic 842 is not as extensive as the separation guidance in Topic 606, the Board expects the guidance to be applied similarly. [ASU 2016-02.BC146]

4.1.80 This means that an entity applying the separate lease components guidance is, fundamentally, deciding whether the lessee has contracted for multiple leases (e.g. to use multiple pieces of similar office equipment) or is, instead, leasing a combined item (e.g. a production facility or a data center comprising multiple underlying assets). This evaluation focuses primarily on the level of integration, interrelation, and/or interdependence between the rights of use that are conveyed under the contract – i.e. whether those multiple rights to use underlying assets significantly affect each other. [ASU 2016-02.BC146]

Additional considerations for land

4.1.90 For leases that include a land element (e.g. a lease of land and a building, or land and integral equipment), the right to use the land is considered a separate lease component unless the accounting effect of separately accounting for the land element would be 'insignificant'. [842-10-15-29]

4.1.100 Topic 842 provides the following examples of circumstances in which the accounting effect of accounting for the land element separately would be insignificant:

- separating the land element would have no effect on lease classification; for example, it would not affect whether the land or the related building (or integral equipment) is classified as a finance or an operating lease; or
- the amount that would be recognized for the land lease component is insignificant. [842-10-15-29]

KPMG observation – Judgment required in determining when to separate a land lease element

4.1.110 The examples in 4.1.100 are not exhaustive, and Topic 842 does not define 'insignificant'. Consequently, determining whether the effect of accounting for a land lease element as a separate lease component would be insignificant may require significant judgment in some cases. [ASU 2016-02.BC147]

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Example 4.1

Leases of multiple underlying assets – Separation criteria met

4.1.120 Lessor LR leases a bulldozer, a truck, and an excavator to Lessee LE to be used in LE's land development operations.

4.1.130 The equipment that LR leases is leased and sold separately by other suppliers and LR regularly leases each of these types of equipment separately. For example, LR regularly leases customers a bulldozer without also leasing that same customer a truck or an excavator.

4.1.140 Despite the fact that LE is leasing all three machines for one purpose (i.e. to engage in land development), LR and LE each conclude that the lease of each underlying machine is a separate lease component for accounting purposes (i.e. there are three separate lease components).

4.1.150 This conclusion is based on the following:

- LE can benefit from each lease on its own, or together with other readily available resources; for example, LE could readily lease or purchase an alternative truck or excavator to use with the bulldozer; and
- The leases are not highly dependent on, or highly interrelated with, each other. The ability of LR to fulfill each lease obligation (i.e. to make each underlying asset available for LE's use) is not affected by the other leases in the contract; LR could fulfill its lease obligation for any one of the three pieces of equipment even if the customer did not enter into a lease for either of the other two pieces of equipment. In addition, LE's ability to derive benefit from each lease is not significantly affected by its decision to lease or not lease the other equipment from LR.

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Example 4.2

Leases of multiple underlying assets – Separation criteria not met

4.1.160 Lessor LR leases a production facility to Lessee LE for LE to produce its widgets for five years.

4.1.170 The production facility includes the building, the land on which the building sits, and several pieces of manufacturing equipment that are installed within the building. The building was designed to house manufacturing equipment, and it would be difficult and costly to remove the manufacturing equipment from the facility. The remaining economic lives of the building and the equipment are substantially longer than the lease term.

Identify the separate lease component(s)

4.1.180 LE could lease or purchase each of the underlying assets independently; for example, it could acquire a piece of equipment to put into the production line or could relocate the equipment to a substantially equivalent vacant building. Therefore, LE can benefit from each lease on its own or together with other readily available resources.

4.1.190 However, the leases in this contract are highly interdependent and highly interrelated. The nature of this arrangement is the lease of an in-place production facility with which LE can produce its widgets. The land, the building, and the installed equipment are, in effect, inputs to the combined item that LE contracted to lease.

4.1.200 The multiple leases significantly affect each other because, absent significant time and expenditure, LR would not be able to fulfill its obligation to lease the land, the building, or any of the pieces of installed equipment without also conveying a right to use those other assets. For example, to grant a lease of the land only, LR would have to uninstall and relocate the manufacturing equipment and demolish the building.

4.1.210 Consequently, there is only a single lease component.

Additional consideration of the land element

4.1.220 The above conclusion notwithstanding, because the contract contains a lease of land, LR and LE also need to consider the guidance specific to leases that include a land element.

4.1.230 Applying that guidance in 4.1.90–100, LR and LE each conclude that the accounting effect of separately accounting for the land lease would be insignificant, and therefore they do not account for the land as a separate lease component. This is because, given the five-year lease term (which is the same for all of the elements), and the lease payments LR and LE expect that each lease (land, building, equipment), if evaluated independently, would be an operating lease. Therefore, separating the land element from the single lease component would not affect the lease accounting.

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US GAAP different from IFRS – Differences in the second criterion for identifying separate lease components

4.1.240 In identifying separate lease components, both Topic 842 and IFRS 16 include a requirement for the lease (or bundle) to be neither highly dependent on, nor highly interrelated with, the other leases in the contract (see 4.1.40). However, this requirement is explained differently in the two standards.

- Under Topic 842, a lease (or bundle of leases) is highly dependent on or highly interrelated with another lease (or bundle) if each lease significantly affects the other. [842-10-15-28(b)]
- IFRS 16 provides the example of a lessee being able to decide not to lease the underlying asset without significantly affecting its rights to use other underlying assets in the contract; under IFRS 16, this might indicate that the underlying asset is not highly dependent on, or highly interrelated with, those other underlying assets. [IFRS 16.B32(b)]

4.1.250 The FASB and the IASB reached converged technical decisions about identifying separate lease components at a joint Board meeting. However, this difference arises from the Boards' different decisions about how to revise the separation guidance applicable to identifying performance obligations in Topic 606 and IFRS 15, from which the separate lease components guidance was derived, as a result of feedback from the FASB-IASB Joint Transition Resource Group on Revenue Recognition (the TRG).

4.1.260 After the issuance of IFRS 16, the IASB decided to amend the separation guidance applicable to identifying performance obligations guidance in IFRS 15 so that it is converged with the same guidance in Topic 606. However, presently it is our understanding that IFRS 16 will not be revised as a result of the amendments to IFRS 15.

4.1.270 Despite the apparent decision of the IASB not to amend the separate lease components guidance in IFRS 16, we expect the separate lease components guidance in Topic 842 and IFRS 16 to be applied similarly given both Boards' assertions that the separate lease components guidance is derived from converged separation guidance in Topic 606 and IFRS 15.

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Comparison with current US GAAP

Separating land lease components

4.1.280 Current US GAAP requires separate accounting for the land and building elements of a lease when the fair value of the land is 25 percent or more of the total fair value of the property at lease inception. [840-10-25-38(b)(2)]

4.1.290 The method by which lease payments are allocated between the land and building represents a change from current US GAAP, which requires lease payments equal to the product of the fair value of the land multiplied by the lessee's incremental borrowing rate to be allocated to the land element and the remaining portion of the lease payments (i.e. the residual portion) to be allocated to the building element. [840-10-25-38(b)(2)]

4.1.300 This difference could change the pattern of expense or income for leases of land and buildings in some cases. However, this potential outcome is mitigated by the relatively high proportion of situations in which the lease classification tests (see sections 6.2 (lessees) and 7.2 (lessors)) likely will result in operating lease classification for both the land and the building lease elements if they were accounted for separately.

Separating other lease components

4.1.310 Current US GAAP requires the equipment element(s) of a lease of both real estate and equipment to be accounted for separately from the real estate element(s). However, lessees and lessors generally account for leases of multiple underlying assets of the same nature (i.e. buildings or equipment) in the aggregate if the separate leased assets are functionally interdependent (e.g. a mainframe computer system, associated terminals, servers, and other peripheral and output devices may be considered functionally interdependent). Conversely, under current US GAAP, lessees and lessors generally account for leases of multiple underlying assets of the same nature separately if the separate leased assets are functionally independent (e.g. a manufacturing facility and an office building typically would be considered functionally independent).

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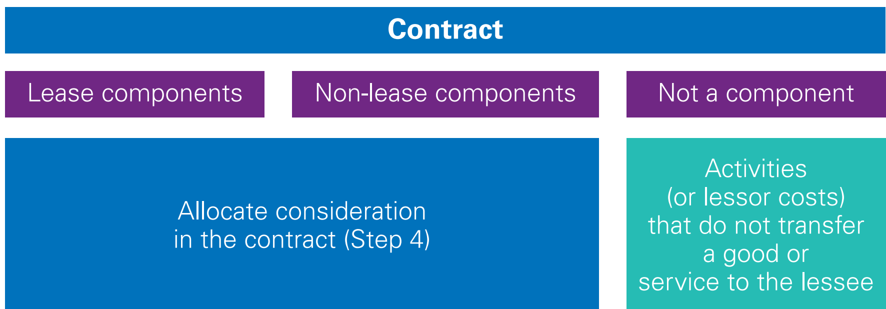
4.2 Step 2: Identify any non-lease components

4.2.10 A contract might contain non-lease components in addition to lease components – e.g. an arrangement to lease a machine with the lessor responsible for machine maintenance, or to lease office space with the lessor responsible for common area maintenance. In these examples, the maintenance is a non-lease component of the contract. The consideration in the contract is allocated between the lease and non-lease components in Step 4 (see section 4.4). [842-10-15-31]

4.2.20 Not every element of a contract that contains a lease is necessarily a 'component'. While it may be intuitive to assume that any activity or payment that is not a lease component or an explicit 'lease payment' must be a non-lease component, this is not how Topic 842 works. Instead, some elements of a contract may not be components at all because they do not transfer a good or service to the lessee. [842-10-15-30]



4.2.30 Examples of activities (or costs of the lessor) that do not transfer a good or service to the lessee include a lessee's reimbursement or payment of the lessor's property taxes and insurance. Such payments are discussed in section 4.6, which highlights the application of Step 4 (allocation) when certain elements of the contract are not components. [842-10-15-30]

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KPMG observation – Lease versus non-lease components evaluation separate from determination of whether a contract is or contains a lease

4.2.40 The guidance in Topic 842 on separating lease from non-lease components of a contract applies only once an entity has determined that a contract is or contains one or more leases (see chapter 3). No aspect of the separation or allocation guidance for lease and non-lease components affects the conclusion already reached that the contract is or contains one or more leases. For example, a determination that the contract involves a very significant service component, on which effective use of the underlying asset depends, does not change the conclusion that there is a lease. [842-10-15-30]

KPMG observation – Components in Topic 842 equivalent to promised goods or services in Topic 606

4.2.50 The guidance on activities or costs that do not transfer a good or service to the lessee (e.g. payments of the lessor's property tax and insurance) is intended to be consistent with the guidance in Topic 606 relating to set-up or other activities that do not transfer a good or service to the customer. In both cases, no consideration is allocated to such activities; consideration is only allocated to promised goods or services. [ASU 2016-02.BC159]

4.2.60 The Board concluded that defining components as only those items that transfer a good or service to the lessee provides a clearer way in which to identify the components of a contract that is likely to be operable for both lessees and lessors. It also prevents entities from structuring how payments are written into a contract to avoid their classification as lease payments, and therefore their inclusion in the lessee's lease liability. [ASU 2016-02.BC160]

KPMG observation – Common area maintenance

4.2.70 Real estate leases that require the lessee to pay the lessor's property taxes and insurance often also require the lessee to pay common area maintenance fees. In contrast to payments for the lessor's property taxes or insurance, common area maintenance generally transfers a good or service to the lessee other than the right to use the underlying asset, and therefore it is a non-lease component of the contract. As a result, a portion of the consideration in the contact is allocated to common area maintenance (non-lease component). [842-10-55-144 – 55-145]

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KPMG observation – Residual value guarantees are not a component of a contract

4.2.80 Under current US GAAP, a lessee residual value guarantee is outside the scope of Topic 460 (guarantees) if the lessee accounts for the lease as a capital lease. Subsequent to the adoption of ASU 2016-02, *any* lessee residual value guarantee is outside the scope of Topic 460 – i.e. regardless of the classification of the lease (or whether the lease is an unrecognized short-term lease). Residual value guarantees are discussed further in section 5.4.6

4.3 Step 3: Measure the consideration in the contract

Lessee

4.3.10 The starting point for a lessee measuring the consideration in the contract is the defined payments in paragraph 842-10-30-5 relating to the use of the underlying asset (see section 5.4), which are then adjusted as follows: [842-10-15-35]

Payments relating to use of the underlying asset

+

Other fixed or in-substance fixed payments

+

Other variable payments that depend on an index or rate[1]

–

Incentives paid or payable to the lessee[2]

=

Consideration in the contract (lessee)

Notes:

1. The payments are calculated using the commencement date index or rate (see section 5.4.1).
2. Other than those included in paragraph 842-10-35-5.

4.3.20 As the above calculation illustrates, not all payments contemplated in the contract are included. For example, a fixed monthly service charge is included, but a variable monthly service charge that does not depend on an index or rate is not included. The following concepts that apply to determining the lease payments also apply to determining whether other payments should be included in the consideration:

- Determining whether a payment is in-substance fixed – see section 5.4.2.
- Determining whether a payment is based on an index or a rate, and calculating the amount to include in the calculation – see section 5.4.1.
- The approach to, and logic for, adjusting for incentives – see section 5.4.3.

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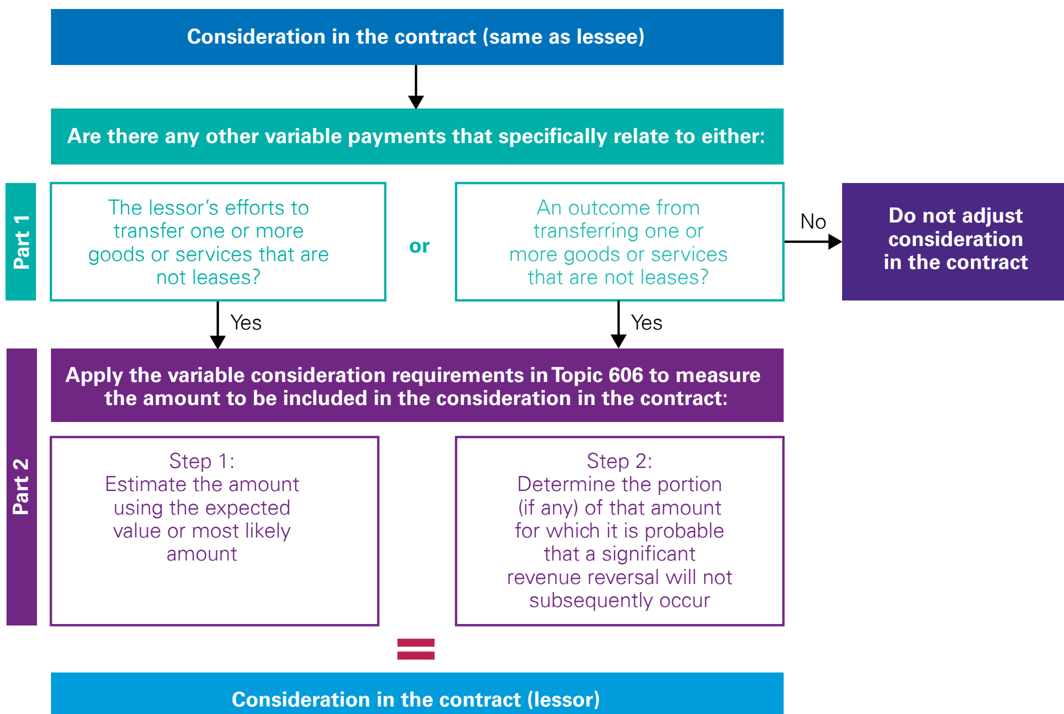
4.3.30 Once the amount of consideration has been measured, it is allocated to the lease and non-lease components of the contract in Step 4 (see section 4.4). The accounting for amounts payable under the contract that are not included in the consideration in the contract is discussed in section 4.4.3. [842-10-15-30]

Lessor

4.3.40 As a starting point, a lessor measures the consideration in the contract in the same way as a lessee. However, further adjustments are made as follows. [842-10-15-38 – 15-39, 606-10-32-8 – 32-14]



4.3.50 In considering whether any variable payments should be included in the consideration in the contract, the objective in Part 1 of the above diagram is to establish whether such payments vary solely on the performance of the non-lease component(s); for example, do the payments depend solely on the lessor's performance of non-lease services or the quality of consumables to be used with the leased asset? This is explored in Example 4.3. [842-10-55-153 – 55-156]

4.3.60 Once the consideration in the contract has been measured, it is allocated to the lease and non-lease components of the contract in Step 4 (see section 4.4). The accounting for amounts payable under the contract that are not included in consideration is discussed in section 4.4.3. [842-10-15-30]

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Example 4.3
Measuring the consideration in the contract – Variable payments

Scenario 1: Variable payments not based solely on non-lease component

4.3.70 Lessee LE and Lessor LR enter into a three-year lease of equipment that includes maintenance services on the equipment throughout the lease term.
LE will pay LR:

– a fixed payment of $110,000 per year; and
– a variable payment of $7,700 each year that the equipment is operational for a minimum number of hours at a specified level of productivity (i.e. the equipment is not malfunctioning or inoperable).

Lessee

4.3.80 LE does not include the variable payments in the consideration in the contract. This is because the variable payments do not depend on an index or rate (and are not in-substance fixed).

4.3.90 Therefore, the consideration in the contract is $330,000 ($110,000 x 3).

Lessor

4.3.100 LR starts with the amount of consideration determined in the same way as LE (i.e. $330,000).

4.3.110 Next, LR considers the link between the variable payments of $23,100 ($7,700 x 3) and the performance of the maintenance services. LR concludes that the variable payments are not solely related to performance of the maintenance services. The quality and condition of the leased equipment also substantively affects whether LR will earn the variable amounts.

4.3.120 Therefore, the variable payments are excluded, and the consideration in the contract is $330,000.

4.3.130 This scenario is continued in Example 4.6, Scenario 1, which illustrates how LR allocates the consideration in the contract (step 4 – see 4.4.20).

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Scenario 2: Variable payments specifically relate to non-lease component – No amounts constrained

4.3.140 Changing the facts of Scenario 1, the maintenance services are highly specialized and no entity would expect the leased equipment to meet the specified performance metrics without the related maintenance services.

Lessee

4.3.150 This change in fact pattern makes no difference for LE. The consideration in the contract remains at $330,000.

Lessor

4.3.160 LR starts with the amount of consideration determined in the same way as LE (i.e. $330,000).

4.3.170 Next, LR considers the link between the variable payments of $23,100 and the performance of the maintenance services. LR concludes that the variable payments relate specifically to an outcome dependent on LR's satisfactory performance of its maintenance services. This is because the maintenance services are highly specialized and critical to the operation of the equipment.

4.3.180 Next, LR applies the variable consideration requirements in Topic 606 to calculate the amount that should be included in the consideration in the contract:

1. LR estimates that the amount to which it expects to be entitled is $23,100.

2. LR concludes that it is probable that including that amount in the transaction price for the maintenance services will not result in a significant revenue reversal when the uncertainty is resolved.

4.3.190 Therefore, the consideration in the contract is $353,100 ($330,000 + $23,100).

4.3.200 This scenario is continued in Example 4.6, Scenario 2, which illustrates how LR allocates the consideration in the contract (step 4 – see 4.4.20).

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Scenario 3: Variable payments specifically relate to non-lease component – Amounts partially constrained

4.3.210 Changing the facts of Scenario 2, LE will pay LR:

- a fixed payment of $102,700 per year; and
- a variable payment of $15,000 each year that the equipment is operational for a minimum number of hours at a specified level of productivity (i.e. the equipment is not malfunctioning or inoperable).

Lessee

4.3.220 LE does not include the variable payments in the consideration in the contract. This is because the payments do not depend on an index or rate.

4.3.230 Therefore, the consideration in the contract is $308,100 ($102,700 x 3).

Lessor

4.3.240 LR starts with the amount of consideration determined in the same way as LE (i.e. $308,100).

4.3.250 Next, LR considers the link between the variable payments of $45,000 ($15,000 x 3) and the performance of the maintenance services. As in Scenario 2, LR concludes that the variable payments relate specifically to an outcome dependent on LR's satisfactory performance of its maintenance services.

4.3.260 Next, LR applies the variable consideration requirements in Topic 606 to calculate the amount that should be included in the consideration in the contract.

1. LR estimates that the amount to which it expects to be entitled is $45,000.
2. LR concludes that only $30,000 of that amount is probable of not resulting in a significant revenue reversal when the uncertainty is resolved.

4.3.270 Therefore, the consideration in the contract is $338,100 ($308,100 + $30,000).

4.3.280 This scenario is continued in Example 4.6, Scenario 3, which illustrates how LR allocates the consideration in the contract (step 4 – see 4.4.20).

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KPMG observation – Timing of measurement

4.3.290 The 'consideration in the contract' for both lessees and lessors *starts* with the payments relating to use of the underlying asset. Those payments are measured at the lease commencement date (see chapter 5). Topic 842 does not provide guidance about how an entity would measure the consideration in the contract if the lessor provides a non-lease component – i.e. other goods or services – before commencement of the lease. For example, assume a lessor agrees to lease a lessee a new piece of IT equipment, the term of which commences in two months when the requested piece of equipment can be delivered and made available to the lessee. The lease includes a lessee renewal option, a lessee purchase option, and the lessee provides the lessor with a residual value guarantee. In addition to the lease, the lessor also agrees to immediately begin maintaining the lessee's existing IT equipment that will remain in service together with the new leased equipment. The lessee should begin recognizing expense, and the lessor income, for the maintenance services being provided; however, it is unclear what amount they should be recognizing because the payments relating to use of the underlying asset are measured at lease commencement. The assessment of whether the lessee is reasonably certain to exercise the renewal or the purchase option or is probable of owing an amount under the residual value guarantee is based on facts and circumstances at lease commencement. [842-10-15-35, 30-5]

4.3.300 This timing issue could also arise for a contract that includes only lease components, but for which the commencement date of those leases differs. Consider an example whereby a lessee leases two pieces of equipment and each lease is a separate lease component. The lessee and the lessor are required to allocate the consideration in the contract to those two separate lease components, and will begin recognizing lease cost or lease income upon commencement of the first lease. However, consistent with the lease and non-lease component example in 4.3.290, they cannot measure the total consideration in the contract before commencement of the second lease.

4.3.310 In the absence of guidance in Topic 842 to resolve this issue, we believe that an entity would be required to make a preliminary estimate of the consideration in the contract. For example, the entity would need to, at the point in time at which it must begin to recognize expense or income in the examples above, measure the consideration in the contract. This would include doing all of the following at that point in time:

- measuring any variable lease payments that depend on an index or rate based on the index or rate at that point in time;
- assessing the likelihood of lessee option exercises (renewal, termination, and/or purchase options) based on the current facts and circumstances; and
- assessing amounts probable of being owed under a residual value guarantee based on the current facts and circumstances.

4.3.320 However, because Topic 842 requires measurement as of the commencement date, we believe that an entity would be required to true up this initial accounting at the commencement date (or the final commencement date in the multiple separate lease components example).

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KPMG observation – Differences between Topic 842 and Topic 606 for lessors

4.3.330 The accounting for variable payments by lessors under Topic 842 is different from how variable consideration is accounted for under Topic 606 by vendors/suppliers.

4.3.340 Therefore, the Board decided that guidance was necessary for lessors to navigate the differences. The guidance is intended to help clarify whether and, if so, when the consideration in the contract for a lessor includes variable consideration (subject to the constraint in Topic 606) – Step 2 in the diagram in 4.3.40. [ASU 2016-02.BC161–BC163]

4.3.350 Paragraph 606-10-15-4 states that if other Topics (e.g. Topic 842) provide separation and measurement guidance, then an entity applies that guidance first. The entity then excludes amounts allocated to items covered by the other Topics from the Topic 606 transaction price that applies to the performance obligations within the scope of Topic 606. In the context of Topic 842, this means that a lessor separates lease from non-lease components (as required by Topic 842), measures the consideration in the contract in accordance with Topic 842, and allocates consideration to the lease and non-lease components in accordance with Topic 842. As a result, the consideration in the contract allocated to a non-lease (e.g. service) component in the scope of Topic 606 may differ from the transaction price that would be determined for that component if it were not associated with a lease. Consequently, applying the separation and measurement guidance in Topic 842 to a non-lease component in the scope of Topic 606 may result in an entity accounting for the same good or service obligation to a customer differently depending solely on whether it is (or is not) provided in conjunction with a lease. [ASU 2016-02.BC163, 842-10-55-150 – 55-156, 606-10-15-4]

4.3.360 Example 4.6 (Scenarios 1 and 2) illustrates the effect of this; namely, that lessors will recognize income attributable to variable amounts that are partially, but not solely, attributable to a non-lease component in the same manner as variable lease payments – i.e. as income when earned – even though the entity's revenue recognition might differ for that service component if it were being provided separately or in conjunction with a sold (rather than leased) piece of equipment.

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US GAAP different from IFRS 16 – Consideration in the contract

Definition

4.3.370 While Topic 842 defines consideration in the contract for lessees and lessors and provides examples of the application of that definition (Example 14 in Subtopic 842-10), IFRS 16 does not define consideration in the contract. Therefore, it is possible that entities applying IFRS will interpret what constitutes the consideration in the contract to be allocated to the separate lease and non-lease components of a contract differently from how it is defined in Topic 842. [IFRS 16.12–17, B32–B33]

Lessee allocation of consideration in the contract

4.3.380 While Topic 842 specifically notes that in some limited circumstances, the use of a residual approach for estimating the stand-alone price of a separate lease or non-lease component may be appropriate for lessees, IFRS 16 is silent. However, given the Boards' discussion of this topic and the publicly available FASB/IASB staff paper on allocating the consideration in the contract to lease and non-lease components, we do not believe that there is an intended difference between Topic 842 and IFRS 16 in this regard.

Comparison with current US GAAP – Lessor accounting for variable payments affected by definition of consideration in the contract

4.3.390 Under current US GAAP, contingent payments are recognized as lease or related non-lease income only when such amounts are earned. While, in general, most variable payments in a lease contract will continue to be recognized only when earned, the requirement for lessors to include variable payments in the consideration in the contract in some cases could affect the pattern of income recognition for lessors.

4.3.400 For example, if a lessor applying Topic 842 includes a performance bonus that it expects to earn from providing a service to the lessee in the consideration in the contract, it generally would recognize that amount as income over the period the service is provided. In contrast, under current US GAAP, that same lessor generally would not recognize the performance bonus until it is earned. [840-10-25-4, 840-20-25-2, 840-30-25-3]

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4.4 Step 4: Separate and allocate consideration between the lease and non-lease components

4.4.1 Allocate the consideration in the contract – In proportion to stand-alone prices

4.4.10 Non-lease components are separated from related lease components unless a lessee elects the practical expedient (see 4.4.30–40). Lease components are accounted for under Topic 842; non-lease components are accounted for under other applicable US GAAP (e.g. Topic 606 for lessors). [842-10-15-31]

4.4.20 The consideration in the contract is allocated between the lease and non-lease components of a contract using different methodologies for the lessee and lessor. [842-10-15-33, 15-38]

	Lessee	Lessor
When there is an observable stand-alone price for each component:	Unless the practical expedient is elected (see 4.4.30–40), separate and allocate based on the relative stand-alone price of components.	Always separate and allocate following the Topic 606 transaction price allocation guidance – i.e. generally on a relative stand-alone selling price basis.
When there is not an observable stand-alone price for some or all components:	Estimate the stand-alone price, maximizing the use of observable information.	
	Remember: Activities (or costs of the lessor) that do not transfer a good or service to the lessee are not components of the contract (see sections 4.2 and 4.6). Therefore, no consideration is allocated to such items.	

Practical expedient for lessees only

4.4.30 As a practical expedient, a lessee may elect not to separate the non-lease components of a contract from the lease component to which they relate. This means that the components will be treated as a single lease component. For example, in a lease of a machine with the lessor responsible for machine maintenance, the lessee may account for a single lease component – i.e. the payments that would otherwise be attributed to the maintenance will be accounted for as lease payments and included in the measurement of the lessee's right-of-use asset and lease liability. [842-10-15-37]

4.4.40 A lessee elects this practical expedient by class of underlying asset – e.g. office equipment, automobiles, office space.

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KPMG observation – Practical expedient for lessees not limited to insignificant non-lease components

4.4.50 The availability of the practical expedient for lessees not to separate non-lease components from the lease components to which they relate is not limited to situations in which the non-lease component is insignificant in comparison to the related lease component. [ASU 2016-02.BC150]

4.4.60 Providing lessees with the practical expedient by class of underlying asset could reduce comparability between entities. However, the Board concluded that lessees will typically elect the practical expedient only for leases with insignificant non-lease components. That is, a lessee will generally not elect the practical expedient if it will significantly increase the amount of lease liabilities that it has to recognize.

4.4.70 Combining a non-lease component with a lease component will generally result in straight-line recognition of the cost for the non-lease component. This pattern of expense recognition might differ in some cases from the pattern of expense recognition that would apply if the non-lease component were accounted for separately from the lease.

Lessee allocation of the consideration in the contract

4.4.80 The consideration in the contract is allocated to the separate lease and non-lease components on a relative stand-alone price basis. The stand-alone price of a component is the price at which a customer would purchase that component separately. Lessees are required to use observable stand-alone prices when they are available and to estimate stand-alone prices if observable prices are not available. [842-10-15-33, 842 Glossary]

4.4.90 'Initial direct costs' are allocated to the separate lease components on the same basis as the lease payments. The definition of and accounting for initial direct costs is discussed in section 5.5.

4.4.100 An observable stand-alone price is the price charged by the lessor or similar suppliers for a similar lease or non-lease component – i.e. a lease of a substantially similar asset or non-lease component under similar terms and conditions; for example, with respect to duration and payment terms – on a stand-alone basis. When estimating stand-alone prices, lessees are required to maximize the use of observable information. In some circumstances, the use of a residual approach for estimating the stand-alone price of a separate lease or non-lease component may be appropriate (see Example 4.5). For example, a residual estimation approach may be appropriate if the stand-alone price for a component is highly variable or uncertain. [842-10-15-33 – 15-34]

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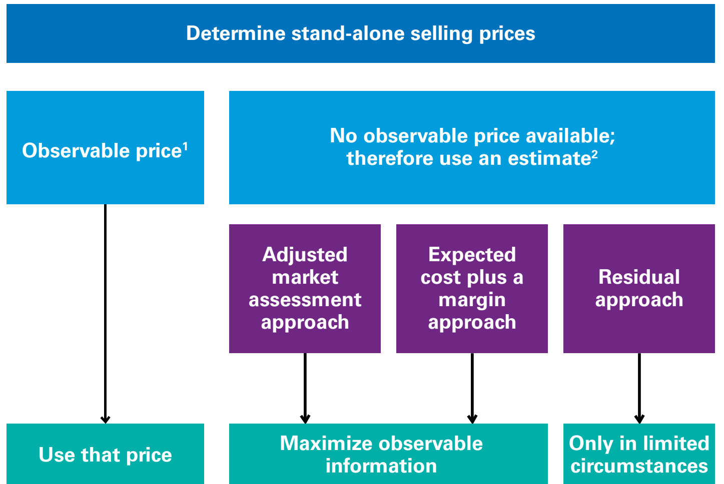
Lessor allocation of the consideration in the contract

4.4.110 In following the guidance in Topic 606, a lessor allocates the consideration in the contract to each separate lease and non-lease component to depict the amount of consideration to which the lessor expects to be entitled (the 'allocation principle' in Topic 606). [842-10-15-38, 606-10-32-28]

4.4.120 The lessor will generally allocate the consideration in the contract to each separate lease component and each non-lease component on a relative basis in proportion to its stand-alone selling price, which is determined as follows. [606-10-32-29 – 32-35]



Notes:

1. An observable price is the price at which the lessor sells *that* component separately in similar circumstances and to similar customers.
2. A lessor considers all information that is reasonably available when estimating a stand-alone selling price – e.g. market conditions, entity-specific factors, and information about the lessee. A lessor also maximizes the use of observable inputs and applies consistent methods to estimate the stand-alone selling price of components with similar characteristics.

4.4.130 In some circumstances, the transaction price allocation guidance in Topic 606 requires the lessor to allocate a bundled discount or variable consideration on an other-than-relative basis to the components of the contract – i.e. a bundled discount or variable consideration may be allocated entirely to only one or some, but not all, of the components. [606-10-32-36 – 32-41]

4.4.140 Topic 606 does not preclude or prescribe any particular method for estimating the stand-alone selling price of a good or service when observable prices are not available, but describes the following estimation methods as suitable approaches. [606-10-32-34]

Approach	Description
Adjusted market assessment approach	Evaluate the market in which goods or services are sold and estimate the price that customers in the market would be willing to pay.
Expected cost plus a margin approach	Forecast the expected costs of satisfying a performance obligation and then add an appropriate margin for that good or service.
Residual approach (limited circumstances – consistent with Topic 606)	Subtract the sum of the observable stand-alone selling prices of other goods or services promised in the contract from the total transaction price.

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Example 4.4

Allocating the consideration in the contract – Observable inputs

4.4.150 Lessor LR leases a bulldozer to Lessee LE to be used in LE's mining operations. LR also provides maintenance services for the bulldozer for the entire lease term. Total consideration for the use of the bulldozer and the maintenance services over the term of the contract is $125,000. There is no variable consideration.

4.4.160 LR and LE each consider stand-alone prices.

- LR regularly leases bulldozers separately for comparable lease terms under similar terms and conditions. Therefore, both LE and LR have access to observable stand-alone prices for the lease component ($100,000).
- Although LR does not provide maintenance services separately from its equipment leases, there are many other service providers that do under similar terms and conditions (e.g. for similar periods and with similar payment terms). Both LR and LE arrive at a stand-alone price of $40,000, but their approaches differ.
  - » LE is able to obtain an observable stand-alone price for the maintenance services. The prices of service providers other than LR for similar services constitutes an observable stand-alone price for LE.
  - » The price charged by other service providers does not constitute an observable stand-alone selling price for LR; instead, LR utilizes the rates charged by other service providers to estimate a stand-alone selling price for the maintenance services (i.e. using a market assessment approach).

4.4.170 In this example, the allocation of consideration is the same for both LR and LE.[1]

Component	Stand-alone price	Allocation	Calculation
Bulldozer lease	$100,000	$ 89,286	(100,000/140,000) x 125,000
Maintenance	40,000	35,714	(40,000/140,000) x 125,000
	$140,000	**$125,000**	

Note 1:

LE does not apply the practical expedient to its mining equipment leases (see 4.4.30–40).

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Example 4.5

Allocating the consideration in the contract – Observable and estimated stand-alone prices

4.4.180 Lessor LR leases a specialized machine for two years to Lessee LE, and provides consulting services to help LE effectively use the machine in its production processes. The machine is not sold or leased separately by LR and there are no similar machines for sale or lease from other suppliers.

4.4.190 The contract consideration is $100,000 for the first year and $80,000 for the second year. LR priced the contract in this way assuming that it will provide more consulting services in the first year.

Lessee

4.4.200 Because LR does not sell or lease the specialized machine, or provide substantially equivalent consulting services separately, LE allocates the consideration in the contract based on observable and estimated relative stand-alone selling prices.

4.4.210 LE determines the stand-alone prices for the lease and the consulting services as follows.

- There are no similar machines for sale or lease from suppliers other than LR, and therefore LE cannot obtain an observable stand-alone price or use a market-based assessment estimation approach. In addition, LE also does not have the information needed to apply an expected cost-plus-margin approach. Consequently, LE concludes that a residual approach is reasonable and appropriate in the circumstances.
- LE obtains an observable stand-alone price for the consulting services based on similar services offered in the marketplace ($40,000).

4.4.220 On this basis, LE allocates the consideration as follows.

Component	Stand-alone price	Allocation	Calculation[1]
Machine lease	$140,000	$140,000	Residual (180,000 - 40,000)
Consulting	40,000	40,000	Observable price
	$180,000	**$180,000**	

Note 1:

This calculation relates to determining the stand-alone prices, which are then allocated to the components of the contracts.

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Lessor

4.4.230 Because LR does not sell or lease the specialized machine, or provide substantially equivalent consulting services separately, LR allocates the consideration in the contract based on *estimated* relative stand-alone selling prices.

4.4.240 LR estimates stand-alone selling prices as follows.

- The specialized nature of the machine precludes the use of a market assessment approach – i.e. there are no similar machines for lease by other suppliers to assess. Consequently, LR uses another estimation technique to arrive at a stand-alone selling price of $160,000 for the machine lease.
- LR uses a market-based assessment approach to arrive at a stand-alone selling price of $40,000 for the consulting services based on similar services offered in the consulting marketplace.

4.4.250 On this basis, LR allocates the consideration as follows.

Component	Stand-alone price	Allocation	Calculation
Machine lease	$160,000	$144,000	(160,000/200,000) x 180,000
Consulting	40,000	36,000	(40,000/200,000) x 180,000
	$200,000	**$180,000**	

KPMG observation – Lessees and lessors apply different separation and allocation guidance

Practical expedient to not separate lease and non-lease components

4.4.260 While lessors are always required to separate lease from non-lease components, lessees may elect, by class of underlying asset, a practical expedient not to separate non-lease components from the lease component to which they relate. [842-10-15-37]

Lessees always allocate on relative basis; lessors do not

4.4.270 Lessees will always allocate the consideration in the contract on a relative stand-alone price basis. In contrast, because lessors will apply the transaction price allocation guidance in Topic 606, they will allocate a discount or variable consideration that is accounted for as consideration in the contract to only one or some of the separate lease or non-lease components of the contract in some cases. [842-10-15-33, 15-38]

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Different perspectives on observable stand-alone prices

4.4.280 For the **lessee**, observable stand-alone prices include those charged not only by the lessor but also by other suppliers for the same or a similar component – e.g. the price charged for the lease of a similar piece of equipment or for similar services. [842-10-15-34]

4.4.290 For the **lessor**, the definition of observable stand-alone selling price is more restrictive, both in terms of using similar goods or services and considering suppliers other than the lessor. Taken from Topic 606, an observable stand-alone selling price is the price for which the *entity* sells *that* good or service separately in similar circumstances and to similar customers. [606-10-32-32]

4.4.300 However, applying a market assessment approach under Topic 606 might include referring to prices from the lessor's competitors for similar goods or services (and adjusting those prices as necessary to reflect the lessor's costs and margins) as an acceptable technique for estimating the stand-alone selling price. Therefore, while the lessor might use similar information to the lessee to determine the stand-alone price of a component, that stand-alone price will be considered 'observable' for the lessee, but 'estimated' for the lessor. [606-10-32-34]

Burden of proof for observable stand-alone prices

4.4.310 Both lessees and lessors are required to maximize the use of observable information in determining the stand-alone price of components. However, we believe that the Board generally intended for lessees to be able to resort to estimation for stand-alone prices more frequently than would be permitted for lessors. This is evidenced by the fact that Topic 842 requires a lessee to estimate stand-alone prices when observable stand-alone prices are not 'readily available'. We believe that it was the Board's intent that lessees should not have to exhaustively search for observable stand-alone prices, particularly when such a requirement might put significant pressure on lessors to provide proprietary information to lessees.

Different estimation techniques

4.4.320 Lessees may rely on estimation techniques different from those used by lessors, because lessors will frequently have greater access to observable information – e.g. its incurred cost data or non-public industry information on the pricing of lease or related non-lease components. Even so, it will generally not be appropriate for a lessee to default to the residual approach when another approach would yield a more representative result. We believe that estimation techniques used should be reasonable and not developed with a bias to reducing amounts allocated to lease components. [ASU 2016-02.BC156]

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Allocating consideration when there are multiple lease and multiple non-lease components

4.4.330 For **lessors**, we believe that each separate lease and non-lease component needs to be identified *before* allocating the consideration in the contract, which is the methodology followed in the examples in Topic 842. This means that each separate component – whether lease or non-lease – is a separate unit of account for the purpose of determining stand-alone prices and allocating consideration. This is relevant because a bundle of two or more components may have a different stand-alone price (e.g. a bundled discount) that would affect allocation if components were grouped. [842-10-55-132 – 55-137]

4.4.340 We believe that the Board intended for **lessees** to identify the separate lease components of the contract and then account for non-lease components that relate to *different* separate lease components as separate units of account.

4.4.350 It is not clear whether a lessee would be required to separately account for multiple non-lease components that relate to a single lease component. In such cases, it may be reasonable for a lessee to determine the stand-alone price for multiple non-lease components that relate to a single lease component as a bundle. However, because Topic 842 requires that stand-alone prices be observable (when readily available) and maximize the use of observable data when estimated, that might limit lessees' choices in this regard. For example, the requirement to maximize the use of observable prices or data would generally mean that it is not appropriate to estimate the stand-alone selling price of a bundle that is not regularly sold separately if there are readily available observable prices for the non-lease components individually.

Comparison with current US GAAP – Separating lease from non-lease components

4.4.360 Topic 842 and current US GAAP are consistent with respect to accounting for non-lease components (or elements) separately from lease components. For example, current US GAAP, like Topic 842, requires services or goods, such as consumables, provided by the lessor to be accounted for separately from the lease elements of a contract. However, unlike Topic 842, current US GAAP does not permit a lessee to *not* separate non-lease components from the lease component to which they relate. [840-10-15-19]

4.4.370 The guidance in Topic 842 with respect to separating lease from non-lease components of a contract is significantly more consequential to a lessee's accounting than the similar guidance in current US GAAP. This is because while operating lease elements and service elements are accounted for similarly under current US GAAP, lease components are subject to substantially different accounting requirements (i.e. the recognition of lease assets and lease liabilities) under Topic 842 than non-lease components. [840-10-15-19]

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Determining the stand-alone price of components and allocating consideration

4.4.380 The requirements of Topic 842 differ from those in current US GAAP in the following key respects.

- Under Topic 842, executory costs that do not transfer a good or service to the customer (e.g. payment of the lessor's property taxes or insurance) are allocated to both the lease and the non-lease components of the contract on the same basis as the other *consideration in the contract* and are not, therefore, excluded from the *lease payments*. Under current US GAAP, all executory costs are excluded from the *minimum lease payments* for a lease.
- While the relative fair value allocation method under current US GAAP is substantially the same as the relative stand-alone price allocation method applicable to lessees under Topic 842, additional rigor is prescribed for determining the stand-alone price of the components of the contract. For example, in no case does Topic 842 permit an entity to default to amounts specified in the contract when determining the stand-alone price for a component. An entity determines the stand-alone price of a lease or a non-lease component based on its observable stand-alone price (if readily available), and estimated stand-alone prices if observable prices are not readily available. Use of contractually stated amounts for lease or non-lease payments as the stand-alone price for components generally will be rare as such amounts should not be presumed to represent the stand-alone price for a component. [840-10-15-19, 15-30]

4.4.2 Allocate variable consideration in the contract – Lessor

4.4.390 If variable payment amounts are included in the consideration in the contract (see section 4.3) for a lessor, they are allocated entirely to the non-lease component(s) to which they relate if that would be consistent with the transaction price allocation objective in Topic 606. [842-10-15-39]

Transaction price allocation objective

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. [606-10-32-28]

4.4.400 If the lessor does not allocate those variable payments entirely to the non-lease component(s) to which they relate, it allocates them on the same basis as the remainder of the consideration in the contract. [606-10-32-39]

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Example 4.6

Allocating the consideration in the contract – Variable payments

4.4.410 This example is a continuation of Example 4.3, which measured the consideration in the contract in three scenarios. This example takes the consideration that was calculated for the *lessor*, and allocates it to components following the guidance in Topic 606. In all three scenarios, the stand-alone prices are assumed to be $315,000 (equipment) and $40,000 (maintenance).

Scenario 1: Variable payments not based solely on non-lease component

4.4.420 Lessee LE and Lessor LR enter into a three-year lease of equipment that includes maintenance services on the equipment throughout the lease term. LE will pay LR.

- a fixed payment of $110,000 per year; and
- a variable payment of $7,700 each year that the equipment is operating a minimum number of hours at a specified level of productivity (i.e. the equipment is not malfunctioning or inoperable).

4.4.430 In Example 4.3, Scenario 1, the consideration in the contract was measured at $330,000, which excluded any variable payments. LR allocates the consideration in proportion to stand-alone prices as follows.

Component	Stand-alone price	Allocation	Calculation
Equipment lease	$315,000	$292,817	(315,000/355,000) x 330,000
Maintenance	40,000	37,183	(40,000/355,000) x 330,000
	$355,000	**$330,000**	

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Scenario 2: Variable payments that specifically relate to a non-lease component – Allocation to lease and non-lease components

4.4.440 Changing the facts of Scenario 1, the maintenance services are highly specialized and no entity would expect the equipment to meet the specified performance metrics without the related maintenance services.

4.4.450 In Example 4.3, Scenario 2, the consideration in the contract was measured at $353,100, which included $23,100 of variable payments related to the maintenance (non-lease) component.

4.4.460 Next, following the allocation objective in Topic 606 (see 4.4.390), LR considers whether allocating the entire variable amount of $23,100 to the maintenance component would depict the amount of consideration to which LR expects to be entitled in exchange for providing the lease and maintenance services to LE. If it does, total consideration would be allocated in one of the two following ways.

Approach 1:

Component	Stand-alone price	Allocation	Calculation
Equipment lease	$315,000	$292,817	(315,000/355,000) x 330,000
Maintenance	40,000	60,283	(40,000/355,000) x 330,000 + 23,100
	$355,000	**$353,100**	

Approach 2:

Component	Stand-alone price	Allocation	Calculation
Equipment lease	$315,000	$330,000	All of the fixed consideration
Maintenance	40,000	23,100	Only the variable consideration
	$355,000	**$353,100**	

4.4.470 However, in this Scenario LR concludes that allocating $60,283 (or $23,100) to the maintenance services would not depict the consideration to which LR expects to be entitled for each component. This is because these two amounts are significantly higher (lower) than the amount to which LR expects to be entitled for the maintenance services. Therefore, LR allocates the total consideration in proportion to the components' stand-alone prices as follows.

Component	Stand-alone price	Allocation	Calculation
Equipment lease	$315,000	$313,314	(315,000/355,000) x 353,100
Maintenance	40,000	39,786	(40,000/355,000) x 353,100
	$355,000	**$353,100**	

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Scenario 3: Variable payments that specifically relate to a non-lease component – Allocation only to non-lease component

4.4.480 Changing the facts of Scenario 2, LE will pay LR:

- a fixed payment of $102,700 per year; and
- a variable payment of $15,000 each year that the equipment is operating a minimum number of hours at a specified level of productivity.

4.4.490 In Example 4.3, Scenario 3, the consideration in the contract was measured at $338,100, which included $30,000 of variable payments related to the maintenance (non-lease) component.

4.4.500 Next, LR concludes that allocating the entire variable amount of $45,000 to the maintenance component (full value of the estimated variable payments, without consideration of the constraint on variable consideration) and the entire fixed amount of $308,100 to the lease would reasonably depict the amount of consideration to which LR expects to be entitled in exchange for providing the lease and maintenance services to LE. The $308,100 and the $45,000 approximate the stand-alone prices of the lease ($315,000) and the maintenance services ($40,000), respectively.

4.4.510 Because the variable payments are allocated entirely to the maintenance services, if the consideration in the contract changes because LR concludes it is now probable that it will earn the full $45,000 in variable payments, that change is allocated entirely to the maintenance services component.

Comparison with current US GAAP – Allocation differences

4.4.520 The transaction price allocation guidance in Topic 606 that must be applied by lessors will not always result in an allocation of the consideration in the contract consistent with the relative fair value allocation method in current US GAAP. In some cases, the lessor allocation guidance in Topic 842 will allocate a discount or variable consideration entirely to only one or some of the components of the contract, rather than on a relative basis. [840-10-15-19, 606-10-32-37, 32-40]

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4.4.3 Variable payments not included in the consideration in the contract

4.4.530 Following from the discussion of Step 3 (see section 4.3), the following types of payments are *not* included in the consideration in the contract.

Lessee:

- Variable payments specifically or partially related to the lease component(s) that do not depend on an index or rate. [842-10-15-35]
- Variable payments specifically related to the non-lease component(s) that do not depend on an index or rate. [840-10-15-35]

Lessor:

- Variable payments specifically or partially related to the lease component(s) that do not depend on an index or rate. [840-10-15-40]

4.4.540 Variable payments not included in the consideration in the contract are recognized in profit or loss when incurred (lessee) or earned (lessor) and are generally allocated to the lease and/or non-lease components consistent with the allocation decisions made in Step 4. Recognition of variable lease payments not included in the consideration in the contract is addressed in section 6.4 (lessees) and sections 7.3–7.4 (lessors). [842-10-15-35, 15-40, 842-20-25-5 – 25-6, 55-1 – 55.2, 842-30-25-2, 25-9, 25-11]

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Example 4.7
Variable lease payments not included in the consideration in the contract

4.4.550 Lessee LE leases a specifically identified space in a building and a printing press from Lessor LR for three years.

4.4.560 The following additional facts are relevant.

- LE and LR each conclude that the building space and the printing press are separate lease components.
- The contractual lease payments for the building space are fixed at $300,000 per year, which is considered to be a market rate.
- The contractual lease payments for the printing press are based entirely on the level of usage, at $50 for each hour operated, which is considered to be a market rate.

  LE and LR each predict that the printing press will be operated for 2,000 hours per year over the three-year lease term, resulting in total expected variable payments of $300,000 over the three-year lease term.
- There are no non-lease components of the contract and the variable payments are not based on an index or rate. Therefore, the consideration in the contract is $900,000 ($300,000 x 3) for LE and LR, and all of the fixed payments are 'lease payments' (see section 5.4).

Lessee

4.4.570 LE allocates the lease payments of $900,000 ($300,000 x 3) to the two lease components as follows.

Component	Stand-alone price	Allocation	Calculation
Building space	$ 900,000	$675,000	(900,000/1,200,000) x 900,000
Press	300,000	225,000	(300,000/1,200,000) x 900,000
	$1,200,000	**$900,000**	

4.4.580 LE recognizes the variable lease cost as incurred, and each variable amount that will be paid is allocated between the building space lease and the printing press lease in the same proportion as the lease payments were originally allocated – 75% to the building space lease and 25% to the printing press lease. This means that if the total variable lease payments ultimately owed by LE are $300,000, they will have been allocated as follows over the term of the lease.

Component	Stand-alone price	Allocation	Calculation
Building space	$ 900,000	$225,000	(900,000/1,200,000) x 300,000
Press	300,000	75,000	(300,000/1,200,000) x 300,000
	$1,200,000	**$300,000**	

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Lessor

4.4.590 LR allocates the $900,000 in fixed lease payments entirely to the building space lease and the $300,000 in expected variable lease payments entirely to the printing press lease.

4.4.600 LR concludes this is appropriate because:

- the variable amounts relate specifically to LE's use of the printing press; and
- this allocation of the fixed and variable lease payments to the building space lease and the printing press lease reasonably depicts the amounts to which LR expects to be entitled for each lease component – i.e. this allocation meets the transaction price allocation objective in Topic 606 (see 4.4.390).

4.4.610 The lease payments used by LR in its evaluation of the lease classification and in accounting for the printing press lease (see chapter 7) are nil because only variable lease payments are allocated to that lease component.

4.4.620 LR recognizes the variable payments when earned, and each amount is allocated entirely to the printing press lease.

4.5 Subsequent changes to the consideration in the contract

Lessee

4.5.10 Lessees remeasure and reallocate the consideration in the contract when:

- there is a remeasurement of the lease liability – e.g. a change in the *lease payments* resulting from a change in the lease term or a change in the amount probable of being owed under a residual value guarantee; or
- there is a contract modification that is not accounted for as a separate contract. [842-10-15-36]

4.5.20 The accounting for changes in consideration in the contract from the lessee's perspective is discussed in sections 6.6 and 6.7.

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$ Lessor

4.5.30 Lessors remeasure and reallocate the consideration in the contract only when a contract modification occurs that is not accounted for as a separate contract. [842-10-15-41]

4.5.40 Changes in the consideration in the contract not resulting from a modification are accounted for in accordance with the changes in the transaction price guidance in Topic 606. An example is changes in the lessor's estimate of variable payments to which it will be entitled specifically for a non-lease component or changes in the estimated amount that are unconstrained. [842-10-15-42, 606-10-32-42 – 32-45]

4.5.50 In many cases, changes in the consideration in the contract will be allocated to the separate lease and non-lease components of the contract on the same basis as was done initially. However, in some cases, changes may be allocated to only one (or some) of the components of the contract. Example 4.6, Scenario 3 describes how the lessor will account for a change in the consideration in the contract – i.e. a change resulting from estimated amounts becoming unconstrained.

KPMG observation – Variable payments and the 'consideration in the contract'

4.5.60 Other than when a variable payment specifically relates to a non-lease component (or to an outcome resulting from transferring or providing a non-lease component) for a lessor (see 4.3.40), variable payments are never part of the 'consideration in the contract' – even when they are subsequently earned. Therefore, as variable payments become owed (by a lessee) or earned (by a lessor) – see 4.4.540 – they do not change the consideration in the contract. In contrast, if a variable payment specifically relates to a non-lease component, changes to that variable payment (e.g. changes to the estimated amount to which the lessor expects to be entitled or changes to the amount of that estimate that is constrained) *is* a change to the consideration in the contract.

4.5.70 This distinction between what is and is not part of the consideration in the contract matters for lessors because there is specific guidance in Topic 606 applicable to changes in the 'transaction price' that lessors are required to consider when there are changes to the consideration in the contract. That specific guidance does not apply to variable payments that are not part of the consideration in the contract. [842-10-15-42]

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KPMG observation – Allocating subsequent changes to the consideration in the contract after a modification or remeasurement

4.5.80 While not explicitly stated, we believe that the Board intended that if the consideration in the contract has been reallocated as a result of a contract modification or remeasurement of the lease liability, changes to the consideration in the contract subsequent to the reallocation should be allocated on the same basis as the most recent reallocation.

4.6 Property taxes and insurance – Gross versus net leases

4.6.10 As discussed in 4.2.20–30, a lessee's reimbursement or payment of the lessor's property taxes and insurance is an example of activities (or costs of the lessor) that do *not* transfer a good or service to the lessee. Therefore, although *fixed* payments attributable to such activities or costs are part of the consideration in the contract, in Step 4 they are allocated only to the separate lease and non-lease components. [842-10-15-30]

4.6.20 This section builds on the concepts in Step 3 (section 4.3) and Step 4 (section 4.4) to explore the different outcomes of a gross lease versus a net lease.

– In a gross lease, payments of lessor costs such as property taxes and insurance are fixed as part of the rental payment specified in the contract.

– In a net lease, the lessee makes variable payments, either to the lessor or to a third party, for items like property taxes and insurance.

Example 4.8
Property taxes and insurance in gross versus net leases

4.6.30 Two companies enter into similar leases of retail space, but with the underlying contracts structured differently.

Scenario 1: Gross lease

4.6.40 Lessee LE1 leases space in a shopping center from Lessor LR1 for 24 months.

4.6.50 LE1 pays CP $20,000 per month with no separate obligation with respect to LR1's property taxes or property insurance (i.e. the lease is a gross lease).

4.6.60 The contract has a single component, which is the lease of the retail space. The consideration in the contract (see section 4.3) is $480,000 ($20,000 x 24). As outlined in Step 4 (see section 4.4), that amount is allocated entirely to the single component of the contract.

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Scenario 2: Net lease

4.6.70 Lessee LE2 leases space of a similar size and condition in a different shopping center from Lessor LR2.

4.6.80 LE2 pays LR2 $18,000 per month, and must reimburse LR2 for LE2's portion of LR2's actual property tax assessments and building insurance costs during the lease term (i.e. the lease is a net lease). Costs of the insurance and property taxes are expected to approximate $2,000 per month.

4.6.90 Although the contract includes an explicit requirement for LE2 to pay LR2's property taxes and insurance, these are not components of the contract. Therefore, as in Scenario 1, the contract has a single lease component (i.e. the lease of the retail space).

4.6.100 There are two types of payments in the contract:

- The fixed payments of $18,000 per month are included in the consideration in the contract.
- The variable payments (approximately $2,000 per month) are not included in the consideration in the contract. Because there are no non-lease components of the contract, the additional considerations applicable to lessors for variable payments are not applicable (see 4.3.40). The payments as they are incurred are variable lease payments.

4.6.110 Like Scenario 1, the contract has a single component, which is the lease of the retail space. The consideration in the contract (see section 4.3) is $432,000 ($18,000 x 24). As outlined in Step 4 (section 4.4), that amount is allocated entirely to the single component of the contract.

Comparing Scenarios 1 and 2

4.6.120 This example illustrates the following points.

- Property taxes and insurance obligations of the lessor are not lease or non-lease components of a contract.
- Variable payments not dependent on an index or rate are excluded from the consideration in the contract.
- Consideration in the contract is allocated only to the lease and non-lease components of a contract.

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KPMG observation – Different accounting for gross versus net leases

4.6.130 Example 4.8 demonstrates the different accounting that will result for gross leases (i.e. payments of lessor costs are fixed as part the rental payment) as compared with net leases (i.e. those for which lessees make variable payments to the lessor or a third party). Lessees will generally recognize smaller lease assets and lease liabilities for a net lease than for a gross lease, because lessees will not include estimates of variable payments in those amounts. [842-10-55-141 – 55-143]

4.6.140 Variable payments for property taxes and insurance will not be excluded from lease accounting in a net lease scenario. Depending on whether the contract also includes non-lease components, either all (or a portion) of the variable payments for the property taxes or insurance will be accounted for as 'variable lease payments' (see sections 6.3 and 7.3–7.4). Lessees and lessors will need to track such amounts for disclosure purposes – i.e. disclosures of variable lease cost and variable lease income, respectively (see sections 12.2–12.3). [842-20-50-4(d), 842-30-50-5(c)]

4.6.150 We believe that the Board recognized that economically similar contracts will be accounted for differently on the balance sheet as a result of its decision on variable payments. However, that different accounting result will not be unique to gross lease versus net lease scenarios. Similarly, a retail lessee required to make fixed payments of $10,000 per month will recognize a significantly different lease asset and lease liability than a substantially similar retail lessee that is required to make a fixed payment of $5,000 per month plus a variable payment of 2% of store sales for the previous month.

Comparison with current US GAAP – Accounting for property taxes and insurance

4.6.160 Topic 842 differs from current US GAAP in two important respects:

- Current US GAAP explicitly excludes executory costs such as insurance, maintenance, and taxes from the definition of minimum lease payments. In contrast, under Topic 842, all or a portion of fixed payments for such costs will be allocated to the lease component(s) of the contract and consequently classified as lease payments. As a result, the lease payments determined in accordance with Topic 842 will exceed what the minimum lease payments would have been under current US GAAP in gross leases.
- Second, while current US GAAP excludes executory costs from minimum lease payments, those amounts are not allocated between the lease and non-lease elements of the contract. That is, those costs are generally considered entirely related to the lease for purposes of classification and presentation. However, under Topic 842, fixed *and variable* payments for items like property taxes and insurance that are not components of the contract are allocated to the lease *and* non-lease components on the same basis as all of the other consideration in the contract. [840-10-15-19, 25-5]

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4.7 Combining two or more contracts

4.7.10 Two or more contracts (at least one of which is or contains a lease) entered into at or near the same time with the same counterparty (or related party) are combined as a single transaction if:

- the contracts are negotiated as a package with a single commercial objective;
- the amount of consideration to be paid in one contract depends on the price or performance of the other contract; or
- the leases in the contracts (or some of the leases) are a single lease component. [842-10-25-19]

Example 4.9
Combination of contracts

4.7.20 Lessee LE leases a specifically identified space in a building and a printing press from Lessor LR for three years. The following additional facts are relevant.

- LR leases the building space and printing press to LE in two separate contracts, executed within a few calendar days of each other.
- The contractual lease payments for the building space are fixed at $250,000 per year, compared to an estimated market rate of $300,000 per year
- There are no non-lease components of the building contract and the variable payments are not based on an index or a rate. Therefore, the consideration in the contract is $750,000 ($250,000 x 3) for LE and LR, and all of the fixed payments are lease payments (see section 5.4).
- The contractual lease payments for the printing press are entirely based on the level of use ($75 for each hour operated), compared to an estimated market rate of $50 for each hour operated.
- LE and PS each predict that the printing press will be operated for 2,000 hours per year over the three-year lease term, giving total expected variable payments of $450,000 over the three-year lease term.
- Total expected fixed and variable consideration is $1,200,000 over the three-year lease term. However, the stated $250,000 per year for the building space lease is a below market rate, and the $75 per hour variable payment for the use of the printing press is considered to be an above market rate. LR agrees to a lower fixed payment to incentivize LE, with the expectation of making up the difference with the above market variable payments.

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4.7.30 In this example, the contracts should be combined and considered a single contract for the purpose of applying Topic 842. This is because the two contracts are executed near the same time, and together they fulfill a single commercial objective. As noted, LR agrees to a lower fixed payment in the first contract to incentivize LE, with the expectation of making up the difference with the above market variable payments in the second contract.

KPMG observation – Aligning contract combinations guidance in Topic 842 and Topic 606

4.7.40 Consistent with the Board's rationale for a number of other decisions in developing Topic 842, the Board concluded that, particularly for lessors, there would be a significant benefit to substantially aligning the guidance on combining contracts in Topic 842 to that in Topic 606. Since many contracts contain components that will be in the scope of both Topics, coming to generally consistent conclusions as to when two or more contracts should be combined will reduce complexity for lessors. [ASU 2016-02.BC165–BC167]

4.7.50 While the contract combinations guidance will be familiar to most entities because of its similarity to the contract combinations guidance in Topic 606, there will be some judgment involved in determining when two contracts must be combined. This judgment includes, but is not limited to, determining:

- what 'at or near the same time' means – some entities have interpreted that to mean within 90 days or within the same fiscal quarter or reporting period when applying that notion to other situations;
- when two or more contracts have the same commercial objective; and
- when consideration to be paid in one contract is dependent on the consideration to be paid in another.

4.7.60 These judgments are not unique to the contract combinations guidance in Topic 842 and Topic 606. Similar judgments are required in the current US GAAP revenue recognition guidance (e.g. within Subtopic 605-25 on multiple-element revenue arrangements, and Subtopic 985-605 on software revenue recognition) such that judgments made historically may continue to be reasonable in applying the new guidance.

KPMG observation – Allocation of consideration in a combined contract

4.7.70 A combined contract (i.e. one comprising two or more separately prepared contracts) may have multiple lease (and potentially non-lease) components. In this scenario, it is likely that the allocation of the consideration in the combined contract will be different from the stated consideration in the original, separately prepared contracts.

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5 Concepts and definitions applicable to lessees and lessors

How the standard works

There are a number of key concepts and definitions that apply to both lessees and lessors that are integral to the guidance in Topic 842. The following are discussed in this chapter, as an introduction to the accounting in chapters 6 (lessees) and 7 (lessors).

Key concept or definition	Application within Topic 842
Commencement date	The date of initial recognition and measurement of a lease for lessees and lessors. In addition, lease classification is determined at lease commencement.
Reasonably certain	Determining whether a lessee is reasonably certain to exercise an option to either extend (or renew) a lease or purchase the underlying asset (or is reasonably certain *not* to exercise an option to terminate a lease) is integral to determining the 'lease term' and the 'lease payments'.
Lease term	The lease term is integral to determining: – lease payments; – lease classification; – the measurement of lease assets and lease liabilities; and – whether the lease is a 'short-term' lease (for lessees).
Lease payments	The lease payments are integral to determining: – lease classification; and – the measurement of lease assets and lease liabilities.

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Key concept or definition	Application within Topic 842
Initial direct costs	Initial direct costs affect: – the discount rate for the lease, if the rate implicit in the lease is used; and – the measurement of lease assets and lease liabilities.
Discount rate for the lease	The discount rate for the lease affects: – lease classification; and – the measurement of lease assets and lease liabilities.
Economic life	The total and remaining economic life of the underlying asset affects lease classification.
Portfolio approach	Topic 842 may be applied on a portfolio basis to similar leases if the entity reasonably expects that the outcome will not differ from applying the standard to the individual leases.

This chapter addresses those concepts and definitions that are key to applying both the lessee and lessor accounting models. There are additional definitions and concepts that apply solely to lessees or solely to lessors that are discussed in chapter 6 (lessee accounting) and chapter 7 (lessor accounting), as well as definitions and concepts that are key to identifying a lease (see chapter 3) and identifying lease/non-lease components (see chapter 4) that are discussed in the respective chapters.

In addition to the concepts and definitions that are discussed in this chapter, Topic 842 uses a number of additional definitions that are defined elsewhere in US GAAP such that they are not specific to the leases guidance (e.g. useful life, probable, and remote). Those additional definitions are not discussed in this chapter.

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5.1 Commencement date

5.1.10 The commencement date of a lease is the date on which the lessor makes the underlying asset available for use by the lessee. [842 Glossary]

5.1.20 A lessee may take possession of or be given control over the use of an underlying asset – i.e. the underlying asset may be made available for use by the lessee – before:

- the lessee begins operations (e.g. the lessee begins selling from a leased retail space);
- lease payments are required to be made under the contract; or
- a stated commencement date in the contract. [842-10-55-19]

5.1.30 A master lease agreement may cover a number of underlying assets, each of which is made available for use by the lessee on a different date. Although a master lease agreement may specify that the lessee must take a minimum number of units or dollar value of equipment, there will be multiple commencement dates unless all of the underlying assets subject to that minimum are made available for use by the lessee on the same date. [842-10-55-22]

Example 5.1
Lease commencement date

5.1.40 Lessee LE signs a lease with Lessor LR for retail space in a shopping mall on June 1, 20X1 – i.e. lease inception is June 1, 20X1.

5.1.50 On August 1, 20X1, LR provides LE with access to the location so that LE can begin constructing leasehold improvements in anticipation of opening the store on September 1, 20X1. On September 1, 20X1, LE opens the store for business and pays LR the first month's lease payment.

5.1.60 In this example, the lease commencement date is August 1, 20X1. This is the date on which LR makes the underlying asset (i.e. retail space) available for use by LE. That LE will commence operations and begin making lease payments only on September 1, 20X1 does not affect determination of the commencement date.

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KPMG observation – Properly identifying the commencement date is key

5.1.70 An improperly-determined commencement date could result in one or more of the following. [ASU 2016-02.BC182–BC184]

- Misstated lease assets and lease liabilities – i.e. the recognition of lease assets and lease liabilities that do not yet exist or not recognizing lease assets and lease liabilities that do exist.
- Improper measurement of lease assets and lease liabilities – key inputs that are used in the initial and subsequent measurement of lease assets and lease liabilities (e.g. the lessee's incremental borrowing rate or the fair value of the underlying asset) change over time such that determining those inputs as of an incorrect date could result in the inaccurate measurement of lease assets and lease liabilities throughout the lease term.
- In the case of sales-type lessors (see section 7.3), selling profit or selling loss that is recognized in the wrong period.

Comparison with current US GAAP – Inception versus commencement date

5.1.80 Under current US GAAP, the initial measurement of a lease (e.g. determination of the discount rate for a capital lease) and the assessment of lease classification occur at inception of the lease, rather than at the commencement date. While the recognition date for leases is consistent between current US GAAP and Topic 842 (commencement date), because inputs such as the fair value of the underlying asset and the lessee's incremental borrowing rate might be different between those two dates, entities might reach different conclusions about initial measurement and lease classification for some leases using the commencement date versus the inception date. [840-10-25-1]

5.2 Reasonably certain

5.2.10 The concept of 'reasonably certain' is integral to determining the 'lease term' (see section 5.3) and the 'lease payments' (see section 5.4).

5.2.20 Leases often include options that permit the lessee to extend or renew the lease (including by *not* exercising a termination option) or to purchase the underlying asset. Such options are accounted for (i.e. included in the measurement of lease assets and lease liabilities) only when it is 'reasonably certain' that the lessee will exercise the option. It is assumed a lessee termination option will be exercised unless the lessee is reasonably certain *not* to do so. [842-10-30-1]

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5.2.30 'Reasonably certain' is a high threshold of probability that must be met to include optional lessee payments in the measurement of lease assets and lease liabilities. When combined with the economic nature of the evaluation, the Board intended the parties to account for lessee options only when the lessee has a compelling *economic* reason to exercise the renewal or purchase option (or not to exercise a termination option). [ASU 2016-02.BC194, BC197, BC218]

5.2.40 An entity assesses whether a lessee is reasonably certain to exercise or not to exercise an option by considering all economic factors relevant to that assessment: contract-based, asset-based, market-based, and entity-based factors. An entity's assessment will often require the consideration of a combination of factors because they are interrelated. Therefore, an expectation of exercise alone (e.g. based on relevant history in similar arrangements or management's intent) does not result in a conclusion that the lessee is reasonably certain to exercise an option if there is not a compelling economic reason to do so. [842-10-55-26, ASU 2016-02.BC193]

5.2.50 All factors are considered together and the existence of any one factor does not necessarily indicate that a lessee is reasonably certain to exercise the option. Although not exhaustive, the following are examples of factors to consider. [842-10-55-26]

Type of factor	Examples
Contract-based	– Amount of the lease payments (including variable lease payments) in any optional period as compared to market rates – Existence and amount of any variable lease payments or other contingent payments – Existence and terms of options (renewal or purchase) – Costs associated with an obligation to return the leased asset in a specified condition or to a specified location
Asset-based	– Location of the asset – Existence of significant leasehold improvements that would be lost if the lease were terminated or not extended – Non-contractual relocation costs – Costs associated with lost production – Costs associated with sourcing an alternative item
Entity-based	– Financial consequences of a decision to extend or terminate a lease – Nature of the leased asset (specialized versus non-specialized; the extent to which the asset is crucial to the lessee's operations, etc.) – Tax consequences of terminating or not extending the lease
Market-based	– Statutory law and local regulations – Market rentals for a comparable asset

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Example 5.2
Assessment of a lessee renewal option

Scenario 1: Not reasonably certain to exercise either of the renewal options

5.2.60 Lessee LE enters into a five-year warehouse lease with Lessor LR.

5.2.70 As part of the contract, LE has the option to renew the five-year lease for two additional five-year terms (i.e. for 15 years in total) at the market price at the date of exercising each renewal option. If LE does not renew the lease, it is responsible for its costs to vacate the facility, relocate to a new facility, and return the warehouse to its pre-lease condition.

5.2.80 LE has a track record of remaining in leased warehouse facilities for at least 10 years. It was in each of its previous three facilities for 15, 10, and 15 years, respectively.

5.2.90 In this scenario, both LE and LR conclude that LE is not reasonably certain to exercise either of the five-year renewal options for the warehouse facility.

5.2.100 LE's history of renewing its warehouse leases may suggest that there is an intent on the part of LE to exercise at least the first of the two five-year renewal options. However, the fact pattern does not suggest that LE is reasonably certain to do so.

5.2.110 The fact that LE will have to incur costs (e.g. relocation, restoration, etc.) if it does not renew the lease also does not make it reasonably certain that LE will renew the lease to avoid those costs. This is because LE will likely incur those costs at some point given the terms of the lease and it is also not reasonably certain that LE will not, five years into the future, offset those costs through favorable lease terms for a replacement facility or other economic factors relevant to the new lease.

Scenario 2: Significant leasehold improvements

5.2.120 Changing the facts of Scenario 1, prior to moving into the leased facility, LE constructs expensive leasehold improvements with an economic life of 15 years.

5.2.130 These leasehold improvements will have significant economic value to LE at the end of both five and 10 years that it will not be able to recover if it vacates the facility. LE will have to remove those improvements and they are not portable to another location.

5.2.140 The construction of the significant leasehold improvements and the economic factors surrounding those improvements (e.g. that a significant portion of their economic value will be lost if LE relocates before the end of 15 years) provides a compelling economic reason for LE to remain in the facility for the full 15 years permitted.

5.2.150 Therefore, in this scenario, both LE and LR conclude that it is reasonably certain that LE will exercise both of its five-year renewal options.

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Scenario 3: Specialized facility

5.2.160 Again changing the facts of Scenario 1, the warehouse is a highly specialized facility. There are only a limited number of facilities of this nature, no two of which (presently or historically) are in the same geographic area. Constructing a facility of this nature is expensive and requires a significant period of time. Having access to a specialized facility of this nature and in this geographic area is vital to LE's core operations.

5.2.170 Between now and the end of the non-cancellable period of the lease (i.e. five years), it is highly unlikely that LR or another entity will construct a suitable alternative facility in the same geographic area as the warehouse being leased. The investment of time and resources that would be required, together with the fact that doing so would invite one of LE's competitors to operate in the area (i.e. by leasing the specialized warehouse from LR), creates a significant economic disincentive for LE to construct its own specialized facility. Therefore, in this scenario, both LE and LR conclude that it is reasonably certain, based on an evaluation of the relevant economic factors, that LE will exercise the first five-year renewal option.

5.2.180 However, both LE and LR conclude that it is *not* reasonably certain, at lease commencement, that LE will exercise the second five-year renewal option. While the same economic circumstances considered in determining that LE is reasonably certain to exercise the first five-year renewal option *might* exist 10 years from now, reasonably certain is a high threshold of probability. The extended period of time between lease commencement and the exercise date for that option (i.e. approximately 10 years) means that it is not *reasonably certain* that those same economic circumstances will exist.

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Example 5.3

Assessment of a lessee purchase option with strike price below expected fair value

Scenario 1: Fair values volatile

5.2.190 Lessee LE enters into a five-year lease with Lessor LR to use a piece of equipment in an evolving area of the technology sector; there are no renewal or termination options. LE has the option under the contract to purchase the underlying asset at the end of the non-cancellable lease term for $500,000. The expected fair value of the asset at the end of the non-cancellable lease term is $650,000.

5.2.200 Both LE and LR conclude that it is *not* reasonably certain that LE will exercise the option. The underlying asset is in an evolving area of the technology sector, and the duration of the non-cancellable period of five years (i.e. the five-year period of time between the assessment of the option at lease commencement and the option exercise date) is significant in that context. Therefore, each party concludes that there is too much uncertainty about what the fair value of the underlying asset will be at the option exercise date to conclude at lease commencement that LE is reasonably certain to exercise the option; for example, newer, better alternative assets may be introduced during the five-year lease term.

5.2.210 In this scenario, the lease term (five years) and specific environment (technology sector) are important factors in reaching the conclusion. A shorter lease term (e.g. one or two years) or a different environment might lead to a different conclusion.

Scenario 2: Fair values historically stable

5.2.220 Changing the facts of Scenario 1, the underlying asset is conventional real estate (e.g. a building that could be used for a variety of purposes) in a market that historically has been highly predictable to within a narrow range – that is, prices have been predictable to within +/- 10 percent over a long period of time.

5.2.230 In this scenario, given the extent of the discount between the strike price ($500,000) and the reasonably predictable expected fair value of the underlying asset ($650,000), each of the parties concludes that it is reasonably certain that LE will exercise the purchase option.

5.2.240 As with Scenario 1, changes to this fact pattern could influence the conclusion reached. For example, if the strike price of the option were $600,000 instead of $500,000, it might not be reasonably certain that LE would exercise the option.

5.2.250 At that strike price, either (1) the $50,000 forecasted discount may not be significant enough to conclude that LE is reasonably certain to exercise the option, or (2) there may be uncertainty, even within the highly predictable real estate market in the example, about whether the strike price will in fact represent a discount from the actual fair value of the building at the option exercise date.

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KPMG observation – 'Reasonably certain' synonymous with 'reasonably assured'

5.2.260 While Topic 842 uses the term 'reasonably certain', current US GAAP uses the term 'reasonably assured' to describe the probability threshold that must be met for including lessee options in the measurement of lease assets and lease liabilities and in considering lease classification. The Board views these terms as synonyms that should be applied in the same way. Therefore, the probability threshold for including lessee options in the measurement of lease assets and lease liabilities, and in considering lease classification, is the same as in current US GAAP. The Board selected the term 'reasonably certain', rather than retaining the term 'reasonably assured', to converge with IFRS 16 terminology in this respect. [ASU 2016-02.BC195]

KPMG observation – Consideration of specific facts and circumstances in assessing 'reasonably certain'

5.2.270 We believe that the particular facts and circumstances of a lease can significantly affect an entity's assessment of a lessee option such that an entity might reach different conclusions for two options with seemingly very similar terms (e.g. the same strike price and the same expected fair value of the underlying asset) based on different underlying facts and circumstances.

5.2.280 For example:

- The further out into the future the option exercise date, the more compelling the evidence must be, on an economic basis, that the lessee will exercise the option. This is because an entity's estimates about conditions that will exist at the option date will be less precise the further out the option date is; these estimates include, but are not limited to, the fair value of the underlying asset, the availability of suitable alternatives to the underlying asset, and the tax environment in a particular jurisdiction.
- The nature of the underlying asset may significantly affect an entity's assessment of a lessee option. Depending on the nature of the underlying asset, it may be more difficult for an entity to predict its fair value or the availability of suitable alternative resources. This is illustrated in Example 5.3.
- The location of the underlying asset could significantly affect relocation costs or the availability of alternative resources. For example, even for two identical underlying assets, considerations about relocation costs or available alternative resources could vary widely if one is deployed in a remote area and the other in a readily-accessible area.
- The jurisdiction governing the lease could significantly affect the assumptions about laws and regulations (including tax consequences) affecting the assessment of the option; for example, laws and regulations in some countries may be more stable and predictable than in other countries.

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KPMG observation – Lessees and lessors may reach different conclusions

5.2.290 The nature of the assessment of 'reasonably certain' means that lessees and lessors may make different assessments about whether it is reasonably certain that a lessee will exercise a renewal or a purchase option, or not exercise a termination option.

US GAAP different from IFRS – Interpreting 'reasonably certain'

Effect of a lessee's past practices on the assessment of lessee options

5.2.300 Generally, the FASB's and the IASB's respective guidance on determining whether a lessee is reasonably certain to exercise an option is converged. The two Boards reached converged decisions in this area, including the decision to use the same words to describe the threshold of evidence necessary to include a lessee option in the measurement of lease assets and lease liabilities (reasonably certain).

5.2.310 However, IFRS 16 includes additional application guidance that states "a lessee's past practice regarding the period over which it has typically used particular types of assets (whether leased or owned), and its economic reasons for doing so, may provide information that is helpful in assessing whether the lessee is reasonably certain to exercise, or not to exercise, an option." We believe that entities could read the Boards' respective guidance on determining whether a lessee is reasonably certain to exercise an option differently. This is because the application guidance in IFRS 16 states that "a lessee's past practice regarding the period over which it has typically used particular types of assets (whether leased or owned), and its economic reasons for doing so, may provide information that is helpful in assessing whether the lessee is reasonably certain to exercise, or not to exercise, an option." [IFRS 16.B40]

5.2.320 In contrast, the authoritative guidance in Topic 842 makes no mention of considering past practices when assessing lessee options, and the basis for conclusions suggests that the assessment of lessee options should *not* consider management estimates or intent and that the key consideration is whether the lessee has "economically little or no choice" but to exercise (or not to exercise) the option. [ASU 2016-02.BC193, BC197]

5.2.330 However, the reference in the IFRS 16 application guidance to 'economic reasons' for the past practices may mitigate the extent of any potential differences in application because it does not appear that an entity's past practice (e.g. of renewing a particular lease or a particular type of lease) is intended to be considered in isolation from the economic reasons for those practices.

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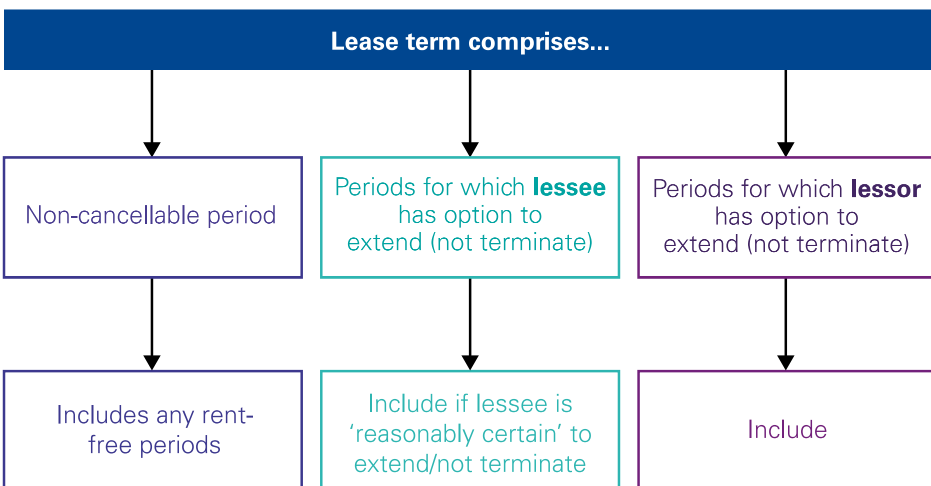
Minimum or fixed cash return

5.2.340 IFRS 16 has application guidance stating that if the lessee guarantees the lessor a minimum or fixed cash return that is substantially the same regardless of whether an option is exercised, an entity assumes that the lessee is reasonably certain to exercise the option to extend the lease, or not to exercise the option to terminate the lease. For example, the lessee might provide a residual value guarantee in the event that a renewal option is not exercised that would effectively prepay to the lessor, on a present value basis, the cash flows the lessor would otherwise receive from the lease payments during the renewal period. [IFRS 16.B38, BC158(b)]

5.2.350 Topic 842 does not provide explicit comparable guidance. However, we believe that this situation is no different in substance from a termination penalty because, in either case of non-renewal (i.e. residual value guarantee of the nature described above or an explicit termination penalty), the lessee is effectively making a payment to the lessor in return for *not* extending the lease. Both IFRS 16 and Topic 842 include the same guidance with respect to termination penalties (see section 5.4.5). Therefore, we believe that an entity applying Topic 842 should not come to a different conclusion about the effect of a minimum or fixed return scenario on the lease term than an entity applying IFRS 16.

5.3 Lease term

5.3.10 Beginning at the commencement date, the lease term always includes the non-cancellable period and may include one or more optional periods. [842-10-30-1, 55-25]



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5.3.20 A contract is an agreement between two or more parties that creates enforceable rights and obligations. When assessing the non-cancellable period of a lease, an entity applies that definition to determine the period for which a contract exists. A lease is no longer enforceable beyond the point that both the lessee and the lessor have the unilateral right to terminate the lease, without permission from the other party and with no more than an insignificant penalty. [842 Glossary, 842-10-55-23]

5.3.30 If only a *lessee* has the right to terminate a lease, that right is considered to be an option to terminate the lease available to the lessee that an entity considers in determining the lease term. [842-10-55-24]

5.3.40 If only a *lessor* has the right to terminate a lease or controls the lessee's ability to exercise an option to terminate the lease, the lease term should assume that the lease will *not* be terminated. [842-10-55-24]

5.3.50 When *both* the lessee and the lessor have the substantive right to terminate a lease, the lease term excludes periods after which both parties' termination rights are exercisable. This is because neither party has enforceable rights *or* obligations. The lessee neither has the right to continue to use the underlying asset (after the lessor's termination rights become exercisable), nor an obligation to make lease payments (after its termination rights become exercisable). The lessor neither has a right to receive lease payments (after the lessee's termination rights become exercisable) or an obligation to extend the lessee's right to use the underlying asset (after its termination rights become exercisable). This principle is illustrated in Example 5.5. [842-10-55-23]

5.3.60 Under a fiscal funding clause, a lease is cancellable if the legislature or other funding authority does not appropriate the funds necessary for the governmental unit (as lessee) to fulfill its obligations under the lease agreement. The existence of such a clause requires an assessment of the likelihood of lease cancellation through exercise of the fiscal funding clause. If it is more than *remote* that the fiscal funding clause will be exercised, the lease term should include only those periods for which funding is reasonably certain. [842 Glossary, 842-10-55-27]

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Example 5.4
Lease term (lessee renewal options)

5.3.70 Assume the same facts as in Scenarios 1, 2, and 3 in Example 5.2. That example, illustrates whether Lessee LE is, or is not, reasonably certain to exercise one or both renewal options provided. This example concludes on the 'lease term' for each of those scenarios based on the conclusions in Example 5.2.

5.3.80 For each of the scenarios in Example 5.2, the lease term equals the non-cancellable period of five years *plus* the periods covered by renewal options that LE is reasonably certain to exercise. That results in lease terms for each scenario as follows.

Example 5.2 Scenario	Lease term
Scenario 1	5 years
Scenario 2	15 years
Scenario 3	10 years

Example 5.5
Termination rights

5.3.90 Lessee LE and Lessor LR enter into a two-year lease of equipment. There are no renewal options in the contract.

Scenario 1: Lessee and lessor both have right to terminate

5.3.100 Both LE and LR have the unilateral right, without penalty and without cause, to terminate the lease at the end of Year 1.

5.3.110 The non-cancellable period of the lease and the lease term are both one year.

- LE does not have a right to extend the lease beyond the end of Year 1 because LR has the right to terminate the lease at the end of Year 1, and does not have an obligation to make lease payments beyond the end of Year 1 because it can terminate the lease.
- LR does not have the right to receive lease payments (i.e. by requiring LE to extend the lease) beyond the end of Year 1 because LE has the right to terminate the lease at the end of Year 1, and does not have an obligation to extend LE's right to use the underlying asset beyond the end of Year 1.

Scenario 2: Lessor has right to terminate

5.3.120 Unlike in Scenario 1, only LR has the right to terminate the lease at the end of Year 1, which it can do without penalty and without cause. The non-cancellable period of the lease is, therefore, one year.

5.3.130 However, the lease term is two years because only the lessor can elect to terminate the lease prior to the end of the two-year stated term. The lease term always includes optional periods controlled by the lessor.

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Example 5.6
No stated term

5.3.140 Lessor LR agrees to lease equipment to Lessee LE. There is no stated duration for the lease in the contract; however, the contract stipulates that LE is required to return the underlying asset to LR's location when it no longer wishes to use the equipment. For each day that the asset remains in LE's possession, LE will pay a fixed fee to LR for the right to use that asset.

5.3.150 The non-cancellable period of the lease is one day, because LE could elect to return the asset to LR's location before the start of Day 2.

5.3.160 Next, LE and LR each consider whether LE is reasonably certain to continue to use the asset beyond the non-cancellable period. Unless LE is reasonably certain to continue the lease beyond the first day, the lease term is only one day.

5.3.170 We believe that the extremely short non-cancellable period of the lease (one day) will likely influence the consideration of whether LE is reasonably certain to renew the lease beyond the non-cancellable period. The costs to LE of terminating the lease (e.g. returning the underlying asset to LR's location) and entering into a new lease (e.g. identifying another asset, entering into a different contract, and training employees to use a different asset) may provide a compelling economic reason for LE to continue to use the same asset for a period that is longer than the non-cancellable period.

KPMG observation – Non-cancellable period is a question of law

5.3.180 Determining whether and for what period a contract creates enforceable rights and obligations on the parties is a question of law, and the factors that determine enforceability may differ among jurisdictions.

5.3.190 However, as a practical matter, in most cases a contract is no longer enforceable after it can be cancelled by either party, assuming that the cancellation/termination option is substantive.

- Once the lessee has the right to cancel the lease, the lessee no longer has an enforceable obligation to make lease payments and the lessor no longer has an enforceable right to receive lease payments.
- Similarly, once the lessor has the right to cancel the lease, the lessee no longer has an enforceable right to use the underlying asset and the lessor no longer has an enforceable obligation to permit the lessee use of the underlying asset.

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KPMG observation – Determining the lease term for cancellable ('evergreen') leases may be difficult

5.3.200 In defining a 'short-term lease', the Board considered that many evergreen leases (i.e. those on a day-to-day, week-to-week, or month-to-month basis) would meet that definition. However, to qualify for the short-term lease exemption (see section 6.3.1) and to determine whether the disclosure requirement for short-term lease costs is applicable (the disclosure requirement applies only to short-term leases with a term greater than one month – see section 12.2), lessees must nonetheless assess the lease term for such leases. [ASU 2016-02.BC379]

5.3.210 The lease term for evergreen leases is established in the same manner as for all other leases, which means considering whether the lessee is reasonably certain to exercise one or more available renewal options.

5.3.220 As highlighted by Example 5.6, determining whether a lessee is reasonably certain to exercise a renewal option in an evergreen lease may involve significant judgment. We believe that, in general, the shorter the non-cancellable period of a lease, the greater the likelihood that the lessee is reasonably certain to exercise one or more lease term renewal options. This is because, in many cases, it may be cost prohibitive to continually substitute leased assets. For example, if a lessee is leasing a piece of construction equipment on a weekly basis, and expects to need a substantially similar piece of equipment for the duration of a four-month project, there may be a compelling economic reason not to continually substitute that asset throughout the period.

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5.4 Lease payments

5.4.10 At lease commencement, the lease payments consist of all of the following payments relating to the use of the underlying asset during the 'lease term' (see section 5.3). [842-10-30-5]

Type of payment during the lease term	Section
– Fixed payments	–
– Variable lease payments that depend on an index or rate.	5.4.1
– Adjustments to fixed payments:	
» in-substance fixed payments (added); and	5.4.2
» lease incentives paid or payable by the lessor to the lessee (subtracted).	5.4.3
– The exercise price of a lessee option to purchase the underlying asset that the lessee is reasonably certain to exercise.	5.4.4
– Penalties for terminating the lease if the lease term reflects the lessee exercising a termination option.	5.4.5
– For lessees only, amounts probable of being owed by the lessee under residual value guarantees.	5.4.6
– Payments by the lessee to the owners of a special-purpose entity for structuring the transaction.	–

5.4.20 Lease payments do *not* include:

- variable lease payments other than those that depend on an index or rate;
- any guarantee by the lessee of the lessor's debt; or
- amounts allocated to non-lease components (see chapter 4). [842-10-30-6]

5.4.30 Obligations to return an underlying asset to its original condition if it has been modified by the lessee (e.g. a requirement to remove lessee-installed leasehold improvements) do not generally meet the definition of lease payments or variable lease payments. They are accounted for in accordance with Subtopic 410-20 (asset retirement obligations). [842-10-55-37]

5.4.40 Costs to dismantle and remove an underlying asset at the end of the lease term that are imposed by the lease agreement are generally considered lease payments or variable lease payments. Lease payments are included in the measurement of lease assets and liabilities – see chapter 6 (lessees) and chapter 7 (lessors). [842-10-55-37]

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5.4.50 Section 6.6 outlines when and how a lessee remeasures the lease payments.

5.4.60 A *lessor* remeasures the lease payments only if the lease is modified and that modification is not accounted for as a separate contract (see section 7.7). A lease modification includes a change to the terms and conditions of the contract that contains the lease if that contract modification changes the 'consideration in the contract', and therefore the lease payments (see KPMG observation at 5.4.80–120). [842-10-35-6]

5.4.70 In addition to remeasurements in accordance with 5.4.60, the lease payments for a lessor may also change if there is a change in the 'consideration in the contract' not resulting from a contract modification that is not allocated entirely to the non-lease component(s) of the contract. A change in the contract consideration can result if an estimate of variable consideration was included in that consideration initially (see section 4.3) and either (1) that estimate changes or (2) there is a change in the lessor's consideration of the constraint on variable consideration. In many of the cases where an estimate of variable consideration will be included in the contract consideration, a portion of that estimated variable consideration is included in the 'lease payments', and therefore a change in that estimate, or a change in the amount of that estimate that is constrained, will change the 'lease payments'. [842-10-35-6]

KPMG observation – Lease payments might be an allocated amount

5.4.80 Chapter 4 deals with the components of a contract, and outlines the following steps:

– Step 1: Identify the separate lease components.
– Step 2: Identify any non-lease components – e.g. a maintenance component.
– Step 3: Measure the 'consideration in the contract'.
– Step 4: Separate and allocate the consideration in the contract between the lease and non-lease components.

5.4.90 The process outlined in chapter 4 highlights that the 'lease payments' for a lease component might be an allocated amount when there are multiple lease components, or when there is at least one non-lease component. The following is a simplified example to highlight this general principle, which is explained in full in chapter 4.

Example – Allocated lease payments

5.4.100 Lessee LE and Lessor LR enter into a three-year lease for a piece of equipment. The following additional facts are relevant.

– LR will maintain the equipment over the three-year term.
– In return for the right to use the equipment and LR's maintenance services, LE will make fixed payments of $100 in Year 1, $110 in Year 2, and $120 in Year 3 ($330 in total).
– The stand-alone price for the lease component is $280, and for the maintenance services is $70.

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5.4.110 On the basis of these stand-alone prices, the payments of $330 are allocated between the lease and non-lease components as follows.

Component	Stand-alone price	Allocation	Calculation
Lease (equipment)	$280	$264	(280/350) x 330
Non-lease (maintenance)	70	66	(70/350) x 330
	$350	**$330**	

5.4.120 On the basis of this calculation, the total lease payments are $264, or 80% of the total. The breakdown of this amount into the different years is calculated using the same proportion as for the total lease payments.

Year	Lease payment	Calculation
1	$ 80	100 x 80%
2	88	110 x 80%
3	96	120 x 80%
	$264	

5.4.1 Variable lease payments

5.4.130 In applying Topic 842, there are two types of variable lease payments.

- Variable lease payments that depend on an index or rate (such as the Consumer Price Index or a market interest rate) are *included* in the lease payments. [842-10-30-5(b)]
- Other variable lease payments are *excluded* from the lease payments. [842-10-30-6(a)]

5.4.140 The amount of variable lease payments that depend on an index or a rate that is included in the lease payments is derived using the index or rate at lease commencement. This is because such payments are considered unavoidable. However, the entity does not attempt to forecast future changes in the index or rate. Consequently, the amount included in the lease payments is just the amount of the initial payment times the lease term. This principle is illustrated in Example 5.7. [842-10-30-5(b)]

5.4.150 A *lessee* remeasures variable lease payments that depend on an index or a rate only when the lease payments are remeasured for another reason – e.g. a change in the lease term (see section 5.3) or a change in the estimate of amounts probable of being owed under a residual value guarantee (see section 5.4.6). The remeasurement is based on the index or rate at the date of remeasurement. [842-10-35-5]

5.4.160 A *lessor* remeasures variable lease payments that depend on an index or a rate only if the lease is modified and that modification is not accounted for as a separate contract. [842-10-35-6]

5.4.170 Some leases contain indemnification clauses that indemnify lessors on an after-tax basis for certain tax benefits that the lessor may lose if a change in the tax law precludes realization of those tax benefits. Although the indemnification payments may appear to meet the definition of variable lease payments, those payments are not of the nature normally expected to arise under variable lease payment provisions. Because of the close association of the indemnification payments to specific aspects of the tax law, any payments should be accounted for in a manner that recognizes the tax law association. The lease classification should not be changed. [842-10-55-38 – 55-39]

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Example 5.7
Variable lease payments that depend on an index or rate

5.4.180 Lessee LE enters into a 10-year lease of space in a shopping center from Lessor LR on January 1, 20X5.

5.4.190 The following facts are relevant.

- Annual payments are calculated as $100 times December CPI-U, with adjustments set once a year based on the latest December CPI-U. Once payments increase, they do not decrease, even if CPI-U were to decrease. There are no fixed lease payments.
- CPI-U was 230 in December 20X3, and 240 in December 20X4, and is expected to increase to 250 in December 20X5, 260 in December 20X6, and 270 in December 20X7.

5.4.200 The annual payment is measured at $24,000 ($100 x 240) – i.e. based on CPI-U at the commencement date. The lease payments over the 10-year lease term are therefore $240,000 ($24,000 x 10). The lease payments do not include any expected increase due to changes in CPI-U during the lease term.

5.4.210 The lease payments will not be remeasured for changes in CPI-U unless they are required to be remeasured for another reason (e.g. a change in the lease term). Therefore, unless the lease payments are remeasured for another reason, the remaining lease payments for the following three years will be:

- at December 31, 20X5: $216,000 ($24,000 x 9 remaining payments);
- at December 31, 20X6: $192,000 ($24,000 x 8 remaining payments); and
- at December 31, 20X7: $168,000 ($24,000 x 7 remaining payments).

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KPMG observation – Balance sheet effect of excluding variable lease payments from lease payments

5.4.220 The Board's decision to exclude most variable lease payments from the definition of lease payments has the following implications for the balance sheet:

- Two leases with very similar economics, but one structured with variable lease payments instead of fixed lease payments (e.g. payments due based on the performance or usage of the underlying asset), will result in substantially different lease liabilities and right-of-use assets. The lessee with the fixed payment only lease will generally recognize a larger lease liability and right-of-use asset throughout the lease term.
- Leases with only variable lease payments will not give rise to any lease liability or right-of-use asset for the lessee upon lease commencement.

5.4.230 By excluding variable lease payments from the definition of lease payments, the right-of-use asset and lease liability are less than they would be had an estimate of the variable lease payments been included. As a result, lessees may wish to include a greater proportion of variable lease payments in their lease agreements to minimize the balance sheet impact of Topic 842. In addition, as a result of the variable lease payments being excluded, some investors and analysts may unwind the lease assets and lease liabilities recorded and estimate their own asset and liability to include variable lease payments, which may require significant effort to make relevant predictions and comparisons.

KPMG observation – Income statement and cash flow effect of excluding variable lease payments from lease payments

5.4.240 In addition to the balance sheet effect of variable lease payments, leases with variable lease payments are more likely to be classified as operating leases (by lessees and lessors) because variable lease payments will not factor into the lease classification test – see sections 6.2 (lessees) and 7.2 (lessors). Therefore, variable lease payments increase the likelihood that lessees and lessors will recognize lease cost or lease income on a straight-line basis (excluding the effect of the variable lease payments) and that lessees will recognize their cash payments for leases as operating cash outflows, rather than as a mixture of operating and financing cash outflows.

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KPMG observation – Remeasurement of variable lease payments that depend on an index or rate

5.4.250 The Board's decision not to require the remeasurement of the lease payments for variable lease payments that depend on an index or rate whenever that index or rate changes, or when the contractual cash flows change (as required in IFRS 16 – see 5.4.290), was principally a cost-benefit decision. The decision was made as part of the Board's broader effort in the final stages of the project to limit the circumstances in which a lessee would be required to remeasure the lease liability for a lease. [ASU 2016-02.BC236–BC237]

5.4.260 While the Board's decision may reduce the effort necessary to apply Topic 842, it is clear that in many cases the result of this decision is that the lease liability will not reflect the remaining fixed payments required under the lease; this will potentially reduce the usefulness of that reported amount and increase the likelihood that investors and analysts will continue to make their own adjustments to reported lease assets and lease liabilities.

5.4.270 Using Example 5.7 as an illustration, at the end of December 20X7, if CPI-U increases as expected, the remaining lease payments that will be reflected in the lessee's lease liability in accordance with Topic 842 are $168,000 ($24,000 x 7 remaining payments) even though the lessee is required to make remaining payments of at least $189,000 ($27,000 x 7 remaining payments).

KPMG observation – Identifying variable lease payments is important for disclosures

5.4.280 Topic 842 includes guidance about items that do *not* result in variable lease payments (e.g. obligations to return an asset to its original condition, and tax indemnification clauses) because differentiating variable lease payments from other payments affects lessee and lessor disclosures. Lessees and lessors are required to disclose variable lease cost and variable lease income, respectively, such that those disclosures will be inaccurate if an entity misidentifies variable lease payments (see sections 12.2–12.3). [842-10-55-37 – 55-38]

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US GAAP different from IFRS – Remeasurement of variable lease payments based on an index or rate

5.4.290 In contrast to Topic 842, IFRS 16 requires the lessee to remeasure its lease liability to reflect changes in an index or a rate used to determine variable lease payments whenever the change in the index or rate results in a change in the contractual cash flows – i.e. when the adjustment to the lease payments takes effect. At that point, the lessee determines the revised lease payments for the remainder of the lease term based on the revised contractual payments. [IFRS 16.42(b)]

5.4.300 Using Example 5.7 to illustrate, the following table shows the differences at each reporting date between IFRS 16 and Topic 842 in the lease payments included in the lessee's lease liability. For this purpose, assume that the CPI-U continues to increase by 10 points each year throughout the 10-year lease term.

Reporting date	Lease payments – IFRS 16	Lease payments – Topic 842
Dec. 31, 20X4	$240,000 (24,000 x 10)	$240,000 (24,000 x 10)
Dec. 31, 20X5	225,000 (25,000 x 9)	216,000 (24,000 x 9)
Dec. 31, 20X6	208,000 (26,000 x 8)	192,000 (24,000 x 8)
Dec. 31, 20X7	189,000 (27,000 x 7)	168,000 (24,000 x 7)
Dec. 31, 20X8	168,000 (28,000 x 6)	144,000 (24,000 x 6)
Dec. 31, 20X9	145,000 (29,000 x 5)	120,000 (24,000 x 5)
Dec. 31, 20Y0	120,000 (30,000 x 4)	96,000 (24,000 x 4)
Dec. 31, 20Y1	93,000 (31,000 x 3)	72,000 (24,000 x 3)
Dec. 31, 20Y2	64,000 (32,000 x 2)	48,000 (24,000 x 2)
Dec. 31, 20Y3	33,000 (33,000 x 1)	24,000 (24,000 x 1)

5.4.310 The FASB and the IASB reached different conclusions about the cost-benefit of remeasuring variable lease payments that depend on an index or a rate. We believe that the IASB's cost-benefit evaluation may have been influenced by the diverse make-up of the jurisdictions applying IFRS. Indices and rates on which variable lease payments can depend often vary by region or country and, in some countries that use IFRS, the periodic changes in indices like CPI or in interest rates can be much more significant than such changes in the US. Therefore, we believe that the IASB may have viewed the potential benefit of remeasurement to investors and analysts, both in terms of comparability between entities applying IFRS in different regions or countries and in terms of relevant information, as being more significant than the FASB.

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5.4.2 In-substance fixed lease payments

5.4.320 In-substance fixed payments include payments that do not create genuine variability and the minimum payments the lessee is required to make when it has alternative payments that it can select from under the lease (e.g. due to optional features within the lease). In-substance fixed payments for a lessee or a lessor might include the following, for example:

- payments that result from clauses that do not have economic substance; or
- the lower of the payments to be made when a lessee has a choice about which set of payments it makes, although it must make at least one set of payments. [842-10-55-31]

5.4.330 Topic 842 does not include any explicit statements about remeasuring in-substance fixed payments. However, because such payments are lease payments, we believe that when the lease payments are required to be remeasured (e.g. because of a change in the lease term – see section 5.3), this would include evaluating whether any remaining variable lease payments are in-substance fixed lease payments.

5.4.340 Example 5.8 illustrates in-substance fixed lease payments in the context of a choice between two sets of payments. Examples 5.9 and 5.10 illustrate in-substance fixed lease payments in the context of variable lease payments.

Example 5.8

In-substance fixed lease payments – Two possible sets of payments

5.4.350 Lessee LE enters into a seven-year lease of land and a building.

5.4.360 The following facts are relevant.

- The lease requires monthly fixed lease payments of $14,000 and variable lease payments that are determined as 10% of LE's annual sales in excess of $1,000,000.
- At the end of the seven-year period, if sales are at least $1,500,000 in each of the last five years of the lease term, LE has the option to purchase the property for $400,000. At the lease commencement date, LE is not reasonably certain to exercise this purchase option.
- If restaurant sales are less than $1,500,000 in any of the last five years of the lease, LE is required to purchase the property for $400,000 at the end of the seven-year period.

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5.4.370 The lease payments under each scenario are calculated as follows.

Payment	Sales ≥ $1.5m	Sales < $1.5m	Calculation
Fixed	$ 840,000	$ 840,000	14,000 x 12 months x 5 years
Minimum variable	250,000	–	(1,500,000 - 1,000,000) x 10% x 5 years
Purchase price	–	400,000	
Total	**$1,090,000**	**$1,240,000**	

5.4.380 The $1,090,000 (which assumes sales are at least $1.5 million per year in the last five years) is lower than $1,240,000 (which assumes sales are less than $1.5 million in any of the last five years, and therefore that LE must purchase the property for $400,000). Therefore, the lease payments are $1,090,000.

Example 5.9
Variable lease payments without economic substance

5.4.390 Lessee LE enters into a 10-year lease of a warehouse from Lessor LR.

5.4.400 The following facts are relevant.

- Lease payments are initially $200,000 per month in arrears.
- The lease payments increase by 1% annually for every 0.1% increase in CPI from the prior year (resulting in a leverage factor of 10 times the change in CPI), limited to a maximum increase of 2% per year.
- Once variable lease payments increase, they cannot decrease under the terms of the lease.
- The CPI increase has exceeded 1% in each of the previous 20 years and there is only a remote likelihood that annual CPI increases will be less than 0.2% during the term of the lease.

5.4.410 If payments under the CPI escalation provision are considered variable lease payments, no increase in rents over the lease term will be included in the lease payments. This is because, absent a remeasurement event (e.g. a change in the lease term), the measurement of the lease payments for the entire lease term would be performed using the CPI index at lease commencement – i.e. lease payments would be $200,000 per month over the 10-year lease term at lease commencement.

5.4.420 However, LE and LR each conclude that the payments under the CPI escalation provision are in-substance fixed payments, rather than variable lease payments, because of the remote likelihood that the change in CPI will be less than 0.2%. Therefore, both LE and LR include a 2% annual increase in the measurement of lease payments at the lease commencement date.

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Example 5.10

Variable lease payments versus in-substance fixed lease payments – Payments based on performance or usage

5.4.430 Lessee LE and Lessor LR enter into a seven-year lease of retail space.

5.4.440 The following facts are relevant.

- The lease requires monthly variable lease payments equal to 5% of sales from the retail space. There are no fixed lease payments.
- LE has an established, successful brand and similar retail stores in similar shopping centers in many locations.
- Based on LE's extensive, relevant history of operating similar stores, LE and LR can reliably forecast, conservatively, that LE will generate *at least* $500,000 in sales from this store each year of the seven-year lease; therefore, it is highly certain that LE will make at least $25,000 in variable lease payments each year ($500,000 x 5%). LE and LR actually each have forecasts for a much greater amount of sales each year.

5.4.450 The lease payments are nil for this lease. This means that LE will have no right-of-use asset or lease liability for this lease at the commencement date; and if this were a sales-type or direct financing lease, LR would have no lease receivable.

5.4.460 Despite the fact that LE is highly certain to make at least $175,000 ($25,000 x 7) in variable lease payments over the lease term, those variable payments are not in-substance fixed payments. The variable terms have economic substance – i.e. they exist as a substantive way for LE and LR to share in the risks and benefits from use of the retail space – and create genuine variability in the lease payments to be made.

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KPMG observation – Concept of in-substance fixed lease payments consistent with current practice

5.4.470 In-substance fixed lease payments are included in the measurement of lease payments because they are unavoidable, and therefore economically indistinguishable from fixed lease payments. Although such payments may appear to contain variability, in fact they do not. [ASU 2016-02.BC203]

5.4.480 The guidance in Topic 842 relies upon a principle rather than a series of more detailed requirements or examples, because the Board concluded that even an exhaustive list of requirements or examples could never be comprehensive. In addition, the Board concluded that introducing a new series of detailed requirements or examples might create new questions or issues for a concept that is generally understood and applied in current practice. Consistent with that thinking, the Board's intent is for the new guidance to be applied in substantially the same manner as it is applied currently; therefore, existing examples of what constitute in-substance fixed (or disguised or de facto) minimum lease payments are likely to continue to be relevant. [ASU 2016-02.BC204]

KPMG observation – Highly certain payments based on performance or usage of the underlying asset

5.4.490 As illustrated in Example 5.10, we believe that even variable lease payments that are highly (or even virtually) certain to occur are not in-substance fixed lease payments *if* the payments are based on performance or usage of the underlying asset. This is consistent with current practice under US GAAP, and therefore is consistent with the Board's statement that the concept of in-substance fixed lease payments under Topic 842 is intended to be consistent with current practice.

5.4.500 In addition, while not included in Topic 842, and therefore not authoritative, the publicly available FASB/IASB staff paper that guided the Board's discussion in April 2014 of in-substance fixed lease payments included an example substantially similar to Example 5.10; the Board discussion generally indicated support for the conclusion reached in that example presented by the staff.

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5.4.3 Lease incentives

5.4.510 The lessor may offer incentives to the lessee to sign the lease agreement. Lease incentives include both:

- payments made to or on behalf of the lessee; and
- losses incurred by the lessor as a result of assuming a lessee's pre-existing lease with a third party. [842-10-55-30]

5.4.520 Regarding losses attributable to the lessor assuming a lessee's pre-existing lease, the lessor and lessee should prepare independent estimates. For example:

- The lessee's estimate of the incentive could be based on a comparison of the new lease with the market rental rate available for similar underlying assets, or the market rental rate from the same lessor without the lease assumption.
- The lessor should estimate any loss based on the total remaining costs reduced by the expected benefits from the sublease or use of the assumed underlying asset. [842-10-55-30]

Example 5.11

Effect of lease incentives on the lease payments

5.4.530 Lessee LE and Lessor LR enter into a 10-year lease with the following terms:

- Annual rent of $1,500, so $15,000 in total.
- LR agrees to provide LE with $1,000 to defray the cost of tenant improvements each of the first 3 years of the lease, so $3,000 in total. LE will simply reduce its annual payment for Years 1 through 3 by $1,000 each year.

5.4.540 The lease payments are $12,000 in this example ($15,000 less the $3,000 incentive). LE will need to factor in the timing and amount of its payments in determining lease classification, and in measuring its lease liability (see section 6.3). That is, the present value of those lease payments will need to factor in three initial net payments of $500, and seven subsequent annual payments of $1,500.

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5.4.4 Purchase options

5.4.550 The exercise price of a lessee option to purchase the underlying asset is included in the lease payments if the lessee is reasonably certain to exercise the option. The analysis of whether a lessee is reasonably certain to exercise a purchase option considers the same economic factors that are evaluated in determining whether to include optional periods in the lease term (see section 5.2). [842-10-30-5(c)]

5.4.560 When there is a change in the assessment of whether it's reasonably certain that the lessee will exercise a purchase option, the lessee remeasures the lease payments. [842-10-35-4(c)(2)]

5.4.570 Reassessments of lessee purchase options and remeasurements of the lease payments resulting from a change in the assessment of a lessee purchase option are discussed in section 6.6 (lessees).

5.4.580 A *lessor* does not reassess whether the lessee is reasonably certain to exercise a purchase option unless the lease is modified and that modification is not accounted for as a separate contract (see section 7.7). [842-10-35-3]

Example 5.12

Purchase option price included in the lease payments

5.4.590 Lessee LE leases a warehouse and land. The following facts are relevant.

- The lease term is five years, with annual fixed lease payments of $1,000,000.
- The lease contract gives LE the option to purchase the warehouse and land at a fixed price of $10,000,000 at the end of the lease term.

5.4.600 Based on an analysis of the economic factors at lease commencement, LE is reasonably certain to exercise the purchase option. Therefore, the total lease payments are $15,000,000.

- $5,000,000 in total annual fixed payments for five years; plus
- $10,000,000 exercise price of the purchase option.

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5.4.5 Termination penalties

5.4.610 The determination of the lease term governs whether a termination penalty is included in lease payments. Termination penalties are included in the lease payments unless it is reasonably certain that the lessee will *not* exercise an option to terminate the lease, and therefore will not incur the penalty. [842-10-30-5(d)]

Example 5.13
Termination penalty included in the lease payments

5.4.620 Lessee LE leases a floor in an office building from Lessor LR for five years for monthly payments of $20,000. The lease contract allows LE to terminate the lease after Year 3 for a lump sum payment of $120,000. At lease commencement, it is not reasonably certain that LE will continue the lease beyond the end of Year 3.

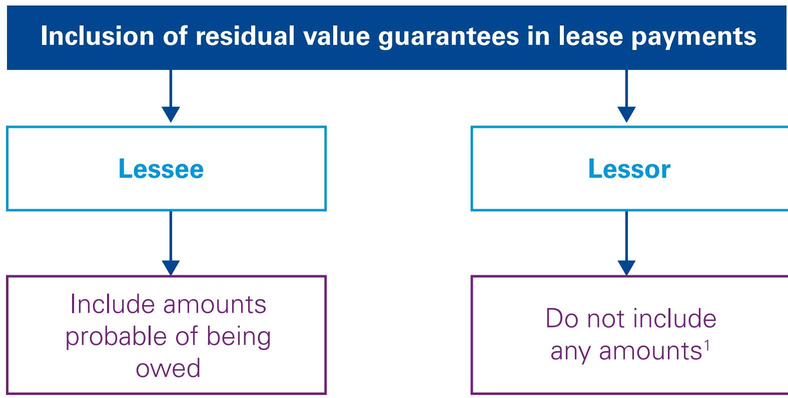
5.4.630 As a result, both LE and LR include the termination penalty in the lease payments. Therefore, the total lease payments are $840,000:

- $720,000 for three years of fixed payments ($20,000 x 36); plus
- $120,000 termination penalty.

5.4.6 Residual value guarantees

5.4.640 A residual value guarantee is a guarantee made to a lessor that the value of an underlying asset returned to the lessor at the end of a lease will be at least a specified amount. Residual value guarantees can be provided by the lessee or by a third party that is unrelated to the lessee or the lessor. [842 Glossary]

5.4.650 The following diagram highlights the different treatment of residual value guarantees for lessees versus lessors: [842-10-30-5]



Note 1:

No residual value guarantee amounts (whether provided by the lessee or by another unrelated third party) are included in the lease payments by a lessor. However, the lessor's 'lease receivable' for sales-type and direct financing leases includes the full amount of any residual value guarantee(s) (see section 7.3.1).

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5.4.660 A provision requiring the lessee to make up a residual value deficiency that is attributable to damage, extraordinary wear and tear, or excessive usage is not a residual value guarantee. Amounts related to such a provision are variable lease payments (see section 5.4). [842-10-55-34]

5.4.670 However, if the lessor has the right to require the lessee to purchase the underlying asset by the end of the lease term (i.e. a lessor put option), the stated purchase price is *included* in lease payments by both the lessee and lessor. Although it is not a residual value guarantee because the lessee receives the underlying asset, the amount is economically similar to a guaranteed residual value. [842-10-55-35]

5.4.680 In general, a lessee's lease payments should not be reduced for any amounts probable of being owed under a residual value guarantee that are covered by a residual value guarantee obtained from a third party by the lessee. However, an exception arises when the lessor explicitly releases the lessee from the residual value guarantee obligation, including a secondary obligation to perform if the third-party guarantor defaults. [842-10-55-36]

5.4.690 Amounts paid by a lessee for a third-party residual value guarantee are also not lease payments. They are executory costs. [842-10-55-36]

5.4.700 Residual value guarantees that are subject to the requirements of Topic 842 are not within the scope of Topic 815 (derivatives and hedging) – see section 2.2. [815-10-15-80]

5.4.710 When there is a change in the assessment of the amount probable of being owed under a residual value guarantee, the lessee remeasures the lease payments (see section 6.6). [842-10-35-4]

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Example 5.14

Residual value guarantee included in the lease payments

5.4.720 Lessee LE leases a new semi-trailer truck from Lessor LR for four years for annual payments of $24,000. Under the contract, LE guarantees a residual value of $60,000 to LR at the end of the lease term.

5.4.730 In deciding whether the lease payments include any amount related to LE's residual value guarantee, LE observes that similar trucks are regularly sold in used condition, with detailed listings published on dealer sites. LE researches those listings and finds similar trucks around four years of age, for sale or with estimated values between $50,000 and $60,000.

5.4.740 Mileage is a key determinant in pricing different trucks of the same age. LE expects to drive the truck 120,000 miles per year, which is at the high end of the range of mileage noted in the used sale listings. Therefore, LE concludes that it is likely that the residual value of the truck will be closer to $50,000 than $60,000 at the end of the lease, and therefore that the probable amount that will be owed by LE at the end of the lease term will be $10,000. Consequently, LE's lease payments include the $10,000.

5.4.750 LR includes no amounts related the residual value guarantee in its measurement of the lease payments. However, if the lease were a sales-type or a direct financing lease, the full $60,000 residual value guarantee would be included in determining LR's *lease receivable* (see section 7.3).

Example 5.15

Lessee accounting for right to receive excess over guaranteed residual value

5.4.760 Continuing Example 5.14, in addition to the guarantee of a residual value of $60,000, the contract stipulates that:

- LR will sell the truck at the end of the four-year lease term; and
- if LR sells the truck for more than $60,000, LR will pay LE any surplus above that amount.

5.4.770 LE accounts for the potential gain on sale of the residual asset as a contingent gain under Subtopic 450-30. Therefore, LE recognizes a gain only when the sale is completed and to the extent that the sale price exceeds $60,000.

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KPMG observation – Including only amounts probable of being owed under a residual value guarantee will increase complexity and judgment

5.4.780 The Board's decision for lessees to include in lease payments only amounts probable of being owed under a residual value guarantee, rather than the entire amount of the guarantee, will result in the recognition of smaller lease liabilities and right-of-use assets by lessees. However, the judgment that will be involved in determining and reassessing amounts probable of being owed and the requirement to remeasure the lease payments whenever that assessment changes, and potentially to allocate those changes to multiple components of the contract (including non-lease components), will add complexity to the lessee accounting model for leases that include a lessee residual value guarantee.

KPMG observation – No guidance on determining probable amounts owed

5.4.790 Topic 842 requires a lessee to estimate, and reassess, the amount probable of being owed under a residual value guarantee it provides to the lessor, but does not provide guidance about how to make this estimate. Example 5.14 demonstrates one way in which we believe that the lessee could estimate the amount probable of being owed in a scenario of that nature.

5.4.800 Another approach that we believe would be reasonable is to assign probabilities to potential outcomes and to include in the lease payments the minimum amount that exceeds the 'probable' threshold.[1] For example, a lessee might consider there to be multiple possible outcomes:

Amount lessee could owe	Probability
$ –	20%
10	25%
20	25%
30	20%
40	10%

5.4.810 Under this approach, the lessee would conclude that it is probable that it will owe at least $10 to satisfy the residual value guarantee. While it is possible that the lessee will owe $30 or $40, and it is more likely than not that the lessee will owe at least $20, the probability of those outcomes is not likely to occur.

5.4.820 However, both Example 5.14 and the above are illustrative only. Because Topic 842 does not prescribe how to make the estimate, there may be a number of acceptable approaches.

Note 1:

'Probable' is defined as the future event or events are likely to occur. [842 Glossary]

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Comparison with current US GAAP – Full amount of residual value guarantees included in minimum lease payments

5.4.830 Under current US GAAP, the definition of *minimum lease payments* for a lessee includes the full amount of any residual value guarantee that it provides (i.e. the $60,000 in Example 5.14), rather than just the amount that it is probable of owing. This is one aspect of Topic 842 that will result in a difference in the accounting for finance leases as compared to capital leases. In general, the lease liability and the right-of-use asset will be lower under Topic 842 for a finance lease that includes a lessee residual value guarantee than what the capital lease obligation and capital lease asset are under current US GAAP. [840 Glossary]

5.4.840 While the definition of *minimum lease payments* applicable to lessors in current US GAAP includes the full amount of any residual value guarantee (provided by the lessee or any other unrelated third party) and the definition of *lease payments* includes no amounts related to residual value guarantees, this will not have any appreciable difference on a lessor's accounting. This is because:

- the full amount of any residual value guarantee(s) will still be included in the lessor's *lease receivable* (which is a component of the lessor's net investment in the lease, together with any unguaranteed residual value and deferred selling profit for direct financing leases, if any) for sales-type and direct financing leases; and
- operating lessors' lease income under current US GAAP was calculated based on the *minimum rental payments*, which excluded guaranteed residual values, rather than the *minimum lease payments*. *Lease payments*, as applicable to lessors, under Topic 842 is substantially the same as *minimum rental payments* in current US GAAP. [842 Glossary]

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5.5 Initial direct costs

5.5.10 Initial direct costs are incremental costs of a lease that would not have been incurred if the lease had not been obtained (i.e. not been executed). [842 Glossary]

5.5.20 This section discusses the costs that meet the definition of initial direct costs, and the accounting is discussed in sections 6.3 (lessees) and 7.3–7.4 (lessors).The following are examples of costs that would typically be included in, or excluded from, initial direct costs. [842-10-30-9 – 30-10, ASU 2016-02.BC222, BC304]

Typical initial direct costs	
Include	**Exclude**
– Commissions – Payments made to an existing tenant to incentivize that tenant to terminate the lease	– Legal fees – Costs of evaluating the prospective lessee's financial condition – Costs of negotiating lease terms and conditions – General overheads

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Example 5.16
Costs that are initial direct costs

5.5.30 Lessee LE and Lessor LR enter into a lease. The following are costs that they incur in connection with the lease:

	Incurred by:	
Cost	**LE**	**LR**
Allocation of employee costs to negotiate lease terms and conditions	$ 5,000	$10,000
External legal fees	12,000	20,000
Travel costs related to inspecting the underlying asset	4,000	–
Commission to tenant's agent (LE) / listing agent (LR)	20,000	30,000
Payment made to existing tenant to obtain the lease	–	20,000

5.5.40 LE has initial direct costs of $20,000 in connection with this lease that it includes in the initial measurement of the right-of-use asset for the lease:

- The $20,000 commission to the tenant's agent is an initial direct cost because it is only incurred upon obtaining the lease – i.e. it would not have been owed if the lease had not been executed.
- None of the other costs incurred by LE are initial direct costs, because they would have been incurred even if the lease had not been obtained. For example, employee salaries are paid regardless of whether the lease is obtained; therefore, the allocation of employee costs is not an initial direct cost. In addition, LE would be required to pay its attorneys for negotiating and drafting the lease even if the lease was not executed.

5.5.50 LR has initial direct costs of $50,000:

- The $30,000 listing agent commission is an initial direct cost for the same reason as it was for LE. In addition, the payment to the existing tenant of $20,000 is an initial direct cost because it is paid only as a consequence of executing the lease.
- None of the other costs incurred by LR meet the definition of initial direct costs, because they would have been incurred even if the lease had not been executed. The allocation of employee costs and the external legal fees are not initial direct costs to LR for the same reasons that they were not initial direct costs to LE.

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KPMG observation – Initial direct costs might be an allocated amount

5.5.60 As noted in the KPMG observation at 5.4.80–100, lease payments might be an allocated amount when there are multiple lease components, or when there is at least one non-lease component. This might also be the case with initial direct costs (e.g. in a contract in which a commission is paid for the lease and the non-lease component). Judgment will be involved in determining whether costs, such as a commission paid to a broker, relate to a lease component, a non-lease component, or both. The following are two examples of how this allocation may work under Topic 842. [ASU 2016-02.BC222, BC306–BC307]

Example A – Allocated initial direct costs

5.5.70 Continuing the simplified example in the KPMG observation at 5.4.100, Lessor LR's standard practice is to pay a commission to its salesperson on the total value of the contract obtained. Therefore, LR concludes that the commission of $25 relates to both the lease and the maintenance services, and allocates the commission on the same basis as the consideration in the contract.

Component	Allocation	Calculation
Lease (equipment)	$20	25 x 80%
Non-lease (maintenance)	5	25 x 20%
	$25	

5.5.80 Therefore, LR has initial direct costs of $20. The $5 allocated to the maintenance services is accounted for in accordance with the contract costs guidance in Subtopic 340-40.

Example B – Initial direct costs

5.5.90 Lessee LE and Lessor LR enter into a five-year lease of retail space in a shopping center. In addition to providing a right to use the retail space, LR will provide common area maintenance. As a result, there are two components of the contract: a lease component comprising the right to use the retail space, and a non-lease component comprising common area maintenance.

5.5.100 Annual rent payments are fixed at $1,000, while charges for common area maintenance will be billed on a proportionate basis to all tenants of the shopping center on a monthly basis.

5.5.110 Both LE and LR pay a broker commission of $250, which equals five percent of the fixed rent payments in the contract. This percentage is the standard commission paid in this market for real estate leases, regardless of whether the lease is a gross lease or a net lease (see section 4.6), and regardless of whether the lease includes non-lease components like common area maintenance.

5.5.120 Consequently, both LE and LR conclude that the commission relates solely to the lease component of the contract. The commission was incurred only as a direct result of the lease being executed; therefore, the commission is an initial direct cost to both LE and LR.

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KPMG observation – Narrowed definition of *initial direct costs* based on contract acquisition costs guidance in Topic 606

5.5.130 The Board's decisions on defining, allocating, and accounting for initial direct costs were intended to align the guidance on initial direct costs by a lessor with the guidance for costs to obtain a contract by a seller of similar goods. [ASU 2016-02.BC306–BC307]

5.5.140 Similar to the initial direct costs guidance in Topic 842, the contract cost guidance in Subtopic 340-40 (other assets and deferred costs – contracts with customers) similarly:

- recognizes as a contract cost asset only those incremental costs to obtain a contract that an entity incurs that would not have been incurred if that contract had not been obtained;
- allocates capitalized costs to the goods and services to which they relate, and similarly relies on judgment to make that determination; and
- amortizes contract cost assets on a systematic basis that is consistent with the transfer to the customer of the goods or services to which the contract cost asset relates. The specific accounting for those costs that meet the definition of initial direct costs under Topic 842 is discussed in sections 6.3 (lessees) and 7.3–7.4 (lessors).

Comparison with current US GAAP – Fewer costs of lease origination are initial direct costs under Topic 842

5.5.150 An entity's initial direct costs for a lease will be substantially less for many leases under Topic 842 than they are under current US GAAP. This is because Topic 842 defines initial direct costs as only those incremental costs of a lease that would not have been incurred if the lease had not been obtained (i.e. not executed), while initial direct costs under current US GAAP also include:

- Other incremental costs that are incurred directly as a result of the lease, even if such costs were incurred to negotiate and arrange the lease and, therefore, would have been incurred even if the lease was not executed (e.g. external legal fees)
- A lessor's incurred costs, even if not incremental to the lease, directly related to fulfilling specified activities to negotiate or arrange the lease. Those specified activities are:
  - » evaluating the prospective lessee's financial condition;
  - » evaluating and recording guarantees, collateral, and other security arrangements;
  - » negotiating lease terms;
  - » preparing and processing lease documents; and
  - » closing the transaction.

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The costs directly related to those activities include only that portion of the employees' total compensation and payroll-related fringe benefits directly related to time spent performing those activities for that lease and other costs related to those activities that would not have been incurred but for the lease. [840-20-25-17 – 25-19]

5.5.160 Because of the narrowed definition of initial direct costs, many entities will recognize significant origination costs for a lease when incurred that they do not recognize as incurred currently. Lessors in that situation will recognize greater margins on their lease income earned over the lease term (e.g. operating lease income or interest income on their direct financing leases) as compared to current US GAAP, while lessees will recognize less lease expense during the lease term as compared to current US GAAP.

5.5.170 The new, narrowed definition of initial direct costs that does not include allocated internal costs may be simpler to apply than the definition in current US GAAP because entities will no longer need to have processes and controls to track employee time spent on negotiating and arranging leases.

5.6 Discount rate for the lease

5.6.10 For a *lessee*, the discount rate for the lease is the rate implicit in the lease unless that rate cannot be readily determined. In that case, the lessee is required to use its incremental borrowing rate. For a *lessor*, the discount rate for the lease is the rate implicit in the lease. [842 Glossary, 842-20-30-3]

5.6.20 The discount rate for the lease is determined based on information available at lease commencement. [842-20-30-2]

5.6.30 A lessee that is not a public business entity is permitted to use a risk-free discount rate for the lease, determined using a period comparable to that of the lease term, as an accounting policy election for all leases in which it is a lessee. [842-20-30-3]

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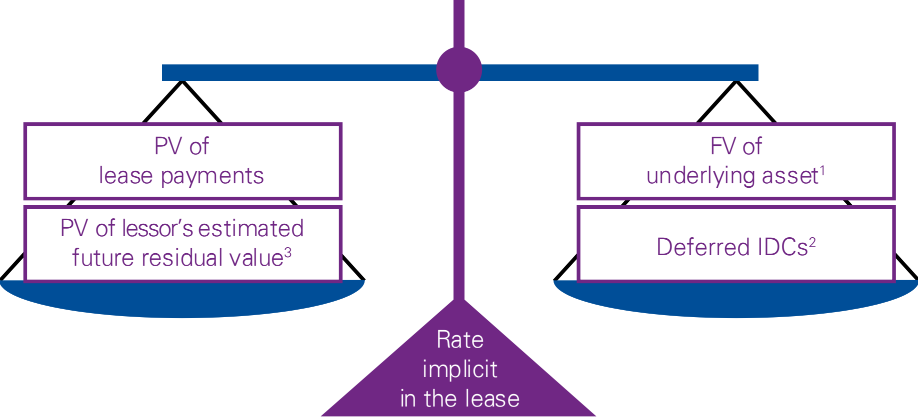
Rate implicit in the lease

5.6.40 The rate implicit in the lease is the rate of interest that, at a given date, causes the aggregate present value of (a) the lease payments, and (b) the amount that a lessor expects to derive from the underlying asset following the end of the lease term *to equal* the sum of (1) the fair value of the underlying asset minus any related investment tax credit retained and expected to be realized by the lessor, and (2) any deferred initial direct costs of the lessor. [842 Glossary]



Notes:

1. For purposes of determining the *rate implicit in the lease*, the fair value of the underlying asset is reduced by the amount of any investment tax credit related to the underlying asset that is retained and expected to be realized by the lessor. [842 Glossary]
2. Initial direct costs are not deferred (i.e. they are expensed at lease commencement) if the lease is a sales-type lease *and* the fair value of the underlying asset differs from its carrying amount at lease commencement (see section 7.3). [842-30-25-1(c)]
3. If a lessee uses the rate implicit in the lease, the estimated future residual value excludes amounts probable of being owed by the lessee to satisfy a residual value guarantee, which are included in the lease payments (see section 5.4.6).

5.6.50 For purposes of determining the rate implicit in the lease to assess the lease classification (e.g. to measure the present value of the lease payments and residual values guaranteed by the lessee or an unrelated third party), a lessor assumes that no initial direct costs will be deferred if, at lease commencement, the fair value of the underlying asset is different from its carrying amount. This is discussed in section 7.2. [842-10-25-4]

Lessee's incremental borrowing rate

5.6.60 The incremental borrowing rate is the rate of interest that a *lessee* would have to pay to borrow on a collateralized basis over a similar term an amount equal to the lease payments in a similar economic environment. [842 Glossary]

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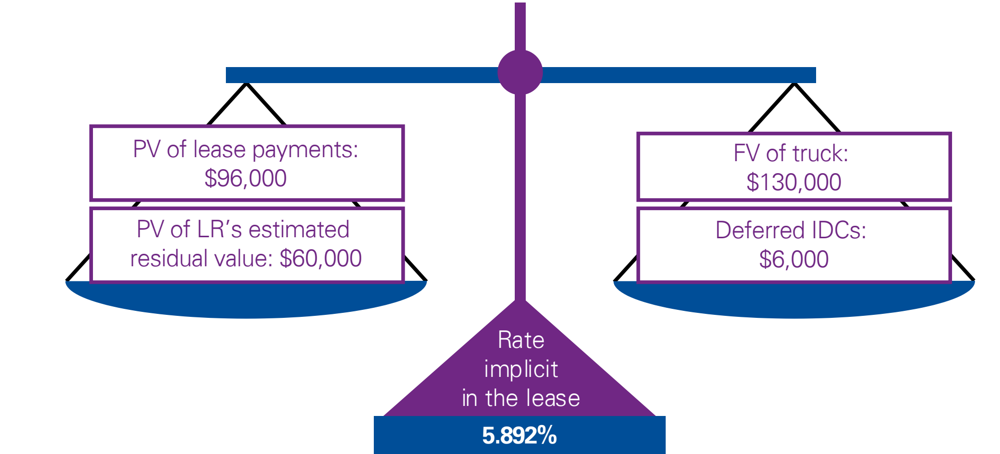
Example 5.17
Lessor determination of rate implicit in the lease

5.6.70 Lessee LE leases a new truck from Lessor LR for four years.

5.6.80 The following facts are relevant.

- Under the contract, LE pays $24,000 per year, payable annually in advance.
- The lease commencement date is January 1, 20x1.
- LR estimates that the residual value of the truck will be $60,000 at the end of the four-year lease term.
- The lease contains no transfer of ownership provisions, no lessee purchase option, no residual value guarantees, and no renewal options.
- There are no non-lease components in the contract (e.g. maintenance services).
- LR incurs $6,000 in initial direct costs associated with executing the lease. These costs will be deferred because LR's purchase price to acquire the truck at lease commencement (i.e. its carrying amount) equals its fair value ($130,000). See discussion in section 7.3.
- LR will not retain any investment tax credit associated with the truck.

5.6.90 The rate implicit in the lease is the rate that balances the following equation, which is 5.892%:



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Example 5.18
Lessee determination of incremental borrowing rate

5.6.100 Assume the same facts as Example 5.17, except that LE:

– does not have readily available information to determine LR's estimated residual value of the truck; and/or

– has readily available information to determine LR's estimated residual value, but does not know LR's deferred initial direct costs.

5.6.110 Without both pieces of information, LE cannot determine the rate implicit in the lease. Therefore, LE will use its incremental borrowing rate as the discount rate for the lease.

5.6.120 In determining the incremental borrowing rate, LE considers the rate of interest that it would have to pay on a secured borrowing in an amount equal to the lease payments ($96,000) under similar terms (e.g. over three years).[1]

5.6.130 LE also considers that it has an unsecured line of credit with a fixed rate of 7% as well as an eight-year term loan with the same national bank, secured by the assets of the company, with an original balance of $10 million and a fixed interest rate of 4%. LE determines the most efficient way for it to arrive at a reasonable incremental borrowing rate is to request its bank to quote a rate for a three-year term loan of $96,000, secured by a commercial vehicle similar to the truck in the lease. LE reviews the quote, which is 5.5%, for reasonableness based on the current risk-free rate and LE's credit history, and determines that it is reasonable. Therefore, LE uses a 5.5% discount rate to calculate the present value of the lease payments.

Note 1:

LE is paying the annual payments in advance so will have made its final payment at the beginning of Year 4 of the lease, not at the end.

KPMG observation – Lessees will likely use their incremental borrowing rate in most cases

5.6.140 It will likely be very difficult for lessees to determine the rate implicit in the lease under Topic 842. This is because of the need to know both the lessor's estimated residual value of the underlying asset (consistent with current US GAAP) and the amount of initial direct costs that the lessor will defer for the lease. Consequently, lessees will likely use their incremental borrowing rate for nearly all leases.

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KPMG observation – Lessor and lessee discount rates are likely to be different

5.6.150 Consistent with many of the other estimates and judgments to be made in accordance with Topic 842, the discount rate for the lease will frequently differ between the rate implicit in the lease determined by the lessor and the lessee's incremental borrowing rate. This is because those two rates are determined in very different ways; even if that were not the case, many of the underlying estimates/judgments (e.g. lease term, assessments of lessee purchase options, etc.) may not be arrived at similarly by the lessee and the lessor, further reducing the chance that the discount rate for the lease will be the same for the lessee and the lessor in any given lease.

KPMG observation – Determining the discount rate for a portfolio of leases

5.6.160 As discussed in section 5.9, the Board concluded that the leases guidance in Topic 842 could be applied at a portfolio level by lessees and lessors in some circumstances. The basis for conclusions and Example 2 in Subtopic 842-20 highlight that the Board expects that some entities will be able to use a portfolio approach to determine the discount rate for a lessee's leases – if the effect of doing so would not materially affect the lessee's accounting for those leases to which it applies a single discount rate. In the Board's view, applying a portfolio approach to determining the discount rate would alleviate some of the concerns that entities expressed about determining (and documenting the basis for) a separate incremental borrowing rate for each and every lease. [842-20-55-18 – 55-20, ASU 2016-02.BC201]

KPMG observation – Subsidiary's use of parent (or group) incremental borrowing rate

5.6.170 In some cases, it might be reasonable for a subsidiary to use a parent entity (or group) incremental borrowing rate as the discount rate for a lease. 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). 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. [842-20-55-18 – 55-20, ASU 2016-02.BC201]

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KPMG observation – 'Cost of money' is not an appropriate discount rate

5.6.180 The cost-of-money rate used to reimburse entities that are required to comply with the Cost Accounting Standards and the Federal Acquisition Regulation is not an appropriate proxy for the discount rate in the lease. This is because it is not necessarily linked to the lessor's implicit rate or to the lessee's incremental borrowing rate. [ASU 2016-02.BC202]

Comparison with current US GAAP

Use of lessor's implicit rate when it is higher than lessee's incremental borrowing rate

5.6.190 Topic 842 requires the lessee to discount future lease payments using the rate implicit in the lease when it is readily determinable even if it is higher than the lessee's incremental borrowing rate. Current US GAAP, like Topic 842, requires the lessee to use the rate implicit in the lease if it is practicable to do so, but only if that rate does not exceed the lessee's incremental borrowing rate. [840-10-25-31(b)]

5.6.200 This is a difference between Topic 842 and current US GAAP that, in theory, could result in a lessee recognizing smaller lease assets and lease liabilities and that could also affect lease classification – i.e. because the present value of the lease payments and any lessee residual value guarantee would be less using a higher discount rate. However, because of the infrequency with which lessees will likely be able to determine the rate implicit in the lease, the circumstances in which a lessee uses a rate implicit in the lease that is higher than its incremental borrowing rate are likely to be rare.

Required use of a secured incremental borrowing rate

5.6.210 The definition of incremental borrowing rate in Topic 842 requires that the rate reflect a secured borrowing rate – i.e. on a 'collateralized basis'. Under current US GAAP, the lessee can generally use a secured or unsecured rate as long as it is consistent with the financing that would have been used had the underlying asset been purchased, rather than leased. Therefore, current US GAAP does not require the use of a secured borrowing rate like Topic 842 does. [840 Glossary]

'Funds necessary to purchase the leased asset' versus 'an amount equal to the lease payments'

5.6.220 The current US GAAP definition of incremental borrowing rate refers to the rate that the lessee would have incurred to borrow the funds necessary to purchase the *leased asset*. Conversely, the new standard states that the incremental borrowing rate is that which the lessee would pay to borrow on a collateralized basis over a similar term an amount equal to the *lease payments*. [840 Glossary]

5.6.230 This change to the definition of incremental borrowing rate arose because under Topic 842 lessees will be capitalizing most leases, rather than just capital leases. As a result, the Board concluded that the interest rate a particular entity, with its individual credit rating and other entity-specific circumstances, might have to pay to borrow the

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funds necessary to purchase the underlying asset in many operating lease scenarios (e.g. a three- or five-year lease of real estate or a long-lived asset such as a ship or an airplane) may differ substantially from the interest rate that same entity would pay to borrow an amount equal to the lease payments (i.e. the rate to finance the purchase of the underlying asset would typically be higher).

5.6.240 Therefore, the current US GAAP definition of incremental borrowing rate, if used in Topic 842, would likely have resulted in discount rates unrelated to the lessor's pricing in the lease (for which the incremental borrowing rate is intended to serve as a readily determinable proxy) and in inappropriately measured lease assets and lease liabilities.

Initial direct costs and the rate implicit in the lease

5.6.250 Under current US GAAP, the rate implicit in the lease does not take into account the lessor's initial direct costs. As defined in Topic 842, the rate implicit in the lease will be lower than that determined under current US GAAP when the lessor defers initial direct costs. However, this difference is mechanical in nature; instead of separately deferring initial direct costs for sales-type and direct financing leases as under current US GAAP, the initial direct costs are automatically included in the lessor's net investment in the lease through the determination of the implicit rate. Lease income and the lessor's net investment in the lease are unaffected by this change in mechanics. [840 Glossary]

5.7 Economic life of the underlying asset

5.7.10 The economic life of an asset is either the period over which the asset is expected to be economically usable by one or more users or the number of production or similar units expected to be obtained from the asset by one or more users. [842 Glossary]

KPMG observation – Economic life is different from useful life

5.7.20 In contrast to the definition of economic life, the useful life of an asset is the period over which the asset is expected to contribute directly or indirectly to future cash flows. The useful life of an asset can differ depending on the asset's intended use by its current owner. [842 Glossary]

5.7.30 Consistent with current US GAAP, the Topic 842 definition of economic life will result in a period that is at least as long as, and typically longer than, the US GAAP definition of useful life.

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KPMG observation – Economically usable

5.7.40 'Economically usable' is not a defined term in US GAAP. However, this phrase, when used in the existing definition of economic life, generally refers to the period over which the asset is expected to be economically viable because the benefits it can produce exceed the costs to replace it or undertake major repairs or an overhaul.

KPMG observation – By one or more users

5.7.50 The phrase 'by one or more users' is intended to convey that the economic life of an asset is an assessment that considers the perspective of the current lessee or owner *and* any future lessees or owners.

Comparison with current US GAAP – Definition of estimated economic life

5.7.60 The current US GAAP definition of estimated economic life for purposes of lease classification is "[t]he estimated remaining period during which the property is expected to be economically usable by one or more users, with normal repairs and maintenance, for the purpose for which it was intended at lease inception, without limitation by the lease term." [840 Glossary]

5.7.70 This differs from the Topic 842 definition of economic life; for example, because the Topic 842 definition does not refer to 'normal repairs and maintenance' or to 'the purpose for which it was intended at lease inception'. However, the two definitions will likely result in similar conclusions in most cases. We believe that the Board did not intend to change current practice with respect to the application of economic life; instead, the wording changes were made to align the wording of the definition with IFRS.

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5.8 Portfolio approach

5.8.10 A lessee or lessor may apply the guidance in Topic 842 to a portfolio of leases with similar characteristics (size and composition) if the entity reasonably expects that the application of the leases model to the portfolio will not differ materially from the application to the individual leases in that portfolio. [842-20-55-18 – 55-20, ASU 2016-02.BC120–BC121]

Example 5.19

Applying the portfolio approach to leases of computer servers

5.8.20 Lessee LE provides IT services, including cloud computing services, to a wide variety of customers. During March 201X, LE entered into a total of 50 individual leases of vehicles for its salesforce. The 50 leases have terms ranging from four to five years, commence on different dates (within the span of a calendar quarter), and annual lease payments of between $5,000 and $6,000 for each vehicle.

5.8.30 Because there is a narrow range of fair values and estimated remaining economic lives for the vehicles, LE reasonably expects that the effect of applying the requirements of Topic 842 to its 50 vehicle leases as a portfolio will not differ materially from applying the requirements individually to each lease. Therefore, LE decides to use a portfolio approach in determining the discount rate for each of the 50 leases. Therefore, LE will use a single discount rate in applying the measurement requirements in Topic 842 to each of the 50 leases in the portfolio.

5.8.40 Because LE is unable to determine the rate implicit in the 50 leases (see section 5.6), it uses its incremental borrowing rate. LE determines its incremental borrowing rate to be 4.25% based on the collateral represented by a representative one of the 50 vehicles and an average of the lease payments for each vehicle (i.e. an amount between $5,000 and $6,000).

KPMG observation – Portfolio approach guidance aligns with Topic 606

5.8.50 The portfolio approach permitted in applying Topic 842 is, and was intended by the Board to be, substantially similar to that included in the new revenue recognition standard, which allows entities to apply the accounting for an individual contract with a customer to a portfolio of contracts under similar circumstances. [ASU 2016-02.BC120–BC121]

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KPMG observation – Cost versus benefits of applying a portfolio approach

5.8.60 The Board does not expect entities to perform quantitative evaluations to determine whether the portfolio approach differs materially from the application of Topic 842 to the individual leases in that portfolio. Instead, entities should be able to take a reasonable approach, applying judgment in selecting the size and composition of the portfolio (e.g. type of underlying asset, lease term, geographic locations, etc.). [ASU 2016-02.BC120–BC121]

5.8.70 The Board noted that the cost relief of applying the portfolio approach could be particularly high for certain aspects of Topic 842 that involve judgments and estimates, such as determining the discount rate or determining and reassessing the lease term. For example, an entity may establish a single discount rate applied to all leases in a portfolio because using that discount rate would not result in a materially different outcome than using a discount rate determined on a lease-by-lease basis. Example 2 in Subtopic 842-20 demonstrates application of the portfolio approach to determining the discount rate. [ASU 2016-02.BC120–BC121]

KPMG observation – Assessing impairment for right-of-use assets within a lease portfolio

5.8.80 During deliberations of the portfolio approach, the Board expressed a view that if some, but not all, right-of-use assets within a lease portfolio are impaired, it would be inappropriate to continue to account for those leases within a portfolio if the impairment is material to the entity. To remove the material difference at the portfolio level, an entity will need to disaggregate the portfolio into smaller portfolios or apply the leases guidance on a lease-by-lease basis. This will ensure that the portfolio is not aggregated above the level at which impairment is measured – i.e. a cash-generating unit under IFRS or an asset group under US GAAP.

US GAAP different from IFRS – Portfolio approach guidance is non-authoritative under US GAAP

5.8.90 The IASB chose to include the portfolio approach guidance for lessors and lessees in the application guidance of IFRS 16, which is authoritative under IFRS. In contrast, the FASB chose to discuss the application of a portfolio approach principally in the basis for conclusions of Topic 842, which is not authoritative under US GAAP. However, Example 2 in Subtopic 842-20, which is within the authoritative implementation guidance, illustrates the use of a portfolio approach for a group of computer server leases.
[IFRS 16.B1]

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6 Lessee accounting

How the standard works

- A lessee recognizes on its balance sheet a (financial) lease liability and a (nonfinancial) right-of-use asset for all leases, including operating leases, with a term greater than 12 months.
- The lease classification distinction (operating versus finance lease) continues to exist in Topic 842 and now affects how lessees measure and present lease expense and cash flows – not whether the lease is on- or off-balance sheet.

	Balance sheet	Income statement	Profile of total lease cost
Finance lease	– ROU asset – Lease liability	– **Operating expense:** Amortization of ROU asset – **Interest expense:** Interest expense on lease liability	– Front-loaded
Operating lease	– ROU asset – Lease liability	– **Operating expense:** Lease expense	– Generally straight-line

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6.1 An overview

Step	Description
Step 1: Determine the 'lease term' (section 5.3)	The lease term is integral to determining: – Whether the lease is a short-term lease – The lease payments and the discount rate for the lease – Lease classification
Step 2: Determine the 'lease payments' (section 5.4)	The lease payments are integral to: – Determining the discount rate for the lease – Determining lease classification – Measuring the right-of-use asset and the lease liability for a lease
Step 3: Determine the discount rate for the lease (section 5.6)	The discount rate for the lease affects: – Lease classification – Measurement of the right-of-use asset and lease liability
Step 4: Lease classification (section 6.2)	Lease classification determines: – How a lessee measures and presents lease expense and cash flows – How a lessee measures the right-of-use asset after initial recognition
Step 5: Initial recognition and measurement (section 6.3)	– Lessee recognizes a right-of-use asset and a lease liability at the commencement date of the lease (unless the lease is a short-term lease) – The right-of-use asset and lease liability for finance and operating leases are initially measured in the same way
Step 6: Subsequent accounting (section 6.4)	– Subsequent measurement of the lease liability is the same for finance and operating leases – Subsequent measurement of the right-of-use asset differs for finance and operating leases
Step 7: Impairment testing (section 6.5)	– Right-of-use assets are evaluated for impairment using the long-lived assets impairment guidance (Topic 360) – Impairment of an operating lease right-of-use asset substantially changes the subsequent accounting for the lease
Steps 8A and 8B: Reassessments and modifications (sections 6.6 and 6.7)	– Lessees may be required to revise the accounting for a lease during the lease term, even if there are no lease modifications – Lessee accounting for lease modifications depends on the nature of the modification
Step 9: Presentation (section 6.8)	– Finance and operating leases are presented differently in the financial statements

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6.1.10 The steps in the chart help frame the big picture of lessee accounting that is applied to separate lease components, which is the unit of account in applying Topic 842 (see section 4.1). Steps 1 to 3 deal with concepts and definitions that apply to both lessee and lessor accounting; therefore, they are included in chapter 5 as an introduction to both accounting models. Each of Steps 4 to 9 is discussed in more detail in this chapter.

KPMG observation – A more faithful financial statement representation of leases

6.1.20 Topic 842 was developed *principally* to improve financial statement users' understanding of lessees' lease obligations. In the Board's view, the recognition of right-of-use assets and lease liabilities for all leases other than short-term leases (see section 6.3.1) will:

- result in a more faithful representation of the rights and obligations arising from leases;
- improve the understanding and comparability of lessees' financial commitments regardless of how the lessee finances the assets used in its business; and
- reduce opportunities for entities to structure leases to achieve a particular accounting outcome on the balance sheet. [ASU 2016-02.BC8]

KPMG observation – Impact on key performance ratios and financial covenants

6.1.30 The requirement to recognize additional assets and liabilities arising from lease transactions may affect some key performance ratios commonly used in credit and investment-making decisions. For example, the additional lease assets and lease liabilities are likely to result in:

- lower liquidity ratios, such as the *current ratio* (current assets ÷ current liabilities) and *quick ratio* ((cash + short-term investments + receivables) ÷ current liabilities) because of increased current liabilities (current portion of the lease liabilities); and
- higher *working capital turnover* (revenue ÷ average working capital) due to reduced working capital because the lease liability is partially current, and a lower *asset turnover* (revenue ÷ average total assets) due to increased total assets.

6.1.40 Changes to a lessee's balance sheet resulting from the new requirements may impact a lessee's compliance with financial covenants. The existence and magnitude of the impacts will depend on lessee-specific facts and circumstances.

6.1.50 However, most financial statement users (e.g. investors and analysts) already adjust lessees' financial statements for operating lease obligations, often overestimating lease obligations compared to what will be recognized under Topic 842.

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6.1.60 The Board believes that the effects of Topic 842 on financial covenants will not be significant, in part because many loan agreements contain provisions preventing or minimizing defaults solely due to a change in accounting standards; but also because operating lease liabilities are considered operating liabilities under Topic 842 rather than debt. [ASU 2016-02.BC14]

6.1.70 Categorizing operating lease liabilities as operating liabilities, rather than debt, may mean that Topic 842 will not have a significant effect on debt-based ratios such as:

– debt-to-capital ratio (total debt ÷ (total debt + total equity)) and debt-to-equity ratio (total debt ÷ total equity); and
– weighted-average cost of capital (WACC). [ASU 2016-02.BC14]

6.1.80 However, entities currently negotiating debt or similar arrangements that will contain financial covenants may nonetheless want to consider the adoption of Topic 842 in their negotiations of financial covenants.

6.2 Lease classification (Step 4)

6.2.10 A lessee determines lease classification for each separate lease component, which is the unit of account in applying Topic 842 (see section 4.1), at the commencement date of the lease (see section 5.1). [842-10-25-1]

6.2.20 The lessee accounting model in Topic 842 is generally intended to classify leases as finance leases when the lease is economically similar to the purchase of a nonfinancial asset. This would be the case when the lessee effectively obtains control of the underlying asset (rather than merely obtaining control over its *use* for the lease term) by being able to direct its use and obtain substantially all of its remaining benefits as a result of the lease. [ASU 2016-02.BC56, BC70]

6.2.30 However, in determining lease classification, there is no separate or additional evaluation of this underlying principle. The Board decided that a lease is classified as a finance lease when any one (or more) of five specified tests are met, even if an entity does not believe that the lessee effectively obtains control of the underlying asset as a result of the lease. [ASU 2016-02.BC70–BC71]

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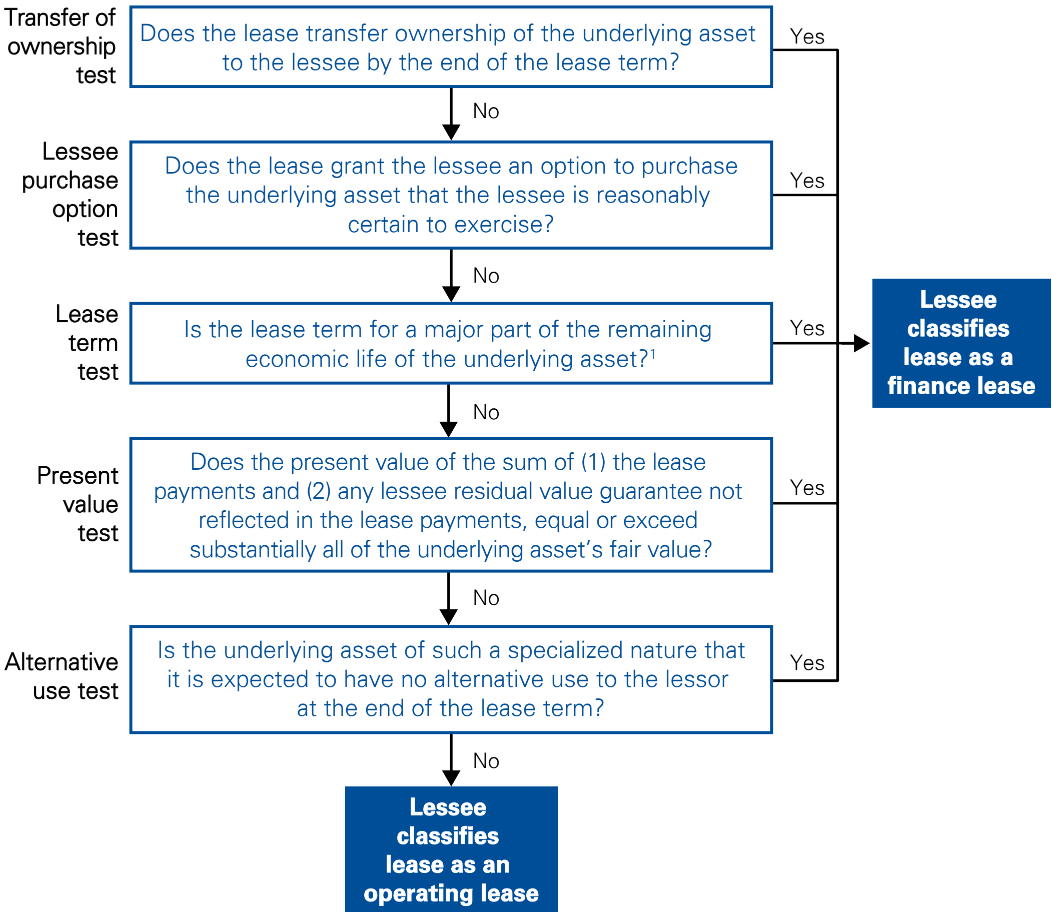
6.2.40 Lease classification is not reassessed after the commencement date unless either:

- there is a change in the assessment of either (1) the lease term, or (2) whether it is reasonably certain that a lessee purchase option will be exercised (see section 6.6); or
- the contract that is or contains the separate lease component is modified and that modification is not accounted for as a separate contract (see section 6.7). [842-10-25-1]

6.2.50 The following are the lease classification tests that are applied by lessees. [842-10-25-2 – 25-3]



Note 1:

If the commencement date is at or near the end of the underlying asset's economic life, this test does not apply.

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Transfer of ownership test

6.2.60 The transfer of ownership test is met in leases that require:

- the lessor to release the underlying asset from the lease and to transfer ownership to the lessee, upon lessee's performance in accordance with the terms of the lease; or
- the lessee to pay a nominal amount in connection with ownership transfer of the underlying asset (e.g. a minimum statutory fee to transfer ownership). [842-10-55-4 – 55-5]

6.2.70 When ownership of the underlying asset transfers to the lessee only if the lessee elects to pay a specified fee (whether nominal or otherwise) to complete the transfer, it is considered a purchase option that is evaluated the same way as any other lessee purchase option (see 6.2.80). [842-10-55-6]

Lessee purchase option test

6.2.80 The lessee purchase option test is met if it is reasonably certain that the lessee will exercise the option. 'Reasonably certain' is a high threshold of probability, and the Board intended the parties to account for lessee options only when the lessee has a compelling economic reason to exercise the option. For further discussion, see section 5.2. [842-10-30-1]

Lease term test

6.2.90 An entity may use the following thresholds when evaluating the lease term test.

- 75 percent or more of the remaining economic life may be considered a major part of the remaining economic life of that underlying asset.
- A lease that commences with 25 percent or less of the underlying asset's total economic life remaining may be considered to commence at or near the end of the asset's economic life. [842-10-55-2]

6.2.100 When a single lease component contains the right to use more than one underlying asset (see section 4.1), an entity considers the remaining economic life of the predominant asset in the lease component when applying the lease term test. The assessment of which underlying asset is predominant is a qualitative one that requires entities to conclude on the most important element of the lease, which the Board expects to be relatively clear in most cases. If an entity is unable to identify the predominant asset, it might be an indicator that there are additional separate lease components in the contract. [842-10-25-5, ASU 2016-02.BC74]

Present value test

6.2.110 An entity may use a threshold of 90 percent or more when determining what constitutes 'substantially all' of the fair value of the underlying asset. [842-10-55-2]

6.2.120 When evaluating lease classification, the fair value of the underlying asset excludes any related investment tax credit retained, and expected to be realized, by the lessor. [842-10-55-8]

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6.2.130 In some cases, it may not be practicable for a lessee to determine the fair value of the underlying asset – i.e. a reasonable estimate of fair value cannot be made without undue cost or effort. Topic 842 notes that practicability is a dynamic concept in that:

- what is practicable for one entity may not be practicable for another;
- what is practicable in one period may not be practicable in another; and
- what is practicable for one underlying asset (or class of underlying asset) may not be practicable for another. [842-10-55-3]

6.2.140 When it is not practicable for an entity to determine the fair value of the underlying asset, lease classification is determined without consideration of the present value test. [842-10-55-3]

Alternative use test

6.2.150 In assessing whether an underlying asset has an alternative use to the lessor at the end of the lease term, an entity considers the effect of contractual restrictions and practical limitations on the lessor's ability to readily direct the underlying asset for another use.

- Contractual restrictions on a lessor's ability to redirect an asset must be substantive (i.e. enforceable) for the asset not to have an alternative use to the lessor.
- Practical limitations exist if the lessor would incur significant economic losses to direct the underlying asset for another use. A significant economic loss could arise because the lessor either would incur significant costs to rework the asset that exceed the economic benefits it would be able to derive from that rework, or would only be able to sell or re-lease the asset at a significant loss. This might occur, for example, with assets that have unique design specifications or that are located in remote areas. [842-10-55-7]

6.2.160 The possibility of a contract with the lessee being terminated is not a relevant consideration for determining whether the lessor would be able to readily direct the underlying asset for another use. [842-10-55-7]

6.2.170 When an underlying asset has no alternative use to the lessor at the end of the lease term, the lessee consumes all (or substantially all) of the remaining benefits from the underlying asset. Absent significant rework or a change in circumstances during the lease term (e.g. the emergence of another potential customer or a new use for the underlying asset in its present, specialized form), there are no (or minimal) remaining benefits inherent in the underlying asset that revert to the lessor at the end of the lease term. Even if such a change in circumstances does occur during the lease term, classification of the lease is not reassessed. [ASU 2016-02.BC71(e)]

Lease of an acquiree

6.2.180 The acquirer retains the acquiree's lease classification, unless the lease is modified as part of the business combination and that modification is not accounted for as a separate contract – see section 6.7 (modifications). [842-10-55-11]

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Related party leases

6.2.190 An entity classifies a lease between related parties on the basis of the legally enforceable terms and conditions of the lease. An entity does not classify the lease based on an evaluation of its economic substance. The classification and accounting for the leases should be the same as for leases between unrelated parties in the separate financial statements of the related parties. [842-10-55-12]

Facilities owned by a governmental unit or authority

6.2.200 Because of special provisions normally present in leases of terminal space and other airport facilities owned by a governmental unit or authority, the economic life of such facilities for lease classification purposes is in effect indeterminate. It may also not be practicable to determine the underlying asset's fair value. Accordingly, these leases are classified as operating leases if:

- they do not transfer ownership of the underlying asset to the lessee by the end of the lease term; and
- it is not reasonably certain that the lessee will exercise an option (if there is one) to purchase the underlying asset. [842-10-55-13]

6.2.210 This guidance also applies to leases of other facilities (e.g. ports and bus terminals), but only if *all* of the following conditions are met:

- the underlying asset is owned by a governmental unit or authority;
- the underlying asset is part of a larger facility (e.g. an airport), operated by or on behalf of the lessor;
- the underlying asset is a permanent structure or a part of a permanent structure (e.g. a building), that could not normally be moved to a new location;
- the lessor (or a higher governmental authority in some circumstances) has the explicit right under the lease agreement or existing statutes or regulations applicable to the underlying asset to terminate the lease at any time during the lease term (e.g. by closing or taking possession of the facility);
- the lease neither transfers ownership nor allows the lessee to purchase or otherwise acquire ownership of the underlying asset; and
- the underlying asset or equivalent asset in the same service area cannot be purchased or leased from a nongovernmental unit or authority. [842-10-55-13]

6.2.220 Leases of underlying assets that do not meet all of the above criteria are assessed using the same criteria for classifying leases that do not involve government-owned property. [842-10-55-14]

Indemnification for environmental contamination

6.2.230 Lessee indemnification for environmental contamination, whether for environmental contamination caused by the lessee during its use of the underlying asset over the lease term or for pre-existing environmental contamination, does not affect lease classification. [842-10-55-15]

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Example 6.1
Lease classification – Lease term test

6.2.240 Lessee LE and Lessor LR enter into a lease of a piece of used, non-specialized production equipment. The following facts are relevant at the lease commencement date.

– Transfer of ownership:	No
– Renewal/purchase options:	None
– Total economic life of equipment:	20 years
– Residual value guarantee:	None
– LE's incremental borrowing rate:	5% (implicit rate cannot be readily determined)
– Initial direct costs:	None

6.2.250 In addition, LE evaluates lease classification using the bright-line thresholds – i.e. the 75%, 25%, and 90% thresholds for the lease term and present value tests (see 6.2.90 and 6.2.110).

Scenario 1: Lease does not begin near the end of the asset's economic life	Scenario 2: Lease begins near the end of the asset's economic life
6.2.260 **Additional facts** – Non-cancellable 5-year lease term. – Equipment has a remaining economic life of 6 years at lease commencement. – Equipment has a fair value of $30,000 at lease commencement. – Present value of lease payments discounted at 5% is $24,245 (fixed lease payments of $5,600 per year in arrears).	6.2.280 **Additional facts** – Non-cancellable 4-year lease term. – Equipment has a remaining economic life of 4.5 years at lease commencement. – Equipment has a fair value of $25,000 at lease commencement. – Present value of lease payments discounted at 5% is $21,276 (fixed lease payments of $6,000 per year in arrears).
6.2.270 **Lease classification** LE classifies the lease as a **finance lease** based on the following. – Transfer of ownership test – No – Lessee purchase option test – N/A – Lease term test – Yes (83%) – Present value test – No (81%) – Alternative use test – No	6.2.290 **Lease classification** LE classifies the lease as an **operating lease** based on the following. – Transfer of ownership test – No – Lessee purchase option test – N/A – Lease term test – N/A (lease commencement falls at or near the end of the equipment's economic life) – Present value test – No (85%) – Alternative use test – No

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Example 6.2

Lease classification – Present value test

6.2.300 Lessee LE and Lessor LR enter into a lease of a truck. The following facts are relevant at the lease commencement date.

– Non-cancellable lease term:	7 years
– Lease payments:	Fixed payments of $2,710 per year in arrears
– Transfer of ownership:	No
– Renewal/purchase options:	None
– Fair value of truck:	$28,272
– Total economic life of truck:	20 years
– Remaining economic life of truck:	10 years
– LE's incremental borrowing rate:	4.5% (implicit rate cannot be readily determined)
– Initial direct costs:	None
– Residual value guarantee (lessee):	Guarantees residual value of $14,545
– Amount probable of being owed under residual value guarantee:	$1,818
– Present value of the lease payments + residual value guarantee:	$26,657 = PV of the 'lease payments' of $17,305 ([$2,710 x 7] + $1,818 at end of Year 7, discounted at 4.5%) + PV of the amount of the RVG not already included in the lease payments of $9,352 ($12,727 [$14,545 - $1,818] at end of Year 7, discounted at 4.5%)

6.2.310 In addition, LE evaluates lease classification using the bright-line thresholds – i.e. the 75%, 25%, and 90% thresholds for the lease term and present value tests (see 6.2.90 and 6.2.110).

6.2.320 **Lease classification**

LE classifies the lease as a **finance lease** based on the following.

- Transfer of ownership test – No
- Lessee purchase option test – N/A
- Lease term test – No (70%)
- Present value test – Yes (94%, or $26,657 ÷ $28,272)
- Alternative use test – No

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Example 6.3
Lease classification – Alternative use test

6.2.330 Lessor LR enters into a contract to customize a piece of production equipment for Lessee LE's specific needs and then to lease LE that equipment for five years. At the end of five years, LR would incur significant costs to rework the design and functionality of the equipment to be able to lease or sell that equipment to another customer that it is unlikely to be able to recover.

6.2.340 The lease is classified as a finance lease by LE (and a sales-type lease by LR). This is regardless of both the other terms and conditions of the lease, and other facts – i.e. regardless of the lease term, the lease payments, whether the lease includes a purchase option, etc.

KPMG observation – Judgment in applying lease term and present value classification tests

6.2.350 The Board decided to *permit*, rather than *require*, the use of bright-line thresholds when evaluating the lease term and present value classification tests. In deciding to permit use of these thresholds, the Board observed that entities need to operationalize the guidance in a scalable manner, which requires the establishment of internal accounting policies and controls. However, because these thresholds are characterized as only one reasonable approach to interpreting what 'major part', 'substantially all', and 'at or near the end' mean, entities are permitted to exercise judgment. That means, for example, that amounts below 90 percent could be considered substantially all in the context of the present value test or that a lease term that is less than 75 percent of the remaining economic life of the underlying asset could be considered a major part of the asset's remaining economic life in the lease term test. [ASU 2016-02.BC73]

6.2.360 Determining reasonable thresholds will require the exercise of judgment. However, in general, we believe that straying from these bright-lines by any significant amount will raise the risk of being questioned about the judgment reached.

Lease term test

6.2.370 Consideration of the control classification principle may be useful in determining an appropriate threshold for applying the lease term test. That is, when considering what might be an acceptable threshold (i.e. other than 75%), an entity should consider that the classification test is intended to capture, as finance (sales-type) leases, those leases that give the lessee the ability to both (1) direct the use of the underlying asset and (2) obtain substantially all of the remaining benefits of the underlying asset. [ASU 2016-02.BC70]

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6.2.380 This is because, in determining the qualitative threshold for the lease term test (i.e. 'major part' rather than 'substantially all'), the Board considered that most assets, particularly equipment, decline in value in a front-loaded manner; this means that the earlier years of an asset's economic life provide a disproportionate percentage of the remaining benefits from the underlying asset. Consequently, an entity that controls the use of an asset for only a *major part* of its remaining economic life may still have the ability to direct its use to obtain substantially all of its remaining benefits. [ASU 2016-02.BC71(c)]

6.2.390 That major part was intended to be a substantively lower threshold than substantially all, also evidenced by the fact that the 75 percent bright-line threshold for a major part is significantly lower than the 90 percent bright-line threshold for substantially all. This means that, potentially, a qualitative evaluation of what constitutes a major part of the asset's economic life should consider the pattern in which the asset is expected to experience a diminution in economic utility or value. This evaluation may differ for different classes of underlying assets; for example, it might be less than 75 percent for an asset with a more front-loaded dimunition in economic utility or value, but more than 75 percent for an asset that holds its economic utility or value more steadily over time.

At or near the end of the economic life

6.2.400 In general, because there is no guidance provided about what *at or near the end* means other than the 25 percent bright-line threshold provided in the implementation guidance, we believe that entities generally should adhere to the bright-line threshold provided of 25 percent. Unlike for the lease term test, the classification principle provides no insight into how to interpret this threshold because the 'at or near the end of the economic life' exception is *contrary* to the classification principle, rather than an application of that principle, and was adopted for cost-benefit reasons. [ASU 2016-02.BC71(c)]

Present value test

6.2.410 In general, we believe that there is little leeway from the 90 percent bright-line threshold in evaluating the present value test. This is because, unlike 'major part' or 'at or near the end', 'substantially all' is used elsewhere in US GAAP and is interpreted on a mostly consistent basis to mean approximately 90 percent; this includes when thinking about whether a customer is obtaining substantially all of the remaining benefits from an asset in other Topics.

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KPMG observation – Alternative use test

6.2.420 The alternative use test is new in Topic 842; current US GAAP has no equivalent. As such, it has not previously been applied in practice. The following are observations based on the basis for conclusions, as well as the guidance in Topic 606, which includes a similar alternative use notion from which the one in Topic 842 is derived. [ASU 2016-02.BC71(e)]

Alternative use test infrequently met on its own

6.2.430 The basis for conclusions states, "In general, it is expected that lessors would lease specialized assets that have no alternative use to them at the end of the lease term only under terms that would transfer substantially all the benefits (and risks) of the asset to the lessee (thus, one of the other criteria for a finance lease also likely will be met)." [ASU 2016-02.BC71(e)]

6.2.440 We believe that this statement is instructive to applying this new test for two reasons.

- It suggests that a conclusion that this test is met without meeting or nearly meeting any of the other accompanying tests may be worthy of further consideration; for example, when the lease term is *almost* a major part of the remaining economic life of the underlying asset, or the present value of lease payments is *almost* substantially all of the fair value of the underlying asset. That is not, however, to say it cannot be met in isolation.
- It emphasizes that this test is focused on capturing scenarios in which the lessor would have to perform significant rework on the underlying asset, or there would have to be a change in circumstances to redirect it for another use. This means that the underlying asset being of a highly specialized nature or subject to highly specialized circumstances (e.g. being located in a remote area) is, in fact, key to meeting this test. This test is not intended to be a second lease term test whereby it is met solely because the asset will have no alternative use at the end of the lease term because of its age.

Contractual restrictions

6.2.450 Enforceable contractual restrictions on the lessor after the end of the lease term can also affect whether this test is met. However, because the alternative use test explicitly applies only when the underlying asset is highly specialized or subject to highly specialized circumstances, we believe that contractual restrictions (e.g. preventing the lessor from re-leasing or selling the asset to another customer) *alone*, without the asset being of a highly specialized nature or subject to highly specialized circumstances, would not meet this test.

6.2.460 Rather, contractual restrictions can affect the evaluation of this test because even a highly specialized asset may have an alternative use to the lessor at the end of the lease term; for example, there may be other customers, even if only a few, that could lease or purchase the asset. A contractual restriction may be placed on the lessor if the lessee designed some of the specifications or paid the lessor a premium to develop or include those specifications in the asset; in that case, the lessee may require the restriction to prevent a competitor from benefitting from its investment in the asset. If that contractual restriction is enforceable, even though the asset could be redirected for an alternative use, then this test would be met.

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Completed asset

6.2.470 Under Topic 606, when considering whether a good or service that will be transferred to the customer has an alternative use to the seller, the seller considers the characteristics of the asset that will ultimately be transferred to the customer. Therefore, this test can be met for an asset that only becomes customer-specific at or near the end of the production, modification, or customization process.

6.2.480 The equivalent notion under Topic 842 is to consider the characteristics of the underlying asset that will ultimately be returned to the lessor at the end of the lease term. While lease classification is assessed at lease commencement, we believe that the assessment considers all relevant expectations about customizations or modifications that will be made during the lease term, and that will affect the characteristics of the underlying asset at the point in time it is returned to the lessor. For example, if there is an agreement for the lessor to make significant customizations after the commencement date that will result in the underlying asset not having an alternative use to the lessor at the end of the lease term, those should be considered at lease commencement when performing the alternative use test. We believe that consideration of the asset that will ultimately be returned to the lessor should not take into account customizations or modifications that are not already agreed or committed to at lease commencement. However, if significant customizations or modifications are made after lease commencement, that *may* result in a reassessment of the lease classification, among other things; this is because significant customizations or modifications to an underlying asset will generally trigger a reassessment of any lessee options in the contract (see section 6.6). [606-10-25-28, ASU 2014-09.BC136]

US GAAP different from IFRS – Single lessee accounting model under IFRS 16

6.2.490 Under IFRS 16, a lessee accounts for a lease under a single lessee accounting model. The IASB determined that a single lessee accounting model, under which all leases are finance leases, provides the most useful information to the widest range of financial statement users and results in greater coherency between the primary financial statements. [IFRS 16.BC41–BC56]

6.2.500 IASB members expressed concerns with an operating lease accounting model similar to that in Topic 842 because of the lack of consistency between the items recognized in the balance sheet and those recognized in the income statement (which could have distorted ratio analyses based on the primary financial statements).

- A lessee would recognize a financial liability (lease liability) in the balance sheet but would not present corresponding interest expense in the income statement.
- A lessee would recognize a nonfinancial asset, but would not recognize any amortization or depreciation.
- Either the right-of-use asset or the lease liability would need to be measured as a balancing figure.

6.2.510 Unlike the IASB, the FASB determined that a dual lessee accounting model better depicts economic differences between various leases that should be reflected in the lessee's financial statements. [ASU 2016-02.BC50–BC51]

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Comparison with current US GAAP – Similar but not the same

6.2.520 While the lease classification tests in Topic 842 are similar to current US GAAP, there may be differences in lease classification even when a lessee uses the bright-line thresholds – i.e. the 75%, 25%, and 90% thresholds for the lease term and present value tests, respectively (see 6.2.90 and 6.2.110). This is because:

- The alternative use test in Topic 842 does not exist under current US GAAP.
- The exception that applies to the lease term test for leases that commence at or near the end of the underlying asset's economic life applies to both the lease term *and* the present value tests in current US GAAP. Therefore, some leases that would have met the present value test under current US GAAP if it were not for the exception may meet that test, and be classified as a finance lease (or sales-type lease for lessors), under Topic 842.
- Most of the specific asset rules in current US GAAP (e.g. for the classification of a lease involving real estate) have not been carried forward to Topic 842. The only specific rule in current US GAAP carried forward is the exception to the lease term test when the lease commences at or near the end of the asset's economic life.
- There are other differences that are relevant for lessors that are discussed in section 7.2. [840-10-10-1, 25-1 – 25-69]

6.2.530 There are also other changes reflected in Topic 842 that potentially could result in different lease classification compared with current US GAAP, even if the lease classification tests were identical. This is because:

- 'Lease payments' under Topic 842 are not the same as 'minimum lease payments' under current US GAAP. For example, executory costs such as property taxes and insurance are specifically excluded from minimum lease payments under current US GAAP, while some (or all) of the payments made by a lessee to reimburse the lessor's costs of ownership of an underlying asset will be reflected in lease payments under Topic 842 if payment for those costs is fixed (see section 4.6).
- Lease payments under Topic 842 may be an allocated amount when there is more than one component of a contract (see section 4.4).

6.2.540 Finally, lease classification under current US GAAP is determined at lease inception, as opposed to lease commencement. [840-10-25-1]

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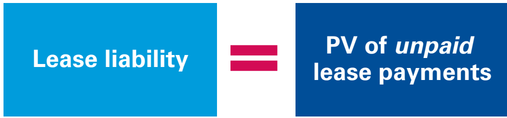
6.3 Initial recognition and measurement (Step 5)

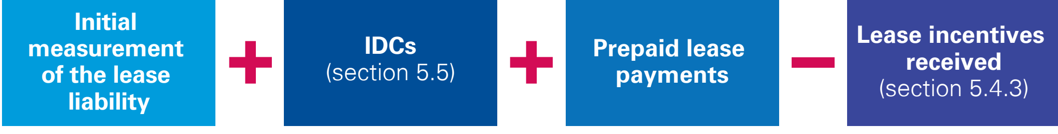
6.3.10 A lessee recognizes a right-of-use asset and a lease liability at lease commencement. [842-20-25-1]

6.3.20 At lease commencement, the lease liability for both finance and operating leases equals the present value of the unpaid lease payments, discounted at the rate implicit in the lease (if readily determinable), or otherwise at the lessee's incremental borrowing rate. The discount rate for the lease is calculated on the basis of information available at lease commencement. For a discussion on determining the 'lease payments', see section 5.4; and on determining the 'discount rate for the lease', see section 5.6. [842-20-30-1 – 30-3]



6.3.30 A lessee that is not a public business entity may use a risk-free discount rate for the lease determined based on a comparable period as the 'lease term' (see 5.6.30). This accounting policy, if elected, is applied to all leases. [842-20-30-3]

6.3.40 The right-of-use asset for finance and operating leases is initially measured at the sum of: [842-20-30-5]



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Example 6.4

Initial measurement of the lease liability and right-of-use asset

6.3.50 Lessee LE enters into a contract with Lessor LR for the right to use office space for a 10-year term. The right to use the office space is a lease and there are no other components of the contract. The following facts are relevant at the lease commencement date.

– Lease payments:	Fixed payments of $14,527 per year in arrears, with a 3% increase every year after Year 1
– Renewal options:	5-year extension; payments during that period are $19,523 per year in arrears, with a 3% increase every year after Year 1 of the extended period
– Termination/purchase options:	None
– Transfer of ownership:	No
– Residual value guarantee:	None
– LE's incremental borrowing rate:	10% (the rate implicit in the lease cannot be readily determined)
– Initial direct costs (LE):	$5,000

Contractual payments

6.3.60 For ease of reference in this and subsequent examples, the contractual payments for the right to use the office space are presented here.

Non-cancellable lease period

Yr 1	Yr 2	Yr 3	Yr 4	Yr 5	Yr 6	Yr 7	Yr 8	Yr 9	Yr 10
$14,527	$14,963	$15,412	$15,874	$16,350	$16,841	$17,346	$17,866	$18,402	$18,954

Extension period

Yr 11	Yr 12	Yr 13	Yr 14	Yr 15
$19,523	$20,109	$20,712	$21,333	$21,973

Lease payments

6.3.70 LE concludes, based on all relevant economic factors at the lease commencement date, that it does not have a compelling economic reason to exercise the extension option, and therefore is not reasonably certain to do so. Therefore, the lease term is 10 years and the lease payments are the $166,535 in payments (see table in 6.3.60) that will be made during the 10-year lease term.

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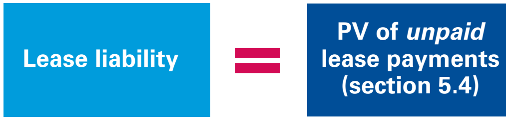
Lease liability

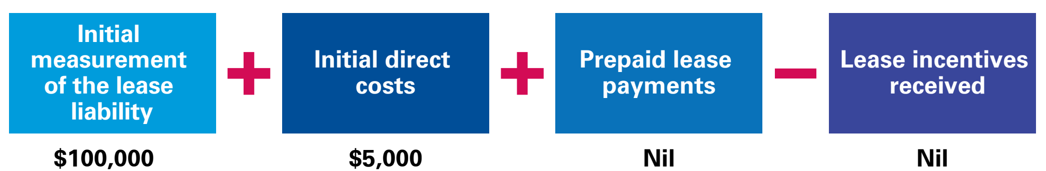
6.3.80 At the lease commencement date, LE recognizes a lease liability of $100,000. This is the present value of the 10 lease payments (starting at $14,527 and escalating at 3% per year), discounted at LE's incremental borrowing rate of 10%.



$100,000

Right-of-use asset

6.3.90 LE recognizes a corresponding right-of-use asset of $105,000, which is calculated as follows.



$100,000	$5,000	Nil	Nil

KPMG observation – Recognition date for right-of-use assets and lease liabilities

6.3.100 The recognition of right-of-use assets and lease liabilities at the lease commencement date is consistent with the overall lease accounting model for lessees. A lessee recognizes a lease asset and a lease liability when it obtains control over the use of the underlying asset, which is at the lease commencement date (see section 5.1). [ASU 2016-02.BC182]

6.3.110 A lease may be an onerous contract (e.g. the lease payments exceed the expected benefits to be derived from the use of the asset by the lessee) between inception and commencement date. In that case, the lessee accounts for the contract in accordance with Topic 450 (contingencies), which may require recognition of a liability before the lease commencement date. [ASU 2016-02.BC117, BC182]

6.3.120 In addition, as discussed in chapter 12 (Disclosures), Topic 842 requires a lessee to disclose qualitative information about significant leases that have been entered into as of the reporting date, but that have not yet commenced. [842-20-50-3]

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Comparison with current US GAAP – Initial measurement

6.3.130 Under current US GAAP, an entity initially *measures* a lease at lease inception – i.e. the date on which an agreement is reached.

6.3.140 In addition, current US GAAP precludes a lessee in a capital lease from measuring the asset recognized at an amount that is greater than the fair value of the underlying asset at lease inception. That requirement is not included in Topic 842. Consequently, the initial measurement of a right-of-use asset at the commencement date could potentially exceed the fair value of the underlying asset, although this outcome is unlikely. [840-30-30-1, 30-3]

6.3.150 Other differences could arise because 'lease payments' under Topic 842 are not the same as 'minimum lease payments' under current US GAAP (see section 5.4).

6.3.1 Short-term lease recognition exemption

6.3.160 A short-term lease is a "lease that, at the commencement date, has a lease term of 12 months or less and does not include an option to purchase the underlying asset that the lessee is reasonably certain to exercise." [842 Glossary]

6.3.170 Although short-term leases are within the scope of Topic 842, a simplified form of accounting is permitted. A lessee can elect, by class of underlying asset, not to apply the recognition requirements of Topic 842 and instead to recognize the lease payments as lease cost on a straight-line basis over the lease term. This is consistent with current US GAAP operating lease accounting. [842-20-25-2]

6.3.180 The lease term and the lease payments are determined in a manner consistent with all other leases (see sections 5.3–5.4). Consequently, the short-term lease exemption may be applied to cancellable leases (e.g. month-to-month, evergreen, and at-will leases) if the lessee is not reasonably certain to renew (or to continue, in the case of a termination option) the lease beyond 12 months. [842-20-25-2]

6.3.190 When the assessment of the lease term or a lessee purchase option changes such that the remaining lease term extends more than 12 months from the end of the previously determined lease term, or it becomes is reasonably certain that the lessee will exercise a purchase option, the lease no longer qualifies for the recognition exemption. In that case, the lessee applies the requirements of Topic 842, including the recognition and measurement requirements, as if the date of the change were the commencement date of the lease. [842-20-25-3]

6.3.200 A lessee is required to disclose each period its lease cost for short-term leases for which it elects the recognition exemption, excluding expenses relating to leases with a lease term of one month or less. [842-20-50-4(c)]

6.3.210 A lessee applying the short-term lease exemption to a class of underlying assets for which it has short-term leases discloses that fact. In addition, if the short-term lease cost for the period is not representative of the lessee's short-term lease commitments, the lessee discloses that fact, and the amount of its short-term lease commitments (see section 12.2). [842-20-50-8]

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Example 6.5
Is it a short-term lease?

Scenario 1: Lease meets the definition of a short-term lease

6.3.220 Lessee LE enters into a contract with Lessor LR to lease a piece of non-specialized equipment for 12 months for construction work at one of its factories. The following facts are relevant at lease commencement.

– Lease payments:	Fixed payments of $500 per month in arrears, with a 3% increase every month after Month 1
– Renewal options:	Two 12-month extensions, with no change in payment structure
– Termination options:	None
– Purchase option:	Option to purchase at then-prevailing fair value at any time during the lease.

6.3.230 At lease commencement, LE determines it is not reasonably certain to exercise the renewal options or the purchase option considering all relevant economic factors – i.e. based on the renewal lease payments or the purchase option exercise price, and the nature of the underlying asset as a non-specialized asset with readily available equivalents in the marketplace.

6.3.240 Therefore, the lease is a short-term lease because the lease term is not more than 12 months and LE is not reasonably certain to exercise the purchase option in the contract.

6.3.250 LE has not already elected an accounting policy for short-term leases. On entering into this lease, LE elects to apply the short-term lease exemption to all short-term leases of assets within the same class of underlying asset. Going forward, LE will be required to apply the exemption for all other short-term leases of that class of underlying asset.

6.3.260 In applying the short-term lease exemption, LE recognizes the lease payments as lease cost on a straight-line basis over the lease term.

Scenario 2: Short-term lease that still meets the definition after a reassessment

6.3.270 Continuing from Scenario 1, three months after entering into the lease, Lessee LE expands the scope and duration of construction at its factory so that it is now reasonably certain to exercise the first renewal option for the equipment. The equipment is installed at the factory such that it would be cost-prohibitive to remove and install a replacement piece of equipment to complete the construction work.

6.3.280 The lease continues to qualify as a short-term lease, because the remaining lease term after the reassessment does not extend more than 12 months from the end of the previously determined lease term.

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6.3.290 However, if the renewal period had been for 13 months instead of 12, the lease would no longer have qualified as a short-term lease and LE would have been required to apply the requirements of Topic 842 as if the date of the change in assessment of the renewal option were the commencement date. In that case, LE would have recognized and measured at the end of Month 3 a lease liability and a right-of-use asset for the equipment lease (reflecting a lease term of 22 months).

Scenario 3: Lease does not meet the definition of a short-term lease

6.3.300 Lessee LE enters into a contract with Lessor LR to lease a car. The lease term is nine months and LE has the option to renew the lease for another six months. At lease commencement, LE is reasonably certain to exercise the renewal option.

6.3.310 The lease does not meet the definition of a short-term lease because the lease term is 15 months.

Example 6.6
Leases with termination options

Scenario 1: Termination option controlled by lessor

6.3.320 Lessee LE enters into a contract with Lessor LR to lease a jackhammer. The lease is for 10 months and is automatically renewed for a further six months unless the lease is terminated by LR.

6.3.330 Periods covered by an option to extend (or not to terminate) the lease where exercise of the option is controlled by the lessor are included in the lease term (see section 5.3). Accordingly, the lease term is 16 months. Therefore, the lease does not meet the definition of a short-term lease because the lease term is more than 12 months.

Scenario 2: Termination option controlled by lessee

6.3.340 Assume the same facts as in Scenario 1, except that the decision about whether to terminate the lease after 10 months is Lessee LE's (rather than Lessor LR's). At lease commencement, LE is not reasonably certain to continue the lease beyond the 10-month non-cancellable term based on all relevant economic factors – i.e. LE is not reasonably certain to not exercise the termination option.

6.3.350 The lease term is 10 months. Therefore, the lease meets the definition of a short-term lease because the lease term is not more than 12 months.

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KPMG observation – Exemption may not create significant structuring opportunities

6.3.360 The Board considered the possibility of leases being structured to meet the definition of a short-term lease. However, there are economic considerations that are likely to affect the appetite that both the lessee and the lessor have to structure short-term leases. For example, lessors who enter into short-term leases will take on more residual asset risk, and therefore may require increased lease payments to mitigate that risk. Other lessors may refuse to take on that additional risk entirely or be unable to do so based on the terms of their financing arrangements to acquire the leased assets. [ASU 2016-02.BC381]

KPMG observation – Short-term lease exemption does not necessarily mean 'business as usual' for those leases

6.3.370 For leases with a non-cancellable period of 12 months or less that include renewal options (including options not to terminate the lease) and/or purchase options, the 'reasonably certain' assessment (see section 5.2) will, in effect, become the on-/off-balance sheet test for these leases if the lessee elects the short-term lease exemption. Therefore, lessees with leases of that nature that elect the exemption will need to have processes and internal controls in place to ensure that the exemption is applied appropriately and, because the exemption is an accounting policy election, is applied consistently to all similar leases.

6.3.380 In addition, the specific disclosure requirements applicable to short-term leases mean that lessees will need processes and controls in place to accumulate and maintain the information necessary to comply with those disclosure requirements. This includes processes to differentiate short-term leases (i.e. those with a lease term of 12 months or less) from very short-term leases (i.e. those with a lease term of one month or less), the costs of which are not disclosed in the short-term lease cost disclosure. The disclosures are discussed in section 12.2.

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US GAAP different from IFRS – Exemptions

Lessee purchase options

6.3.390 The definition of a short-term lease in IFRS 16 states that a lease that contains a lessee option to purchase the underlying asset is not a short-term lease. This is different from the definition of a short-term lease in Topic 842, which only precludes short-term lease categorization if the lessee is reasonably certain to exercise its option to purchase the underlying asset. [IFRS 16.A]

Changes in short-term lease categorization

6.3.400 Both IFRS 16 and Topic 842 require lessees to re-evaluate whether a lease qualifies as a short-term lease in the event that the lease is modified or there is a change in the lease term. However, Topic 842 also states that a lease is no longer a short-term lease if it becomes reasonably certain that the lessee will exercise an option to purchase the underlying asset. This additional provision is unnecessary under IFRS 16 because any lessee purchase option precludes short-term lease categorization. [IFRS 16.7]

6.3.410 Under Topic 842, a short-term lease only loses that categorization if the change in the lease term results in the remaining lease term being more than 12 months beyond *the end of the previously determined lease term*. The FASB decided on this approach because it was concerned that a lessee might exercise a renewal option prior to the end of the existing lease term and the FASB did not want that action alone to trigger the recognition and measurement requirements of Topic 842 for that lease. Therefore, if a lessee has a 12-month lease and exercises a 12-month renewal option 30 days before the end of the initial 12-month lease term, the remaining lease term at the date of the option exercise would be 13 months. However, the lease would still qualify as a short-term lease.

6.3.420 In contrast, a short-term lease is assessed as a new lease under IFRS 16 if the lease is modified or there is any change in the lease term (e.g. the lessee exercises an option not previously included in its determination of the lease term). It is presently unclear, under IFRS 16, in the example in 6.3.410, whether the lease would continue to qualify as a short-term lease. [IFRS 16.7]

Exemption for leases of low-value assets under IFRS 16

6.3.430 Under IFRS 16, a lessee is permitted not to apply the recognition and measurement requirements to leases of assets that are of low value when new. This exemption, unlike the short-term lease exemption, can be made on a lease-by-lease basis. The exemption permits a lessee applying IFRS 16 to account for qualifying leases in the same manner as existing operating leases. However, if an underlying asset of low value is highly dependent on, or highly interrelated with, other underlying assets, a lessee should not apply the recognition exemption to the lease of that individual asset on the basis that it is not a separate lease component. [IFRS 16.5(b), B3–B8]

6.3.440 In applying IFRS 16, a lessee will not provide the disclosures applicable to other leases (e.g. a maturity analysis of the remaining lease payments) for leases of low-value assets. However, it will disclose low-value asset lease expense (for those leases to which it applies the exemption) for each reporting period presented in the financial statements.

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6.3.450 The IASB included the low-value assets lease exemption on the basis that it would provide substantial cost relief for many lessees (and, in particular, smaller entities). The exemption is intended to apply to assets with a value of $5,000 or less when new, such as those of small IT equipment (e.g. laptops, desktops, tablets, mobile phones, individual printers) and office furniture. The exemption is not intended to capture underlying assets such as automobiles and most photocopiers. The exemption applies without regard to materiality (individually or in aggregate) of the leases to the reporting entity. This exemption could have a significant effect on certain industries – e.g. a telemarketing firm that leases a large number of phones and low-value IT equipment. In turn, this may complicate the comparison of financial statements of entities in such industries reporting under US GAAP and IFRS, given the FASB's decision not to provide a similar exemption. [IFRS 16.BC98–BC105]

6.3.460 The FASB decided against a low-value asset exemption because current guidance on materiality permits a lessee to exclude leases that are immaterial to its financial statements. The FASB observed that a lessee may be able to adopt reasonable capitalization thresholds below which lease assets and lease liabilities are not recognized, consistent with capitalization thresholds currently used by some entities in other areas of US GAAP (e.g. for capitalizing purchases of property, plant, or equipment).

6.3.470 If a lessee uses capitalization thresholds to account for its leases, it should have processes and controls in place to monitor that the capitalization thresholds used continue to result in an immaterial effect, individually and in the aggregate, on the lessee's financial statements in the current and future periods. While use of capitalization thresholds may be acceptable, we believe that the considerations about how to determine an appropriate capitalization threshold are different for leases from those that apply in determining appropriate capitalization thresholds for purchases of property, plant, or equipment. Specifically, we believe that an entity should independently evaluate the effect on the financial statements of the right-of-use assets and the lease liabilities that would not be recognized. Because non-recognition of liabilities generally has a greater quantitative and qualitative effect on the financial statements than non-recognition of assets, we believe that lease capitalization thresholds would typically need to be lower than those established for the capitalization of property, plant, and equipment.

Comparison with current US GAAP – Short-term leases

Short-term lease exemption not relevant under current GAAP

6.3.480 There is a possibility (albeit remote) that some leases that are classified as capital leases under current US GAAP may qualify for the short-term lease exemption, and therefore be derecognized as a result of the short-term lease exemption. However, the exemption is most likely to apply to current operating leases, which are not required to be recognized on-balance sheet currently.

Similar disclosure requirements

6.3.490 Current US GAAP requires lessees to disclose rental expense for all leases with a lease term of more than one month. Therefore, the requirement to disclose short-term lease cost for all such leases with a term greater than one month is not incremental to the current disclosure requirements. However, the requirement to disclose short-term lease cost each period separately from other lease costs (e.g. operating lease cost and variable lease cost) may involve some incremental effort. [840-20-50-1]

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6.4 Subsequent accounting (Step 6)

6.4.1 Finance leases

6.4.10 After lease commencement, a lessee measures the lease liability on an amortized cost basis. The lease liability is increased to reflect interest on the lease liability and decreased to reflect the lease payments made during the period. [842-20-35-1(a)]

6.4.20 Interest on the lease liability is determined each period during the lease term as the amount that results in a constant periodic discount rate on the remaining balance of the lease liability. [842-20-35-1(a)]

6.4.30 After lease commencement, a lessee measures the right-of-use asset at cost, less accumulated amortization and any accumulated impairment losses (see section 6.5). [842-20-35-1(b)]

6.4.40 A lessee amortizes the right-of-use asset on a straight-line basis, unless another systematic basis is more representative of the pattern in which the lessee expects to consume the future economic benefits of the right-of-use asset. After an impairment, amortization is generally on a straight-line basis based on the carrying amount of the right-of-use asset following the impairment. [842-20-35-7]

6.4.50 In general, amortization of the right-of-use asset is recognized over the period from the commencement date to the earlier of (1) the end of the useful life of the right-of-use asset, or (2) the end of the lease term. However, if the lease transfers ownership of the underlying asset to the lessee or the lessee is reasonably certain to exercise a purchase option to acquire the underlying asset, the lessee amortizes the right-of-use asset to the end of the underlying asset's useful life. [842-20-35-8]

6.4.60 A lessee recognizes the following amounts in the income statement each period of the lease term (unless the costs are included in the carrying amount of another asset in accordance with other US GAAP):

- amortization of the right-of-use asset;
- interest on the lease liability;
- variable lease payments in the period in which the obligation is incurred (see 6.4.70); and
- any impairment of the right-of-use-asset (see section 6.5). [842-20-25-5]

6.4.70 For variable lease payments based on the achievement of a specified target, a lessee recognizes the costs in annual periods and in interim periods before the achievement of the specified target that triggers the variable lease payments, to the extent the achievement of that target is considered probable. Variable lease costs recognized are reversed if it becomes probable that the specified target will not be met. [842-20-55-1 – 55-2]

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Example 6.7

Subsequent measurement of a finance lease

6.4.80 In Example 6.4, Lessee LE recognized a lease liability of $100,000 and a right-of-use asset of $105,000 for its lease of office space with Lessor LR. Assume that the lease is actually of a piece of equipment (rather than office space), and the following facts are changed from Example 6.4.

– Remaining economic life of equipment:	12 years
– Renewal options:	None

6.4.90 LE classifies the lease as a finance lease. This is based on the lease term test: 10/12 years equals 83% of the remaining economic life of the equipment (see 6.2.50).

6.4.100 LE expects to consume the right-of-use asset's future economic benefits evenly over the lease term. Accordingly, LE amortizes the right-of-use asset on a straight-line basis over 10 years.

6.4.110 During the lease term, LE will account for the lease liability and the right-of-use asset as follows (assuming no remeasurements, modifications, or impairments).

Year	Lease liability				ROU asset		
	Beg. balance	Interest	Pmts	End. balance	Beg. balance	Amort.	End. balance
1	$100,000	$10,000	$(14,527)	$95,473	$105,000	$(10,500)	$94,500
2	95,473	9,547	(14,963)	90,057	94,500	(10,500)	84,000
3	90,057	9,006	(15,412)	83,651	84,000	(10,500)	73,500
4	83,651	8,365	(15,874)	76,142	73,500	(10,500)	63,000
5	76,142	7,614	(16,350)	67,406	63,000	(10,500)	52,500
6	67,406	6,741	(16,841)	57,306	52,500	(10,500)	42,000
7	57,306	5,731	(17,346)	45,691	42,000	(10,500)	31,500
8	45,691	4,569	(17,866)	32,394	31,500	(10,500)	21,000
9	32,394	3,239	(18,402)	17,231	21,000	(10,500)	10,500
10	17,231	1,723	(18,954)	–	10,500	(10,500)	–

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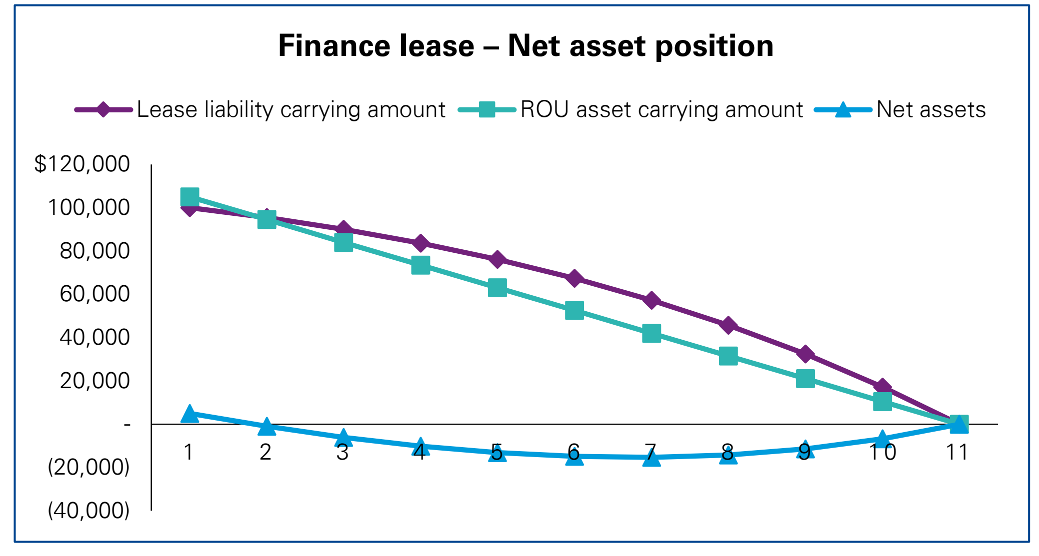
KPMG observation – Negative net asset position for most finance leases

6.4.120 The subsequent measurement guidance in Topic 842 for finance leases will generally result in a negative net asset position for the lessee (in leases with no prepaid rent) throughout the lease term other than at lease commencement and at the end of the lease term (assuming a straight-line basis of amortization for finance lease right of use assets). The finance lease amortization model results in a balance sheet impact that is generally consistent with the effect that assets entirely acquired with debt financing have on the balance sheet.

6.4.130 The following chart illustrates these effects for lessees using the fact pattern in Example 6.7.



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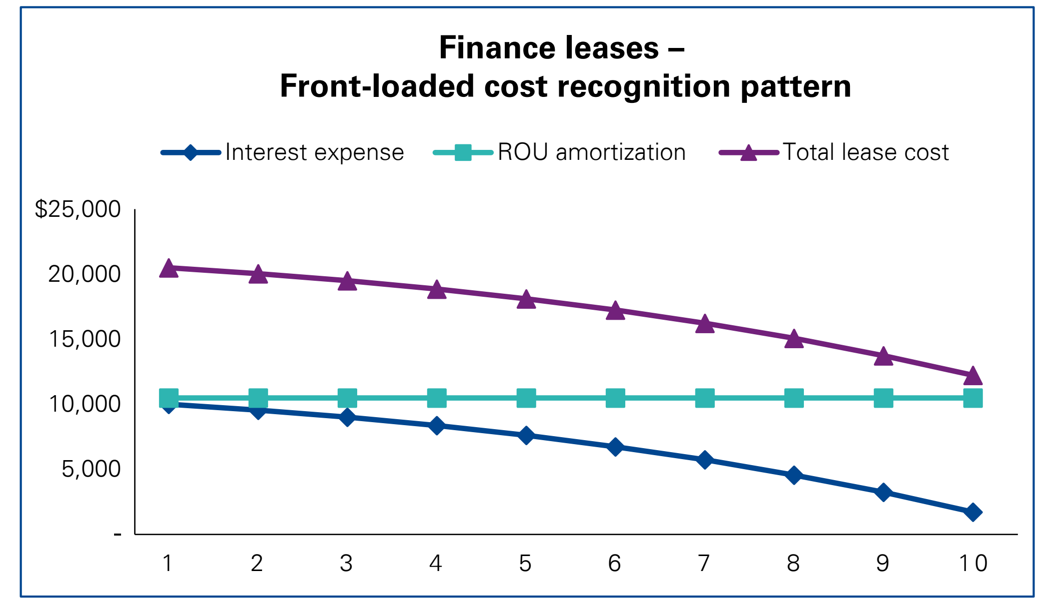
KPMG observation – Front-loaded pattern of expense recognition for finance leases

6.4.140 Because the right-of-use asset is generally amortized on a straight-line basis while interest is calculated on the lease liability using the effective interest method, finance leases will generally result in a front-loaded pattern of total expense recognition. This is illustrated in the following chart using the fact pattern in total Example 6.7.



KPMG observation – Lease cost may be capitalized as part of the cost of another asset

6.4.150 The guidance in Topic 842 refers to lease costs (for finance and operating leases) potentially being included in the carrying amount of another asset in accordance with other US GAAP. Consistent with current US GAAP, some or all of the cost of a lease may be capitalized as part of the cost of another asset (e.g. an item of property, plant, or equipment or an item of inventory). [842-10-25-5, 25-6]

6.4.160 This focus on lease cost, rather than lease expense, has been carried forward to the lessee disclosure requirements (see section 12.2) to ensure that financial statement users have a more complete picture of a lessee's leasing activity. The Board concluded that the adjustments made by many financial statement users would be based on incomplete information if the quantitative disclosures were based on amounts recognized as lease expense in the income statement rather than total lease cost.

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US GAAP different from IFRS – Subsequent measurement

6.4.170 Unlike Topic 842, after the commencement date, a lessee applying IFRS is:

- required to measure right-of-use assets that meet the definition of investment property at fair value if the lessee has an accounting policy to measure investment property at fair value; and
- permitted to apply the revaluation model to all of its right-of-use assets that relate to a class of property, plant, and equipment to which the lessee applies the revaluation model. [IFRS 16.29, 34–35]

Comparison with current US GAAP – Important differences between finance lease accounting and capital lease accounting

6.4.180 As outlined in chapters 4 and 5, there are important separation/allocation model differences (e.g. allocation of certain executory costs) and definitional differences (e.g. 'lease payments' in Topic 842 versus 'minimum lease payments' in current US GAAP) that mean that the accounting for a finance lease under Topic 842 will often differ from the accounting for a capital lease under current US GAAP.

6.4.190 In addition, while the guidance about how to amortize the right-of-use asset and accrete the lease liability in a finance lease is substantially the same as that applicable to capital leases in current US GAAP, the subsequent accounting for a finance lease will differ substantially from a capital lease in the following ways.

- Having to monitor for reassessment events; for example, a significant event requiring a reassessment of the lease term or a change in the amount probable of being owed under a residual value guarantee (see section 6.6.1).
- Having to remeasure the lease liability (and right-of-use asset) if a reassessment event occurs (see section 6.6.2).
- The accounting for modifications to a finance lease (see section 6.7).

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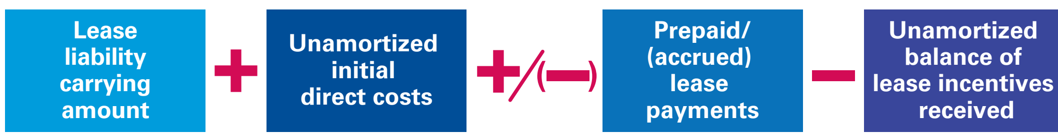
6.4.2 Operating leases

6.4.200 After lease commencement, a lessee measures the lease liability at the present value of the unpaid lease payments discounted at the discount rate for the lease established at the commencement date. An exception to this general principle occurs when the rate is updated as a result of a lease remeasurement (see section 6.6) or lease modification (see section 6.7). [842-20-35-3(a)]

6.4.210 Although Topic 842 describes the subsequent measurement of an operating lease liability differently from a finance lease liability, the carrying amount of the lease liability throughout the lease term is not affected by the classification of the lease. The carrying amount will equal the present value of the remaining, unpaid lease payments throughout the lease term.

6.4.220 After lease commencement, a lessee measures the right-of-use asset as follows, unless the right-of-use asset has been impaired (see section 6.5). [842-20-35-3(b)]



6.4.230 Alternatively, the carrying amount of an operating lease right-of-use asset can be determined using a second method, which produces the same carrying amount throughout the lease term. This alternative method also only applies if the right-of-use asset has *not* been impaired (see section 6.5).

Note 1:

The amortization of the right-of-use asset each period is calculated as the difference between the straight-line lease cost for the period (including amortization of initial direct costs) – see 6.4.250 – and the periodic accretion of the lease liability using the effective interest method.

6.4.240 Regardless of lease classification as finance or operating, the right-of-use asset is a non-monetary asset while the lease liability is a monetary liability. Therefore, for a lease denominated in a foreign currency, remeasurement into the lessee's functional currency is required using the following rates. [842-20-55-10, 830-10]

	Current exchange rate	Commencement date exchange rate
Lease liability	✔	✘
Right-of-use asset	✘	✔

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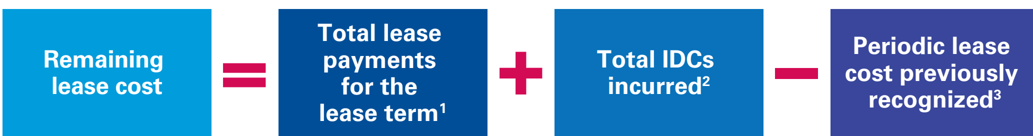
6.4.250 After the lease commencement date, a lessee recognizes the following amounts in the income statement (unless the costs are included in the carrying amount of another asset in accordance with other US GAAP).

- **A single lease cost**, calculated so that the remaining cost of the lease is allocated over the remaining lease term on a straight-line basis (if another systematic and rational basis is not more representative of the benefit expected to be derived from the right to use the underlying asset), unless the right-of-use asset has been impaired (see section 6.5).



Notes:

1. Paid and unpaid, reflecting any adjustments resulting from a remeasurement (see section 6.6) or a modification (see section 6.7).
2. Those attributable to that lease.
3. The total amount of lease cost recognized (including capitalized as part of the cost of another asset) for the lease in prior periods.

- **Variable lease payments** in the period in which the obligation is incurred, or achievement of the target that triggers the variable payments becomes probable (see 6.4.260).
- Any **impairment** of the right-of-use-asset (see section 6.5). [842-20-25-6, 25-8]

6.4.260 For variable lease payments based on the achievement of a specified target, a lessee recognizes the costs in annual periods and in interim periods before the achievement of the specified target that triggers the variable lease payments, to the extent the achievement of that target is considered probable. Variable lease costs recognized are reversed if it is probable that the specified target will not be met. This means that the cumulative amount recognized at any point in time will be the amount of variable lease payments either paid or probable of being paid. [842-20-55-1 – 55-2]

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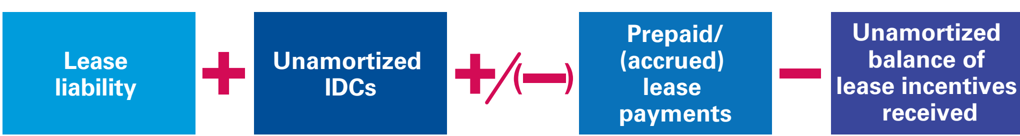
KPMG observation – Choice of subsequent measurement methods for operating lease right-of-use assets

6.4.270 As discussed in 6.4.220–230 and illustrated in Example 6.8, the subsequent measurement of the right-of-use asset in an operating lease can be determined in either of two ways, which yield the same carrying amount. An exception arises if the right-of-use asset is impaired (see section 6.5).

Method 1: Derive the right-of-use asset from the lease liability

6.4.280 The carrying amount of the ROU asset is derived from the carrying amount of the lease liability at the end of each reporting period as illustrated below. [842-20-35-3]



6.4.290 Method 1 is what a lessee would use if it does not want to recognize right-of-use assets and lease liabilities for operating leases until it closes its books during the financial reporting process; sometimes referred to as a 'display approach'. Under this method, at each reporting date, the lessee creates a journal entry to (1) credit a lease liability for the present value of the remaining unpaid lease payments, (2) reverse other accrual-based operating lease accounting balances reflected in the balance sheet (i.e. prepaid or accrued rent, unamortized initial direct costs, and unamortized lease incentives), and (3) debit a right-of-use asset for the balancing amount.

Method 2: Amortize the right-of-use asset

Note 1:

The amortization of the right-of-use asset each period is calculated as the difference between the straight-line lease cost for the period (including amortization of initial direct costs) – see 6.4.250 – and the periodic accretion of the lease liability using the effective interest method.

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Method 1 or Method 2?

6.4.300 Method 1 is the only method described in Topic 842. The basis for conclusions indicates that this method will permit many entities to perform the new accounting for operating leases without significant changes to systems or processes. However, we believe that Method 1 will generally not be practicable to apply for entities other than those with a smaller volume of leases that are relatively straightforward. Method 1 is inherently a manual process that likely will be unwieldy when applied to a large portfolio of leases, especially in the context of the more complex circumstances that will arise under the guidance in Topic 842 (e.g. modifications, remeasurements, impairments, and foreign currency translation adjustments).

6.4.310 We believe that Method 2 will more readily enable a lessee to implement systems, processes, and internal controls where lease liabilities and right-of-use assets are tracked separately in a manner more consistent with other assets and liabilities. It is more likely to be effective for addressing the more complex circumstances outlined above that are likely to arise for many lessees. For leases denominated in a foreign currency, where different exchange rate requirements apply to the lease liability and the right-of-use asset, maintaining and amortizing the right-of-use asset (Method 2) may be significantly easier than attempting to establish the carrying amount of the right-of-use asset anew at each reporting date (Method 1).

Example 6.8

Subsequent accounting for an operating lease – Assuming no impairments, remeasurements, or lease modifications

Scenario 1: Subsequent measurement using method described in Topic 842

6.4.320 In Example 6.4, Lessee LE recognized a lease liability of $100,000 and a right-of-use asset of $105,000 for its lease of office space with Lessor LR.

6.4.330 The following facts in addition to those in Example 6.4 are relevant.

– Remaining economic life of office space:	35 years
– Fair value of office space:	$400,000

6.4.340 LE classifies the lease as an operating lease, because none of the tests for classification as a finance lease are met (see 6.2.50). There are no impairments (see section 6.5), no remeasurements (see section 6.6) or modifications (see section 6.7) during the lease term.

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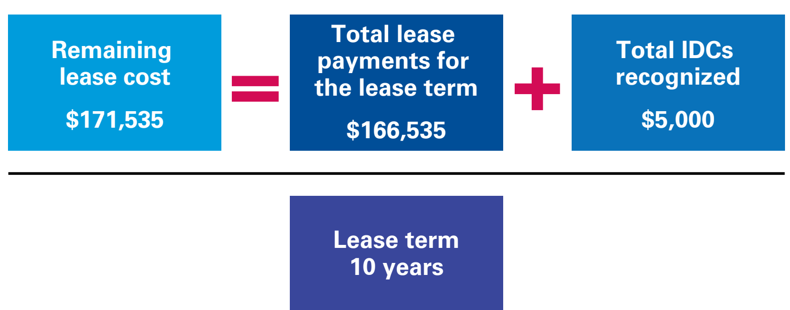
6.4.350 LE recognizes a single lease cost of $17,154 each year of the 10-year lease, which is calculated as follows.



6.4.360 Whether a lease is classified as an operating or a finance lease, the carrying amount of the lease liability is the same throughout the lease term. Therefore, the carrying amount of the lease liability in this example is the same throughout the lease term as it is in Example 6.7, which at all times equals the present value of the unpaid lease payments (discounted at 10%, which is the discount rate for the lease determined at lease commencement in Example 6.4).

6.4.370 Following the subsequent measurement method described (and illustrated) in Topic 842, LE subsequently accounts for the operating lease right-of-use asset as follows.

Year	Lease liab. carry. amt.	Unamort. IDCs[1]	Prepaid (accrued) lease pmts[2]	ROU asset carry. amt.
1	$95,473	$4,500	$(2,127)	$97,846
2	90,057	4,000	(3,818)	90,239
3	83,651	3,500	(5,060)	82,091
4	76,142	3,000	(5,840)	73,302
5	67,406	2,500	(6,144)	63,762
6	57,306	2,000	(5,956)	53,350
7	45,691	1,500	(5,263)	41,928
8	32,394	1,000	(4,050)	29,344
9	17,231	500	(2,301)	15,430
10	–	–	–	–

Notes:

1. Initial direct costs are amortized on a straight-line basis over the 10-year lease term.
2. Represents the cumulative difference between the annual straight-line lease cost (excluding initial direct costs) of $16,654 and the amount of the lease payments.

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Scenario 2: Alternative subsequent measurement method

6.4.380 As described in paragraph 6.4.230, the carrying amount of the right-of-use asset can be determined using a second method, which produces the same carrying amount as the method used in Scenario 1 throughout the lease term.

Note 1:

The amortization of the right-of-use asset each period is calculated as the difference between the straight-line lease cost for the period (including initial direct costs) and the periodic accretion of the lease liability using the effective interest method.

6.4.390 LE calculates the annual single lease cost for the 10-year lease term of $17,154 in the same manner as illustrated above in Scenario 1.

6.4.400 However, the amortization of the right-of-use asset, and carrying amount of the right-of-use asset at the end of each period, are determined as follows.

	ROU asset amortization			ROU asset carrying amount		
Year	Straight-line lease cost	Lease liab. accret.	ROU asset amort.	Beg. balance	ROU asset amort.	End. balance
1	$17,154	$(10,000)	$ 7,154	$105,000	$ (7,154)	$97,846
2	17,154	(9,547)	7,607	97,846	(7,607)	90,239
3	17,154	(9,006)	8,148	90,239	(8,148)	82,091
4	17,154	(8,365)	8,789	82,091	(8,789)	73,302
5	17,154	(7,614)	9,540	73,302	(9,540)	63,762
6	17,153	(6,741)	10,412	63,762	(10,412)	53,350
7	17,153	(5,731)	11,422	53,350	(11,422)	41,928
8	17,153	(4,569)	12,584	41,928	(12,584)	29,344
9	17,153	(3,239)	13,914	29,344	(13,914)	15,430
10	17,153	(1,723)	15,430	15,430	(15,430)	–

6.4.410 As illustrated in this example, the ending balance of the right-of-use asset is the same throughout the lease term for the two scenarios. In addition, the single lease cost recognized by LE each period of the lease and the carrying amount of the lease liability at the end of each period of the lease is unaffected by which subsequent measurement method LE chooses for the right-of-use asset.

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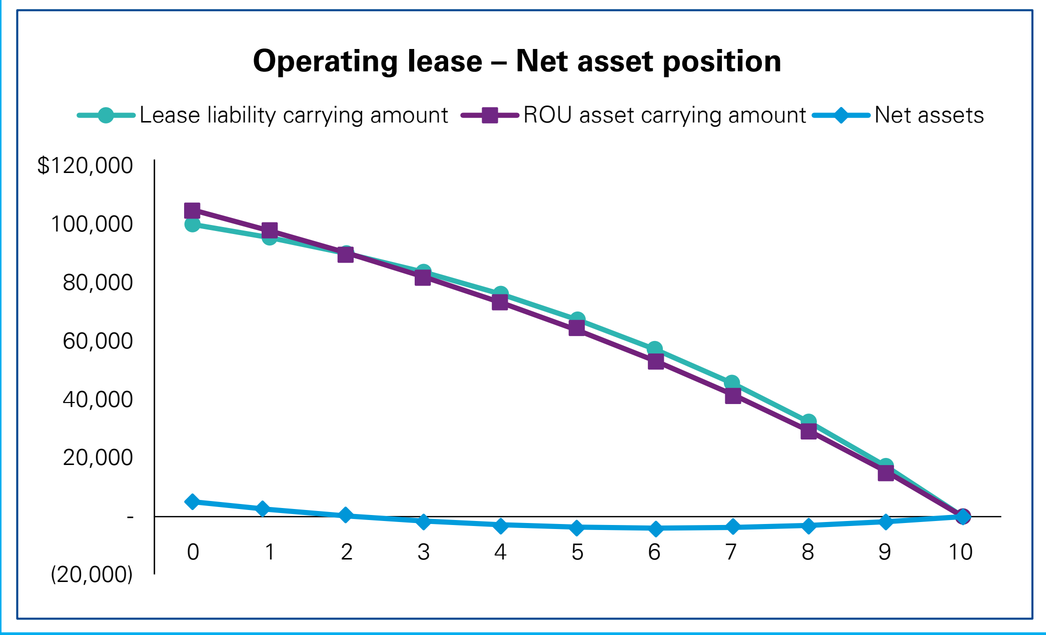
KPMG observation – Operating lease right-of-use assets likely to track more closely to lease liability

6.4.420 The carrying amount of an operating lease right-of-use asset is likely to track more closely to the carrying amount of the lease liability throughout the lease term than a finance lease right-of-use asset. As noted in the KPMG observation at 6.4.120–130, a finance lease right-of-use asset will generally result in a negative net asset position for a particular lease. The balance sheet impact between an operating lease and a finance lease may be an important consideration relating to the impact on balance sheet ratios based on assets and liabilities.

6.4.430 The following chart illustrates how the right-of-use asset tracks with the lease liability for Example 6.8.



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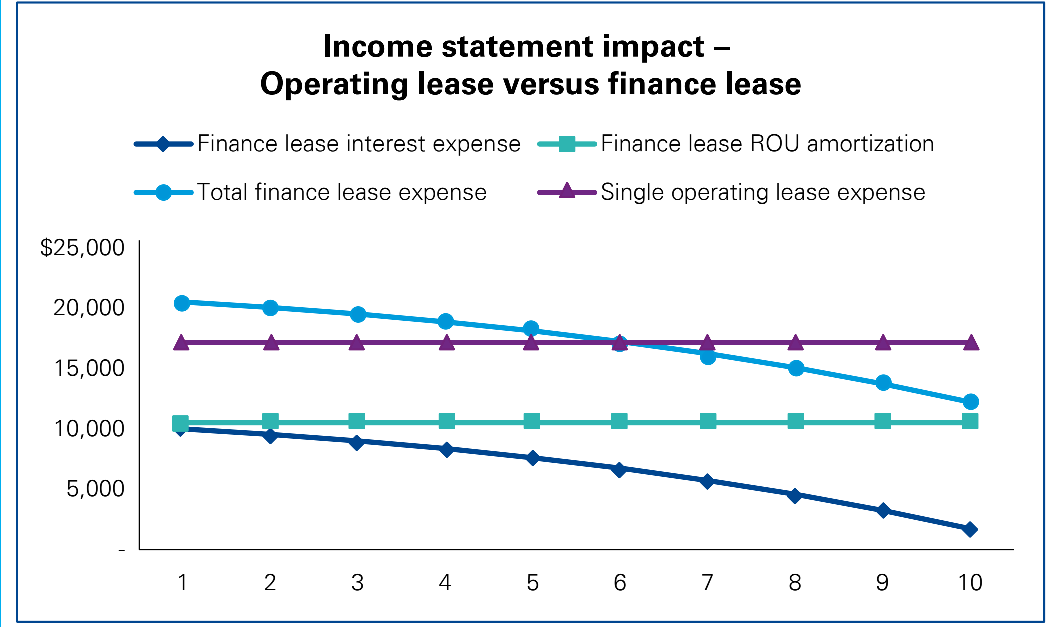
KPMG observation – Operating lease and finance expense recognition patterns differ

6.4.440 The following chart depicts the differences in lease expense recognition patterns between a finance lease and an operating lease under Topic 842 using the fact pattern in Examples 6.7 and 6.8. The difference in expense recognition pattern may be less dramatic in a portfolio of leases; for example, for a lessee with a large revolving portfolio of leases that have varying maturities.



US GAAP different from IFRS – Single model under IFRS

6.4.450 There is no equivalent IFRS 16 guidance to that included in this section, because all leases that are recognized on the balance sheet under IFRS 16 are accounted for in a manner similar to finance leases under Topic 842.

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6.5 Impairment testing (Step 7)

6.5.10 A lessee uses the long-lived assets impairment guidance (Topic 360) to determine whether a right-of-use asset is impaired, and if so, the amount of the impairment loss to recognize. The impairment loss related to a right-of-use asset is presented in the same manner in the income statement as an impairment loss recognized for any other long-lived asset. [842-20-35-9]

6.5.20 After the impairment of a right-of-use asset, the asset is measured at its carrying amount immediately after the impairment less any accumulated amortization subsequent to the impairment. *Regardless of the lease classification*, a lessee amortizes the right-of-use asset after impairment on a straight-line basis (unless another systematic basis is more representative of the pattern in which the lessee expects to consume the future economic benefits) from the date of impairment to the earlier of the end of the right-of-use asset's useful life or the end of the lease term. [842-20-35-10]

6.5.30 If an operating lease right-of-use asset has been impaired, for each period from the date of impairment through the end of the lease term, the *single lease cost* for the operating lease (which is still presented in a single income statement line item as before the impairment) is calculated as the sum of the following. [842-20-25-7]

Note 1:

Determined for each remaining period during the lease term as the amount that produces a constant periodic discount rate on the remaining balance of the liability – i.e. the effective interest method.

6.5.40 Topic 842 characterizes operating lease liabilities as operating liabilities, rather than as debt. [ASU 2016-02.BC14(c)]

KPMG observation – Long-lived assets impairment model for right-of-use asset impairment

6.5.50 The Board concluded that a lessee should not continue to recognize a right-of-use asset from which it does not expect to obtain future economic benefits or to measure that asset at an inflated amount above what the lessee expects to recover. The Topic 360 impairment model is the appropriate one to apply to right-of-use assets because the right-of-use asset in a finance lease or an operating lease is a long-lived, nonfinancial asset. [ASU 2016-02.BC255]

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KPMG observation – Including lease liabilities in the carrying amount of the asset group

6.5.60 The recoverability test for a held-and-used asset group excludes (1) financial and nonoperating liabilities from the carrying amount of the asset group, and (2) the cash flows attributable to the financial and nonoperating liabilities in determining the undiscounted future expected cash flows of the asset group (e.g. both interest and principal components of the financial and nonoperating liabilities should be excluded). However, consistent with Example 1 to Topic 360, an entity should include operating liabilities (e.g. accrued liabilities and accounts payable) in the carrying amount and the cash flows used in the recoverability test. Any terminal value of the asset group included in the recoverability test should reflect the value inclusive of normal operating working capital assets and liabilities and not how the asset group is financed (e.g. through debt or equity). [ASU 2016-02.BC14, 360-10-55-20 – 55-22]

6.5.70 We believe that the conclusion as to whether a lease liability should be included in the carrying amount of the asset group to which the right-of-use asset relates depends on the classification of the lease or its qualification as a short-term lease.

Finance leases

6.5.80 For finance leases, we believe that the lease liability should be *excluded* in determining the carrying amount of the asset group, and the interest and principal components of the lease liability *excluded* in determining the undiscounted future expected cash flows of the asset group in the recoverability test.

6.5.90 This is consistent with the accounting related to capital leases under current US GAAP; capital lease obligations are not included in the carrying amount of the asset group that includes the related capital lease assets. Capital lease obligations are a financial liability that is equivalent to debt and the impairment guidance in Topic 360 has long been premised on the view that debt, as simply a form of capitalization other than equity, should not be included in the asset group.

Operating leases

6.5.100 For operating leases, we believe that either of the following approaches could be consistent with US GAAP, although Approach A appears more consistent with how similar financial, but also operating, obligations (e.g. asset retirement obligations) are considered in the long-lived asset impairment guidance. However, as demonstrated in Example 6.9, we believe that entities should not come to different impairment conclusions regardless of the approach taken.

Approach A

6.5.110 *Exclude* the carrying amount of the lease liability in determining the carrying amount of the asset group, and therefore also *exclude* the operating lease payments in determining the undiscounted future expected cash flows of the asset group.

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6.5.120 An operating lease liability is a financial liability even though the Board decided it should be characterized as an operating liability for presentation purposes. We have observed that, in discussions about operating lease liabilities and their characterization as operating liabilities for presentation purposes, the Board frequently compared those lease liabilities to other discounted, financial liabilities that are not characterized as debt, including those related to asset retirement obligations (AROs).

6.5.130 An analogy to AROs would suggest that Approach A is appropriate because, in accordance with Topic 360, the carrying amount of an ARO is *excluded* from the carrying amount of the asset group to which it relates, as are the estimated cash flows related to the liability. In addition, the introduction to ASU 2016-02 acknowledges leasing as a form of financing. Because the impairment guidance in Topic 360 is *not* intended to create different impairment results solely based on how an entity capitalizes (or finances its operations), this further supports our belief that Approach A is an acceptable application of the impairment guidance in Topic 360. [360-10-35-18]

Approach B

6.5.140 *Include* the carrying amount of the lease liability in determining the carrying amount of the asset group, and *include* the operating lease payments (net of the portion that relates to accretion of the operating lease liability) in determining the undiscounted future expected cash flows of the asset group.

6.5.150 The Board explicitly stated that operating lease liabilities are operating in nature. Therefore, consistent with the view that an entity should include operating liabilities (e.g. accrued liabilities and accounts payable) in the carrying amount of the asset group and in the undiscounted cash flows of the asset group, we believe that Approach B is an acceptable application of the impairment guidance in Topic 360.

Short-term lease payments

6.5.160 If a short-term lease is not recognized on the balance sheet (see section 6.3.1), the short-term lease payments should be *included* in determining the undiscounted future expected cash flows of the asset group to which the lease relates.

Variable lease payments

6.5.170 For finance and operating leases (and short-term leases recognized on the balance sheet), *include* variable lease payments in determining the undiscounted future expected cash flows of the asset group.

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Example 6.9

Recoverability test for a held-and-used asset group that includes a right-of-use asset

6.5.180 This example is a continuation of Examples 6.4 and 6.8, in which Lessee LE leases office space from Lessor LR for 10 years.

6.5.190 LE tests one of its asset groups for impairment because of a triggering event. The asset group being tested includes the right-of-use asset related to the office space that LE leases from LR. The impairment test coincides with the end of Year 2 of LE's lease.

6.5.200 The following additional facts are relevant.

– Carrying amount of asset group:	$770,000 (includes the right-of-use asset but not the operating lease liability)
– Undiscounted future expected cash flows:	$100,000 annually (before considering the lease payments associated with the lease)
– Period over which recoverability test performed (for illustrative purposes):	8 years
– Terminal value at the end of Year 8:	Nil

6.5.210 As outlined in the KPMG observation at 6.5.100, we believe that it may be reasonable for an entity to apply either one of the following two approaches (A or B) as to inclusion of the operating lease liability in the asset group that includes the operating lease right-of-use asset.

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Scenario 1: Approach A – Do not include operating lease liability in the asset group

6.5.220 LE *excludes* the operating lease liability in determining the carrying amount of the asset group, and *excludes* the cash outflows from the lease payments in determining the undiscounted future expected cash flows of the asset group. Accordingly, LE's recoverability test is as follows.

	Yr 1	Yr 2	Yr 3	Yr 4	Yr 5	Yr 6	Yr 7	Yr 8	Total
Undiscounted future expected cash flows before lease pmts.	$100,000	$100,000	$100,000	$100,000	$100,000	$100,000	$100,000	$100,000	$800,000
Effect of lease pmts.	–	–	–	–	–	–	–	–	–
Total	$100,000	$100,000	$100,000	$100,000	$100,000	$100,000	$100,000	$100,000	$800,000

Carry. amt. of asset group, excl. operating lease liab.	$770,000	
Less carry. amt. of operating lease liab.	N/A	
Carry. amt. of asset group	770,000	
Total undiscounted future expected cash flows	800,000	
Excess	**$ 30,000**	**Asset group does not fail the recoverability test**

Scenario 2: Approach B – Include operating lease liability in the asset group

6.5.230 LE *includes* the lease liability in determining the carrying amount of the asset group, and *includes* the operating lease payments (net of the portion that relates to accretion of the operating lease liability) in determining the undiscounted future expected cash flows of the asset group. Accordingly, LE's recoverability test is as follows, the result of which is the same as under Approach A.

	Yr 1	Yr 2	Yr 3	Yr 4	Yr 5	Yr 6	Yr 7	Yr 8	Total
Undiscounted future expected cash flows before lease pmts.	$100,000	$100,000	$100,000	$100,000	$100,000	$100,000	$100,000	$100,000	$800,000
Effect of lease pmts.	(15,412)	(15,874)	(16,350)	(16,841)	(17,346)	(17,866)	(18,402)	(18,954)	(137,045)
Add back portion related to lease liab. accret.	9,006	8,365	7,614	6,741	5,731	4,569	3,239	1,723	46,988
Total	$ 93,594	$ 92,491	$ 91,264	$ 89,900	$ 88,385	$ 86,703	$ 84,837	$ 82,769	$709,943

Carry. amt. of asset group, excl. operating lease liab.	$770,000	
Less carry. amt. of operating lease liab.	(90,057)	
Carry. amt. of asset group	679,943	
Total undiscounted future expected cash flows	709,943	
Excess	**$ 30,000**	**Asset group does not fail the recoverability test**

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Example 6.10

Operating lease accounting before and after impairment

6.5.240 Assume that instead of passing the recoverability test in Example 6.9, the asset group is impaired and the amount of the impairment allocated to the right-of-use asset is $10,000. The following table illustrates the accounting for the right-of-use asset before and after impairment.

	ROU asset carrying amount				Lease liability	Income statement[2]		
Year	Beg. balance	ROU asset amort.	Impair. charge	End. balance	Carry. amt. (end. balance)[1]	Accret.	ROU asset amort.	Single lease cost
1	$105,000	$ (7,154)		$97,846	$95,473	$10,000	$ 7,154	$ 17,154
2	97,846	(7,607)	$(10,000)	80,239	90,057	9,547	7,607	17,154
3	80,239	(10,030)		70,209	83,651	9,006	10,030	19,036
4	70,209	(10,030)		60,179	76,142	8,365	10,030	18,395
5	60,179	(10,030)		50,149	67,406	7,614	10,030	17,644
6	50,149	(10,030)		40,119	57,306	6,741	10,030	16,771
7	40,119	(10,030)		30,089	45,691	5,731	10,030	15,761
8	30,089	(10,030)		20,059	32,394	4,569	10,030	14,599
9	20,059	(10,030)		10,029	17,231	3,239	10,030	13,269
10	10,029	(10,029)		–	–	1,723	10,029	11,752

Lease expense recognized during the lease term:	161,535
Impairment of ROU asset recognized in Year 2:	10,000
Total lease cost	$171,535

Notes:

1. The lease liability carrying amount at the end of each year is unaffected by the impairment of the right-of-use asset – i.e. it is the same as in Example 6.8 where the right-of-use asset is not impaired.
2. The accretion of the lease liability and the right-of-use asset amortization are shown separately for illustrative purposes only. For an operating lease, a lessee presents a single lease expense in the income statement, whether or not the right-of-use asset is impaired (and will not calculate these amounts separately before an impairment if the lessee applies Method 1 in subsequently measuring the right-of-use asset). However, the impairment loss allocated to the right-of-use asset will be presented in the same manner in the income statement as the remainder of the impairment loss allocated to other assets in the asset group.

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6.5.250 As illustrated in 6.5.240:

- The amortization of the right-of-use asset is determined as follows.
  - **Before impairment**. Amortization equals the difference between the straight-line lease cost for the period ($17,154) and the periodic accretion of the lease liability using the effective interest method. LE uses Method 2 for the subsequent measurement of its operating lease right-of-use asset (see KPMG observation at 6.4.270–310).
  - **After impairment**. Like a finance lease, it is amortized on a straight-line basis over the remaining lease term (right-of-use asset carrying amount post-impairment of $80,239 ÷ 8 remaining annual periods).
- The single lease cost is determined as follows.
  - **Before impairment**. So that the remaining cost of the lease is allocated over the remaining lease term on a straight-line basis (total lease cost at lease commencement of $171,535 ÷ 10 annual periods).
  - **After impairment**. Front-loaded pattern of lease cost recognition due to the accretion of the lease liability, and amortization of the right-of-use asset, which is now on a straight-line basis over the remaining lease term (rather than as a balancing amount that increases each period throughout the lease term).

KPMG observation – Proportional allocation of impairment losses to an asset group

6.5.260 An impairment loss of an asset group generally is allocated on a pro rata basis to all of the long-lived assets in the group on a relative carrying amount basis. However, no portion of the impairment loss is allocated to an individual long-lived asset within the asset group if doing so would reduce the carrying amount of that asset below its fair value *and* that fair value is determinable without undue cost or effort. [360-10-35-28]

6.5.270 Based on these requirements, right-of-use assets will often be written down because of an allocated impairment loss, rather than because of an event or occurrence specific to that right-of-use asset. When an asset group includes multiple operating lease right-of-use assets, all of those right-of-use assets will generally receive an allocation of the impairment loss; therefore, all of those leases will be subject to the post-impairment operating lease accounting model illustrated in Example 6.10.

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KPMG observation – Operating lease cost post-impairment similar to current US GAAP

6.5.280 The front-loaded single lease cost recognition pattern post-impairment for an operating lease under Topic 842 has some similarities with the lease cost recognition that results for an operating lease under current US GAAP after the recognition of a termination cost liability under Topic 420 (exit or disposal cost obligations). [ASU 2016-02.BC257–BC259]

6.5.290 Under Topic 842, the post-impairment single lease cost for the remainder of the lease term will be front-loaded – i.e. the combination of the straight-line amortization of the remaining right-of-use asset and the accretion of the remaining lease liability. Similarly, under current US GAAP, the remaining lease cost after recognition of a Topic 420 liability is front-loaded – i.e. the combination of the generally straight-line remaining lease expense, if any, and accretion of the contract termination liability. [ASU 2016-02.BC258]

6.5.300 In some cases, the net effect of those leases on the balance sheet under Topic 842 and current US GAAP will be similar. The generally net liability position of the lease under Topic 842 (i.e. carrying amount of the right-of-use asset less the carrying amount of the lease liability) may not differ substantially from the balance of the Topic 420 liability that would be recognized under current US GAAP.

US GAAP different from IFRS – Impairment of right-of-use assets

Guidance specific to the impairment of an operating lease right-of-use asset

6.5.310 IFRS 16 does not have any guidance about the impairment of operating lease right-of-use assets because IFRS 16 does not have a lease classification test for lessees. All leases that are recognized on the balance sheet (i.e. all leases other than short-term leases or leases of low-value assets) are accounted for in a manner substantially consistent with finance lease accounting for lessees under Topic 842.

Existing US GAAP/IFRS differences in assessing and accounting for impairment of long-lived assets

6.5.320 There are existing differences between the long-lived assets impairment guidance in US GAAP and the equivalent guidance in IFRS. None of those differences were affected by the issuance of ASU 2016-02 and IFRS 16, respectively. Therefore, there will be differences in how lessees assess and account for impairments of right-of-use assets between US GAAP and IFRS.

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Comparison with current US GAAP – Impairment testing

6.5.330 Under current US GAAP, consistent with the requirements in Topic 842 applicable to finance lease right-of-use assets, capital lease assets are assessed for impairment in accordance with the long-lived assets impairment guidance in Topic 360. However, finance lease assets may frequently have different carrying amounts than their capital lease asset counterparts. For example:

- A finance lease right-of-use asset may have a *lower* carrying amount because it includes only amounts probable of being owed under a residual value guarantee rather than the full amount of the guarantee.
- A finance lease right-of-use asset may have a *greater* carrying amount because it may include amounts related to certain executory costs (e.g. payment of the lessor's costs for property taxes or insurance) that are excluded from a capital lease asset. [840-30-35]

6.5.340 The differences in carrying amounts will affect the carrying amount of the asset group, and therefore could affect the results of the impairment analysis.

6.5.350 There are no operating lease right-of-use assets under current US GAAP; therefore, assessing such assets for impairment is a new concept resulting from the issuance of Topic 842.

6.5.360 Charges are recognized for operating leases under current US GAAP based on the contract termination and other associated costs guidance in Topic 420. That guidance differs substantially from how operating lease right-of-use assets will be assessed for impairment under the long-lived assets impairment guidance. Charges recognized in accordance with Topic 420 are generally only recognized at the earlier of:

- when the lessee formally terminates the lease agreement – i.e. a contractual commitment is made through formal notice of intent to exercise a termination option or agreement is reached mutually with the lessor – the termination charge is measured at fair value; or [420-10-25-12]
- when the lessee ceases use of the underlying asset (e.g. when the lessee vacates the building) – the charge (and related liability) represents costs that will be incurred without economic benefit to the lessee, and is measured at fair value. [420-10-25-13]

6.5.370 In addition to the differences above, another important difference is that a lessee recognizes charges in accordance with Topic 420 on a specific lease basis – i.e. a charge relates to a specific lease only. Under the long-lived assets impairment guidance, if a right-of-use asset is part of a larger asset group, it may receive an *allocated* impairment charge – i.e. an allocation of a larger impairment charge taken on all, or substantially all, of the asset in the asset group – even if there is no specific indication that the right-of-use asset was impaired.

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6.6 Lease reassessments (Step 8A)

6.6.10 A lease reassessment or modification (that is not accounted for as a separate contract) will often result in the remeasurement of the lease liability and the right-of-use asset. The following diagram provides an overview of the reassessment and modification requirements applicable to lessees, which are explained in this section (reassessments) and in section 6.7 (modifications). [842-10-35-4]

	Remeasurement of the lease liability and the right-of-use asset occurs when:				
	Lease modification not accounted for as a separate contract (section 6.7)	Change in lease term	Change in assessment of lessee purchase option being exercised	Change in amount probable of being owed by lessee under residual value guarantee	Variable lease payments become lease payments following resolution of contingency
When do I reassess?	N/A	Only when there is a triggering event (as defined)		Whenever relevant facts and circumstances change	
In remeasuring, what do I update:					
Lease payments?[1]	✔	✔	✔	✔	✔
Consideration in the contract?	✔	✔	✔	✔	✔
Allocation of consideration in the contract?	✔	✔	✔	✔	✔
Discount rate?	✔	✔	✔	✘	✘
Lease classification?	✔	✔	✔	✘	✘

Note 1:

This includes updating variable lease payments that depend on an index or rate using the index or rate as of the remeasurement date.

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6.6.1 When to reassess

6.6.20 The discussion that follows is based on the diagram in 6.6.10, and deals with lease reassessments. Lease modifications are discussed in section 6.7.

Reassessment of the lease term or a lessee purchase option

6.6.30 The lease term and the likelihood of a lessee exercising a purchase option are only reassessed when one of the following occurs.

- An event written into the contract obliges the lessee to exercise (or not exercise) an option.
- The lessee elects to exercise an option that it had previously determined that it was not reasonably certain to exercise.
- The lessee elects not to exercise an option that it had previously determined that it was reasonably certain to exercise.
- A 'triggering event'. [842-10-35-1, ASU 2016-02.BC232]

6.6.40 A triggering event is a significant event or significant change in circumstances that both:

- is within the lessee's control; and
- directly affects the assessment of whether the lessee is reasonably certain to exercise an option. [842-10-35-1, ASU 2016-02.BC232]

6.6.50 The following are examples of triggering events. [842-10-55-28, ASU 2016-02.BC232]

Constructing significant leasehold improvements[1]	Subleasing the asset for a period beyond the end of the lease term[2]
Significantly modifying or customizing the asset	Making a business decision directly relevant to option exercise[3]

Notes:

1. The lessee constructs leasehold improvements that are expected to have significant economic value beyond the end of the previously assessed lease term. For example, assume that in Year 6 of the 10-year office space lease in Example 6.4, the lessee constructs leasehold improvements that will have significant economic value for 10 years. The construction of those leasehold improvements might make it reasonably certain that the lessee will extend the lease to obtain the remaining economic benefits from those leasehold improvements.
2. For example, subleasing an asset for which the lease term was initially assessed as 15 years (15-year non-cancellable period with two 5-year renewal options), to a sublessee for a non-cancellable period of 25 years or subleasing it for the remainder of the head lease term with renewal options that the sublessee is reasonably certain to exercise. In those cases, fulfilling the sublease makes it reasonably certain that the entity will exercise its renewal options on the head lease.
3. For example, extending the lease of a complementary asset or disposing of an alternative asset.

6.6.60 Changes in *market-based* factors (e.g. changes in the real estate market) do not, in isolation, trigger the reassessment of a lessee option – i.e. to extend or terminate the lease or purchase the underlying asset – because they are generally not within the lessee's control. [842-10-55-29, ASU 2016-02.BC232]

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Resolution of a contingency

6.6.70 The resolution of a contingency on which some or all variable lease payments to be paid over the remainder of the lease are based may be resolved, and result in those payments prospectively meeting the definition of lease payments. For example, if the payments for Years 2-10 of a retail store lease will be based on 10 percent of Year 1 retail store sales, at the end of Year 1 the lease payments for Years 2-10 become fixed payments. In this scenario, a remeasurement of the lease payments is required. [842-10-35-4(b), ASU 2016-02.BC238]

Example 6.11
Is reassessment required?

6.6.80 Lessee LE leases a building, to be used as a retail store, from Lessor LR for a non-cancellable period of five years. The following facts are relevant at the lease commencement date.

– Renewal options:	Two options for 5 years each (at market rentals)
– Purchase option:	$250,000 (estimated fair value) at the end of Year 5, increasing by 1% a year if LE exercises one or both of the renewal options
– Transfer of ownership:	No

6.6.90 At lease commencement, LE concludes that it is not reasonably certain to exercise either of the five-year renewal options or the purchase option. Therefore, the lease term at commencement is five years.

Scenario 1: Change in market value of underlying asset

6.6.100 In addition to the basic facts for this example, assume that at the end of Year 2 of the five-year lease term, the city announces a major renovation of the downtown neighborhood in which the building is located. The renovation is expected to significantly increase both (1) the fair value of the building, and (2) consumer traffic in the area.

6.6.110 As a result, the exercise price of the purchase option is expected to be significantly lower than the fair value of the building, and the rental payments during the two renewal periods are expected to be at a bargain compared to market rentals. The increased consumer traffic is also expected to substantially affect the revenues that will be generated by the retail store once the renovation is completed.

6.6.120 In this scenario, LE does not reassess either the lease term (i.e. consider whether it is now reasonably certain to exercise one or both of the renewal options) or the purchase option. This is because the significant event and significant change in circumstances related to the building were not within the control of LE. The city, not LE, undertook the action that is significantly changing the circumstances surrounding this lease. In addition, market-based factors (e.g. a change in the real estate market) not within the control of the lessee do not, in isolation, trigger a reassessment of a lessee option.

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Scenario 2: Change in business climate

6.6.130 In addition to the basic facts for this example, assume the following.

- LE is operating a retail store that is unproven in the marketplace where the leased building is located (e.g. it has not been tested in this part of the country).
- By the end of Year 3 of the lease term, the store is far exceeding initial expectations and has developed a devoted customer base in the neighborhood for a variety of reasons that were validly not anticipated at lease commencement. It is not expected that LE could relocate to another location within the city and replicate its results at the present location. Therefore, LE concludes that it is reasonably certain to exercise at least the first five-year renewal option.

6.6.140 Despite the fact that LE now views itself as reasonably certain to exercise the first five-year renewal option, unless LE actually exercises that renewal at the end of Year 3, LE does not reassess the lease term based on the facts presented. The success of the retail store is not a significant event or significant change in circumstances undertaken by LE – LE is merely operating the retail store in this new location successfully.

Scenario 3: Business decision that affects lessee's economic reasons to exercise (or not to exercise) an option

6.6.150 In addition to the basic facts for this example, assume the following.

- LE has been fulfilling all of its online sales orders from this retail location and one other retail location. None of its other retail locations engage in online fulfillment or are equipped, without significant expense, to do so.
- At the end of Year 4 of the lease term, LE terminates its lease of the other retail location engaged in online fulfillment activities and vacates that building. Between the end of Year 4 and the end of the lease term for this retail store, LE will be unable to relocate and recreate its fulfillment activities absent significant cost (either to move to an outsourcing model or pay a premium to acquire the proper space needed and have it customized).

6.6.160 The decision to terminate the lease of the other retail location was within the control of LE and affects LE's economic reasons to exercise (or not exercise) the renewal options related to the building lease in this example. Therefore, LE reassesses the lease term of the building lease in this example.

6.6.170 Upon reassessment, as a result of making the business decision to terminate the lease of the other location, based on the facts presented, LE concludes that it is now (at the end of Year 4) reasonably certain to exercise the first five-year renewal option. LE will remeasure the lease payments based on a revised remaining lease term of six years from the reassessment date.

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KPMG observation – Reassessment of a lessee option will not always result in remeasurement

6.6.180 A reassessment will result in a remeasurement of the lease payments when the event leading to the reassessment is one of the following.

- An event written into the contract obliges the lessee to exercise (or not to exercise) an option.
- The lessee elects to exercise an option even though it had previously determined that it was not reasonably certain to do so.
- The lessee elects not to exercise an option even though it had previously determined that it was reasonably certain to do so. [842-10-35-1]

6.6.190 In each of those cases, the event *will* change the lease term or the reasonably certain assessment of a purchase option.

6.6.200 However, because reasonably certain is a high threshold of assurance (see section 5.2), a significant event or significant change in circumstances (within the control of the lessee and directly related to the assessment of the lessee option) – i.e. a 'triggering event' – may not result in a change to the previous assessment of whether the lessee is reasonably certain to exercise an option (or not exercise a termination option). Although reassessments will not always result in a formal change to the assessment of lessee option exercise, we believe that they usually will, particularly if the triggering event is one of the examples in Topic 842 (see 6.6.50).

KPMG observation – Impacts to processes and controls of option reassessment guidance

6.6.210 The reassessment requirements should not require lessees to continually reassess the lease term and lessee purchase options. However, given the pervasive, and potentially material, effect that lease reassessments could have on a lessee's financial statements, lessees will need to implement new processes and controls to address the new risk points. [ASU 2016-02.BC232]

6.6.220 These include processes and controls to monitor and, where relevant, account for (1) significant events or changes in circumstances (i.e. triggering events) within their control; (2) the exercise of options or a decision taken not to exercise an option; and (3) events specified explicitly in the contract that require the lessee to exercise (or not to exercise) an option. This effort likely will need to involve cross-functional coordination to ensure timely identification of events requiring revisions to lease accounting.

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KPMG observation – Changes to amounts probable of being owed under a residual value guarantee

6.6.230 Unlike for reassessments of the lease term or lessee purchase options, Topic 842 does not provide specific guidance about when a lessee must reassess amounts probable of being owed under a residual value guarantee. However, the basis for conclusions suggests that it is the Board's intent for lessees to remeasure the lease payments whenever facts and circumstances change, suggesting that the amount previously estimated is no longer accurate (subject to materiality considerations). [ASU 2016-02.BC239]

6.6.240 Therefore, the lease payments may be required to be remeasured, which results in a number of additional accounting steps (see section 6.6.2), whenever there is a change in the estimated residual value of the underlying asset at the end of the lease term that affects the amount payable under a residual value guarantee – typically a decrease in the estimated residual value.

KPMG observation – Resolution of a contingency upon which future lease payments are based

6.6.250 The Board decided to specify that a lessee should remeasure its lease liability if a contingency on 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 (on a prospective basis) meet the definition of 'lease payments'. This is illustrated in Example 6.13. [ASU 2016-02.BC238]

6.6.260 The Board considered scenarios in which entities might attempt to circumvent the lessee right-of-use asset and lease liability recognition and measurement requirements by initially structuring the lease payments at a nominal amount. For example, lease payments could be set at $10 for Year 1 of a 10-year lease and then become fixed (or partially fixed) after Year 1 for the remainder of the lease term based on a percentage of Year 1 sales using a leased building, or based on Year 1 production using a piece of leased equipment. [ASU 2016-02.BC238]

6.6.270 Absent this requirement, some stakeholders suggested that the guidance would not require the lessee to reassess the lease payments and update its lease liability and right-of-use asset in those scenarios. If so, the lessee might not recognize a meaningful right-of-use asset or lease liability throughout the lease term even though the terms of the lease would require fixed payments after resolution of the contingency. Therefore, the Board decided to specify that if variability in some or all of the remaining lease payments is resolved, those amounts prospectively meet the definition of lease payments and should be reflected, from that point forward, in the right-of-use asset and the lease liability. [ASU 2016-02.BC238]

6.6.280 This general provision on the resolution of contingencies does not apply to variable lease payments that depend on an index or rate. For example, if the periodic lease payments increase based on the change in CPI, and under the terms of the lease the periodic lease payments will never decrease after they have increased (i.e. even if CPI were to decrease), the payment increase linked to the change in CPI is not captured by this general contingency guidance. Instead, the guidance appears to be intended to capture only situations related to all other types of variable lease payments (e.g. those related to usage or performance of the underlying asset).

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6.6.2 Accounting for a change arising from a reassessment

6.6.290 The discussion, diagram, and table that follows complement the overview diagram in 6.6.10, and deal with remeasurements resulting from lease reassessments. Lease modifications are discussed in section 6.7.

6.6.300 The accounting steps a lessee must undertake depend on which of the following circumstances (see section 6.6.1) requires the lessee to undertake the remeasurement. [842-10-25-1, 842-10-35-4, 842-20-35-4 – 35-5]

6.6.310 The following table summarizes the accounting steps a lessee must undertake in each of the above circumstances.

Accounting steps	Circumstance			
	1	2	3	4
Remeasure and reallocate the 'consideration in the contract' to the remaining lease and non-lease components of the contract (see chapter 4).	✔	✔	✔	✔
Remeasure the lease liability to reflect the revised lease payments, using a 'discount rate for the lease' (see section 5.6) *determined at the remeasurement date.*[1,2]	✔	✔	✘	✘
Remeasure the lease liability to reflect the revised lease payments, *using the original discount rate for the lease.*[1]	✘	✘	✔	✔
Adjust the amount of the right-of-use asset by the amount of the remeasurement of the lease liability. However, once the right-of-use asset is reduced to zero, then the remaining amount of the lease liability remeasurement is recognized in the income statement.	✔	✔	✔	✔
Reassess lease classification (see section 6.2) at the remeasurement date based on the circumstances at that date (e.g. fair value and remaining economic life of the underlying asset at the remeasurement date).	✔	✔	✘	✘
If there is a change in lease classification (see section 6.2), adjust the remaining lease cost recognition pattern and presentation in the income statement and statement of cash flows prospectively.	✔	✔	✘	✘

Notes:

1. When a lessee remeasures the lease payments, variable lease payments that depend on an index or rate are measured using the index or rate as of the remeasurement date.
2. The discount rate is not updated for circumstances #1 or #2 if the discount rate for the lease already reflects that the lessee has an option to extend or terminate the lease or to purchase the underlying asset. [842-10-35-5, ASU 2016-02.BC237]

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6.6.320 After the commencement date, a lessee remeasures the lease liability to reflect the changes to the lease payments. [842-20-35-4]

6.6.330 A lessee recognizes as an adjustment to the right-of-use asset the amount of remeasurement of the lease liability, unless the carrying amount of the right-of-use asset is reduced to zero (in which case any remaining amount of the remeasurement is recognized in net income). [842-20-35-4]

Example 6.12
Change in assessment of the lease term

6.6.340 Assume the same facts as in Examples 6.4 and 6.8, in which Lessee LE leases office space from Lessor LR.

6.6.350 At the end of Year 6, LE constructs leasehold improvements that are expected to have significant economic value at the end of the 10-year lease term, such that it becomes reasonably certain that LE will exercise the five-year extension option. Lease payments during the original and the revised lease term are as follows.

Non-cancellable lease period

Yr 1	Yr 2	Yr 3	Yr 4	Yr 5	Yr 6	Yr 7	Yr 8	Yr 9	Yr 10
$14,527	$14,963	$15,412	$15,874	$16,350	$16,841	$17,346	$17,866	$18,402	$18,954

Extension period

Yr 11	Yr 12	Yr 13	Yr 14	Yr 15
$19,523	$20,109	$20,712	$21,333	$21,973

Remeasuring the lease liability and right-of-use asset

6.6.360 Because the remeasurement of the lease payments results from a change in the assessment of the lease term, LE is required to use a discount rate for the lease determined at the remeasurement date (i.e. at the end of Year 6). The rate implicit in the lease is not readily determinable. Accordingly, LE uses its incremental borrowing rate at the end of Year 6 (12%) as the discount rate for the modified lease, taking into account:

- a remaining lease term of nine years (four years remaining from the original lease term plus the five-year extension period); and
- the remeasured lease payments for the revised lease term of nine years.

6.6.370 At the end of Year 6, the carrying amounts of the lease liability and right-of-use asset immediately prior to remeasurement are $57,306 and $53,350, respectively (see Example 6.8).

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6.6.380 LE remeasures the lease liability at the present value of the remaining lease payments for the revised lease term (i.e. Years 7 though 15), discounted at 12%, which is $102,048 (or an increase of $44,742). LE records the following journal entry.

	Debit	Credit
Right-of-use asset	44,742	
Lease liability		44,742
To remeasure the ROU asset and lease liability following reassessment of lease term		

6.6.390 After this journal entry, the carrying amount of LE's right-of-use asset is $98,092 ($53,350 + $44,742).

Lease classification reassessment

6.6.400 LE is required to reassess the original classification of the lease as an operating lease (see Example 6.8). The fair value of the office space has increased from lease commencement to $420,000, while the remaining economic life of the building in which the office space resides is 29 years. Therefore, the reassessed lease is an operating lease.

Accounting subsequent to remeasurement

6.6.410 LE calculates the remaining lease cost for the lease as follows. [842-20-25-8]

Total lease payments (including those paid and those not yet paid), reflecting the adjustment resulting from the lease term reassessment (i.e. all lease payments from Year 1 through Year 15)	$ 270,185
Plus: Total initial direct costs	5,000
Less: Periodic lease cost recognized in prior periods calculated as (straight-line lease cost of $17,154 x 6 years prior to remeasurement)	(102,923)
Remaining cost of the lease	**$ 172,262**

6.6.420 LE recognizes a single lease cost, calculated so that the remaining cost of the lease is allocated over the remaining lease term on a straight-line basis (i.e. $19,140 per year the remaining nine years).

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6.6.430 LE accounts for the lease liability and the right-of-use asset after the remeasurement using the guidance in Topic 842 for an operating lease, as illustrated below (using Method 2 to subsequently measure the right-of-use asset).

	ROU asset amortization			ROU asset carrying amount			
Year	Straight-line lease cost	Lease liab. accret.	ROU asset amort.	Beg. balance	ROU asset amort.	End. balance	Lease liab. balance
7	$19,140	$(12,246)	$ 6,894	$98,092	$ (6,894)	$91,198	$96,948
8	19,140	(11,634)	7,506	91,198	(7,506)	83,692	90,716
9	19,140	(10,886)	8,254	83,692	(8,254)	75,438	83,200
10	19,140	(9,984)	9,156	75,438	(9,156)	66,282	74,230
11	19,140	(8,908)	10,232	66,282	(10,232)	56,050	63,615
12	19,140	(7,634)	11,506	56,050	(11,506)	44,544	51,140
13	19,140	(6,137)	13,003	44,544	(13,003)	31,541	36,565
14	19,141	(4,388)	14,753	31,541	(14,753)	16,788	19,620
15	19,141	(2,353)	16,788	16,788	(16,788)	–	–

Example 6.13

A contingency on which payments are based is resolved

6.6.440 Lessee LE leases long-lived equipment (operating lease) to be used in its production process for a lease term of five years. The following facts are relevant at lease commencement.

– Lease payments:	Fixed payments of $1,000 per year (in arrears) plus $2 each hour that the equipment is used
– Renewal/termination/purchase options:	None
– Transfer of ownership:	No
– LE's incremental borrowing rate:	5% (implicit rate cannot be readily determined)
– Initial direct costs:	None
– Lease incentives:	None

6.6.450 In addition, the lease contains a clause specifying that the payments will become fixed at $2,500 per year for the remainder of the contract if the equipment is utilized more than 600 hours in Year 1.

6.6.460 At lease commencement, LE determines that the total cost for the lease is $5,000 ($1,000 x 5 payments). The variable payments that will be made by LE are variable lease payments. LE measures the lease liability based on the present value of the lease payments, discounted at 5%, which is $4,329. Because there are no initial direct costs or lease incentives, the initial measurement of the right-of-use asset is equal to the initial measurement of the lease liability, $4,329.

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6.6.470 LE utilizes the equipment for 675 hours during Year 1. Accordingly, LE's straight-line operating lease cost is $1,000, but LE also incurs variable lease cost of $1,350. The carrying amount of the lease liability and the right-of-use asset at the end of Year 1 is $3,545.

6.6.480 Because Year 1 utilization of the equipment exceeded 600 hours, the payments contingent on use of the equipment become fixed at $1,500 for the remaining lease term. Accordingly, LE remeasures the lease liability, considering four remaining lease payments of $2,500 ($1,000 original fixed annual payment + $1,500 additional amount that becomes fixed for the remaining four years of the lease upon resolution of the contingency), discounted at 5%, which results in a revised lease liability balance of $8,865 (an increase of $5,320).

6.6.490 LE does not update the discount rate for the lease in remeasuring the lease liability because the remeasurement relates to the resolution of a contingency on which payments for use of the equipment were based.

6.6.500 LE records the following entry at the end of Year 1.

	Debit	Credit
Right-of-use asset	5,320	
Lease liability		5,320
To remeasure the ROU asset and lease liability following resolution of contingency		

6.6.510 LE does not reassess lease classification because the remeasurement is not the result of a change in the assessment of the lease term, a change in the assessment of a lessee purchase option, or a lease modification.

6.6.520 LE calculates the remaining cost of the lease as follows. [842-20-25-8]

Total lease payments (including those paid and those not yet paid), reflecting the adjustment resulting from resolution of the contingency (i.e. $1,000 for Year 1 and $2,500 thereafter)	$11,000
Plus: Total initial direct costs attributable to the lease	–
Less: Periodic lease cost recognized in prior periods	(1,000)
Remaining lease cost	**$10,000**

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6.6.530 LE will recognize a single lease cost, calculated so that the remaining lease cost is allocated over the remaining lease term on a straight-line basis (i.e. $2,500 per year for each of the remaining four years).

6.6.540 LE will account for the lease liability and right-of-use asset from the effective date of the remeasurement using the guidance in Topic 842 for an operating lease, as illustrated below.

	ROU asset amortization			ROU asset carrying amount			
Year	Straight-line lease cost	Lease liab. accret.	ROU asset amort.	Beg. balance	ROU asset amort.	End. balance	Lease liab. balance
2	$2,500	$(443)	$2,057	$8,865	$(2,057)	$6,808	$6,808
3	2,500	(340)	2,160	6,808	(2,160)	4,648	4,648
4	2,500	(232)	2,268	4,648	(2,268)	2,380	2,380
5	2,500	(120)	2,380	2,380	(2,380)	–	–

Example 6.14
Variable lease payments indexed to CPI

6.6.550 Lessee LE enters into a lease of a building for a five-year term with a two-year extension option. At lease commencement, LE does not consider exercise of the extension option to be reasonably certain.

6.6.560 LE's base payment under the lease is $100,000 per year (paid in arrears). The base payment will be adjusted each year by the change in CPI after the lease commencement date. The CPI index value at lease commencement is 196.800. LE incurs no initial direct costs to enter into the lease, does not prepay any lease payments, and does not receive any lease incentives.

6.6.570 LE cannot readily determine the rate implicit in the lease. Therefore, LE's incremental borrowing rate, which is 6% at lease commencement, is the discount rate for the lease.

6.6.580 The lease is classified as an operating lease. LE initially measures the lease liability as the present value of $100,000 per year for five years, discounted at 6%. The $100,000 initial payment already reflects the CPI index at the lease commencement date.

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Scenario 1: Lease is not modified and lease liability is not remeasured

6.6.590 The following table summarizes LE's accounting for the lease assuming that there is no remeasurement of the lease liability and no lease modification. The table assumes that the actual outcomes during the lease term (CPI index) are known by LE at lease commencement.

						Single lease cost				
Year	Base pmts.	CPI index	Actual pmts.	End. ROU asset	End. lease liab.	ROU asset amort.	Lease liab. accret.	Single lease Cost	Variable lease cost	Total lease cost
0		196.800		$421,236	$421,236					
1	$100,000	201.800	$102,541	346,510	346,510	$ 74,726	$25,274	$100,000	$ 2,541	$102,541
2	100,000	210.036	106,726	267,301	267,301	79,209	20,791	100,000	6,726	106,726
3	100,000	210.228	106,823	183,339	183,339	83,962	16,038	100,000	6,823	106,823
4	100,000	215.949	109,730	94,339	94,339	89,000	11,000	100,000	9,730	109,730
5	100,000	219.179	111,371	–	–	94,339	5,661	100,000	11,371	111,371
	$500,000		**$537,191**			**$421,236**	**$78,764**	**$500,000**	**$37,191**	**$537,191**

Scenario 2: Lease liability is remeasured at the end of Year 3

6.6.600 Assume the same facts as in Scenario 1, except that at the end of Year 3, LE constructs leasehold improvements that will have significant economic value to LE at the end of the original five-year lease term. Because of this triggering event, LE reassesses the lease term, determining it is now reasonably certain to exercise the two-year extension option. That is, at the end of Year 3, LE reassesses the remaining lease term to be four years (two years remaining from the original lease term plus the two-year extension period).

6.6.610 Accordingly, LE remeasures the lease liability based on a revised discount rate for the lease at the remeasurement date and updated lease payments for the revised lease term (and because the lease payments are remeasured for a change in the lease term, LE also remeasures the variable lease payments based on CPI using the CPI index at the remeasurement date, which is 210.228). LE's incremental borrowing rate at the end of Year 3 is 7%, taking into consideration the remaining, revised lease term and the updated lease payments.

6.6.620 The remeasured lease liability is $361,832 (four payments of $106,823 discounted at 7%).

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6.6.630 LE reassesses the lease classification, based on the facts and circumstances as of the reassessment date, and determines that the lease is still an operating lease.

6.6.640 LE calculates the remaining cost for the lease as follows. [842-20-25-8]

Total lease payments (including those paid and those not yet paid), reflecting the adjustment resulting from the remeasurement (i.e. $100,000 for the first 3 years and $106,823 for the 4 remaining years)	$ 727,292
Plus: Total initial direct costs attributable to the lease	–
Less: Periodic lease cost recognized in prior periods	(300,000)
Remaining lease cost for the lease	**$ 427,292**

6.6.650 LE will recognize a single lease cost, calculated so that the remaining cost of the lease is allocated over the remaining lease term on a straight-line basis (i.e. $106,823 per year for each of the remaining four years).

6.6.660 The following table summarizes LE's accounting for the lease before and after the remeasurement. The table assumes that the actual outcomes during the lease term (CPI index) are known by LE at lease commencement.

						Single lease cost				
Year	**Base pmts.**	**CPI index**	**Actual pmts.**	**End. ROU asset**	**End. lease liab.**	**ROU asset amort.**	**Lease liab. accret.**	**Single Lease Cost**	**Variable lease cost**	**Total lease cost**
0		196.800		$421,236	$421,236					
1	$100,000	201.800	$102,541	346,510	346,510	$ 74,726	$ 25,274	$100,000	$ 2,541	$102,541
2	100,000	210.036	106,726	267,301	267,301	79,209	20,791	100,000	6,726	106,726
3	100,000	210.228	106,823	183,339	183,339	83,962	16,038	100,000	6,823	106,823
Remeasurement lease liability and ROU asset				361,832	361,832					
4	106,823	215.949	109,730	280,337	280,337	81,495	25,328	106,823	2,907	109,730
5	106,823	219.179	111,371	193,138	193,138	87,199	19,624	106,823	4,548	111,371
6	106,823	222.454	113,036	99,835	99,835	93,303	13,520	106,823	6,213	113,036
7	106,823	224.765	114,210	–	–	99,835	6,988	106,823	7,387	114,210
	$727,292		**$764,437**			**$599,729**	**$127,563**	**$727,292**	**$37,145**	**$764,437**

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Example 6.15

Remeasurement and reallocation of the consideration in the contract

Original lease

6.6.670 Lessee LE leases a machine from Lessor LR for three years. As part of the contract, LR will maintain the machine for LE. The following facts about the underlying lease (an operating lease, properly classified) are relevant at the lease commencement date:

– Fixed payments:	Fixed payments of $120,000 per year (paid in arrears)
– Transfer of ownership:	No
– Options:	A single two-year extension option, not reasonably certain of exercise at lease commencement
– Fair value of machine:	$600,000
– Remaining economic life of machine:	8 years
– Residual value guarantee (lessee):	The first $50,000 that the residual value is below $350,000 If the extension option is exercised, then the first $50,000 that the residual value is below $220,000
– Amount probable of being owed under the residual value guarantee:	$18,000
– LE's incremental borrowing rate:	7% (implicit rate cannot be readily determined)

6.6.680 Based on the information above, the consideration in the contract is $378,000.

– Fixed payments:	$360,000 ($120,000 × 3 years)
– Amount probable of being owed under the residual value guarantee:	$18,000

6.6.690 LE concludes that the contract has two components, the machine lease and the (non-lease) machine maintenance, and allocates the consideration in the contract to those components as follows.

Component	Stand-alone price	Allocation	Calculation
Machine lease	$330,000	$315,000	(330,000/396,000) × 378,000
Maintenance	66,000	63,000	(66,000/396,000) x 378,000
	$396,000	**$378,000**	

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6.6.700 At lease commencement, LE recognizes a lease liability and a right-of-use asset based on rental payments of $100,000[1] per year and a residual value guarantee payment of $15,000[2] at the end of Year 3.

– Lease liability:	$274,676[3]
– Right-of-use asset:	$274,676[4]

Notes:

1. ($330,000 ÷ $396,000) × $120,000 annual rental payment = $100,000
2. ($330,000 ÷ $396,000) × $18,000 end of lease RVG payment = $15,000
3. The present value of the unpaid lease payments (3 annual payments of $100,000 and one residual value guarantee payment of $15,000 probable of being owed at the end of the lease term), discounted at 7%.
4. Equal to the lease liability because there are no initial direct costs, no lease incentives, or rent prepayments.

Lease reassessment

6.6.710 At the end of Year 2, LE decides to exercise its two-year renewal option, triggering a reassessment of the lease term. At that date, the following facts are relevant.

– Remaining, reassessed lease term:	3 years
– Lease payments:	Fixed payments of $120,000 per year (paid in arrears)
– Remaining options:	None
– Residual value guarantee:	The first $50,000 that the residual value is below $220,000
– Amount probable of being owed under the residual value guarantee:	$6,000
– LE's incremental borrowing rate:	6%

6.6.720 Based on the information above, the remaining consideration in the contract is $366,000:

– Fixed payments:	$360,000 ($120,000 × 3 years)
– Amount probable of being owed under the residual value guarantee:	$6,000

6.6.730 LE reallocates the remaining consideration in the contract to the machine lease and the machine maintenance based on relative stand-alone prices.

Component	Stand-alone price	Allocation	Calculation
Machine lease	$335,000	$306,525	(335,000/400,000) × 366,000
Maintenance	65,000	59,475	(65,000/400,000) x 366,000
	$400,000	**$366,000**	

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6.6.740 At the end of Year 2, before the reassessment of the lease term, the balance of the right-of-use asset and the lease liability is:

Lease liability:	$107,476
Right-of-use asset:	$97,476

6.6.750 Due to the change in the lease term, and based on the allocation of the remaining consideration in the contract, LE remeasures the lease payments at $306,525, which is based on:

- allocated rental payments of $100,500[1] per year; and
- An allocation of the residual value guarantee payment at the end of the revised lease term, equal to 5,025[2].

6.6.760 This results in a lease liability and a right-of-use asset immediately after the remeasurement of:

Lease liability:	$272,857[3]
Right-of-use asset:	$262,857[4]

6.6.770 LE recognizes the adjustment from the remeasurement with the following journal entry; there is no profit or loss effect of the remeasurement.

	Debit	Credit
Right-of-use asset	165,381[5]	
Lease liability		165,381[5]
To remeasure the ROU asset and lease liability following reassessment of lease term		

Notes:

1. ($335,000 ÷ $400,000) × $120,000 annual payment = $100,500.
2. ($335,000 ÷ $400,000) × $6,000 end of lease RVG payment = $5,025.
3. The present value of the unpaid lease payments (3 annual payments of $100,500 paid in arrears, and one probable residual value guarantee payment of $5,025 at the end of the lease term), discounted at 6%.
4. $97,476 + ($272,857 - $107,476) = $262,857.
5. $272,857 - $107,476 = $165,381.

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KPMG observation – Lease liability remeasured with an equal adjustment to the right-of-use asset

6.6.780 The Board determined that changes in the lease term or lease payments related to a purchase option represent a lessee's expectation that it has acquired more or less of the right to use the underlying asset; and the adjustment to the right-of-use asset should be made to appropriately measure the total cost of the asset. Meanwhile, changes in estimates of the amount probable of being owed under a residual value guarantee and changes to the lease payments resulting from the resolution of a contingency reflect changes to the cost of the right-of-use asset. [ASU 2016-02.BC232, BC238–BC239]

6.6.790 Consequently, changes to the lease liability are recognized as an adjustment to the right-of-use asset unless the adjustment will result in a negative right-of-use asset carrying amount. This means that the effect of the remeasurement in the income statement is *prospective*.

6.6.800 Changes to the carrying amount of the right-of-use asset as a result of revised assessments of the lease term or lessee purchase options also require the lessee to revise useful life estimates for the right-of-use asset (and related assets, such as leasehold improvements) and amortization expense on a prospective basis.

KPMG observation – Remeasurement of a non-lease component

6.6.810 Topic 842 does not address the accounting for non-lease components (e.g. how to recognize the cost of a non-lease component). In Example 6.15, Lessee LE initially allocates $63,000 to the three-year non-lease maintenance component of the contract. Assuming that the maintenance is effectively a stand-ready obligation on the part of Lessor LR, absent the remeasurement outlined above, LE would likely recognize that allocated amount as expense ratably over the three-year lease term (which is also the maintenance services period). However, after the remeasurement, LE allocates $59,475 of the remaining consideration in the contract to the remaining three years of maintenance services.

6.6.820 Consequently, LE might account for the remeasurement as a true-up to a five-year maintenance service, with a total price of $101,475.[1] In that case, LE would recognize contra-expense of $1,410[2] at the time of remeasurement, with an offsetting accrual for that amount. However, because the remeasurement results from a change in estimate, we believe that it would be more appropriate for LE to simply account for the remaining maintenance services to be provided over the final three years of the revised lease term prospectively; this is consistent with how LE will account for the remainder of the lease. Therefore, LE would recognize the $59,475 allocated to the maintenance services ratably over the remaining three-year lease term after the remeasurement; no contra-expense amount would be recognized at the remeasurement date.

Notes:

1. ([$63,000 initial allocation to the 3-year maintenance service ÷ 3 years] × 2 years) + $59,475 allocation after the remeasurement at the end of Year 2 = $101,475.
2. $40,590 (which equals [$101,475 ÷ 5 years] × 2 years) - $42,000 ([$63,000 ÷ 3 years] × 2 years) = $(1,410).

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KPMG observation – Reassessment of the discount rate for the lease

6.6.830 The Board decided that, in general, an entity should not reassess the discount rate used to measure the lease liability during the lease term, which is generally consistent with the amortized cost accounting for other, similar financial liabilities. However, the Board concluded that a change in the lease term or in the assessment of a lessee purchase option represent a significant change in the economics of the arrangement, and therefore the discount rate for the lease should be adjusted in those cases. [ASU 2016-02.BC240–BC242]

US GAAP different from IFRS – Remeasurements more frequent under IFRS 16

6.6.840 Under IFRS 16, lessees remeasure the lease liability for changes in variable lease payments based on an index or rate on the date when:

- like Topic 842, lease payments are remeasured for other reasons (e.g. a reassessment due to a change in the lease term); and
- unlike Topic 842, there is a change in the cash flows – i.e. when an adjustment to the lease payments based on an index or rate takes effect under the lease's terms. [IFRS 16.42(b)]

6.6.850 Under IFRS 16, lessees remeasure the lease liability using a revised discount rate when:

- like Topic 842, there is a change in the lease term or the assessment of whether the lessee is, or is not, reasonably certain to exercise a purchase option;
- like Topic 842, there is a lease modification that is not accounted for as a separate contract; and
- unlike Topic 842, there is a change in future lease payments as a result of a change in floating interest rates. [IFRS 16.43]

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Comparison with current US GAAP – Reassessments

Requirement to revise lease liability represents a significant change from capital (finance) lease accounting

6.6.860 A requirement to potentially revise the lease liability during the lease term is a significant change from current US GAAP requirements for capital leases where the liability is not remeasured during the lease term unless the lease is modified. [840-30-35-17]

Residual value guarantees

6.6.870 Under current US GAAP, any amounts expected to be payable under a residual value guarantee within an operating lease are accrued separately. For a capital lease, the full amount of the residual value guarantee is included in the determination of the capital lease obligation and the capital lease asset and is not separately accounted for. [840-10-25-6(b)]

Updating the discount rate for the lease

6.6.880 Topic 842's requirement to reassess the discount rate for the lease represents a shift from current US GAAP for capital leases where a lessee, subject to certain requirements, uses the initial discount rate that was determined at lease inception to calculate the change in the lease liability as a result of a change in the amount of remaining minimum lease payments due to a lease modification. [840-30-35-8]

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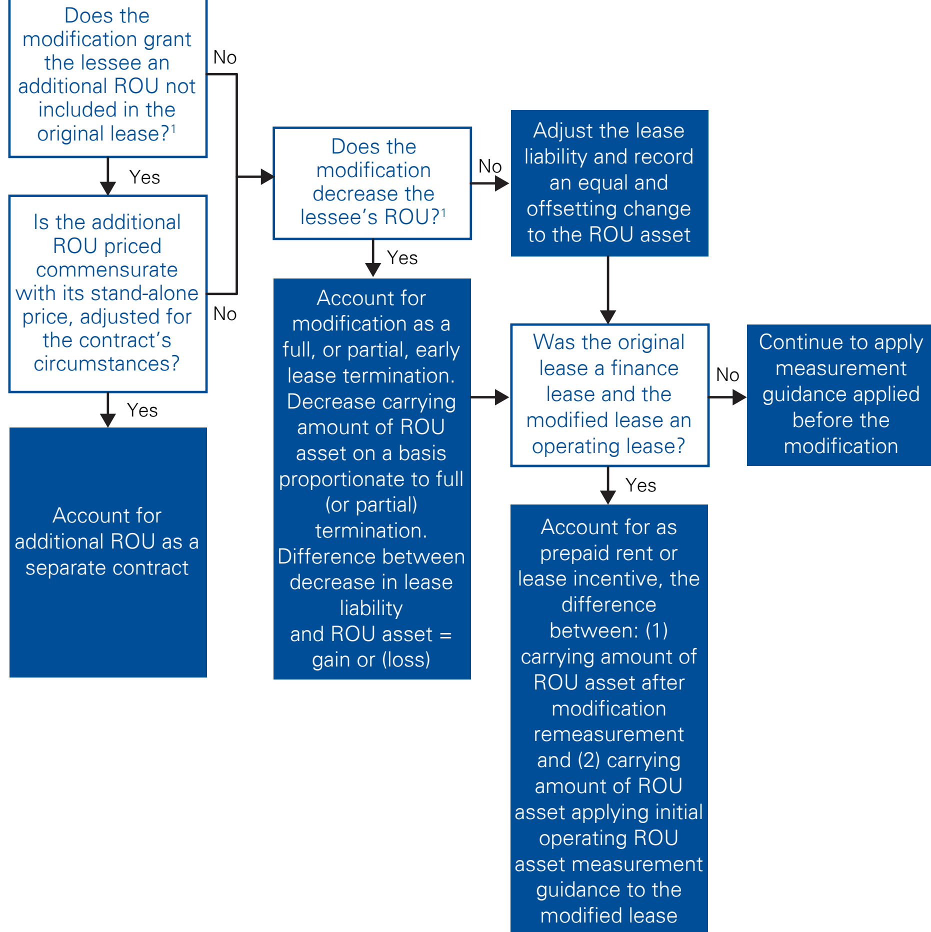
6.7 Lease modifications (Step 8B)

6.7.10 A lease modification is a change to the terms and conditions of a contract that results in a change in the scope of or the consideration for a lease (for example, a change to the terms and conditions of the contract that adds or terminates the right to use one or more underlying assets or extends or shortens the contractual lease term) is a lease modification. [842 Glossary]

6.7.20 The effective date of a lease modification is the date the modification is approved by both the lessee and the lessor. [842 Glossary]

6.7.30 The following flowchart summarizes the lease modification requirements applicable to a lessee. [842-10-25-8 – 25-14]



Note 1:

Lease term is an attribute of the lessee's right to use the underlying asset (i.e. an extension does not grant the lessee an additional right of use).

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6.7.40 An entity accounts for a modification as a separate contract when the following conditions are met:

- the modification grants the lessee an additional right-of-use that was not included in the original lease (e.g. a right to use an additional asset); and
- the lease payments increase commensurate with the stand-alone price of the additional right-of-use, adjusted for the circumstances of the contract. For example, the stand-alone price for the lease of one floor in an office building in which the lessee already leases other floors may be different than the stand-alone price of a similar floor in a similar office building because the lessor did not have to incur costs it would have incurred for a new lessee. [842-10-25-8]

6.7.50 The accounting steps an entity performs for a lease modification that is not accounted for as a separate contract are similar to the steps a lessee performs when remeasuring lease liabilities for changes in the lease term or in the assessment of a lessee purchase option, with some differences for Steps 3 and 4 described below. [842-10-25-9 – 25-13]

Accounting steps for a lease modification not accounted for as a separate contract
1. Remeasure and reallocate the consideration in the contract to the remaining lease and non-lease components of the contract at the effective date of the modification (see chapter 4).
2. Remeasure the lease liability to reflect the revised lease payments, using a discount rate for the lease (see section 5.6) determined at the effective date of the modification.[1]
3. Either: a. If the modification decreases the lessee's right-of-use (e.g. reduces the number of assets leased or reduces the space leased in a building), then the carrying amount of the right-of-use asset is reduced on a proportionate basis to the full (or partial) termination of the existing lease; and any difference between the reduction in the lease liability and the reduction in the right-of-use asset is recognized as a gain (loss) at the effective date of the modification. b. Otherwise,[2] adjust the amount of the right-of-use asset by the amount of the remeasurement of the lease liability.
4. Account for initial direct costs (see section 5.5), lease incentives (see section 5.4.3), and other payments in connection with the modification in the same manner as for a new lease.
5. Reassess lease classification as of the effective date of the modification based on the circumstances at that date (e.g. fair value and remaining economic life of the underlying asset at that date).
6. If there is a change in lease classification, adjust the remaining lease cost recognition pattern and presentation in the income statement and statement of cash flows prospectively.

Notes:

1. When a lessee remeasures the lease liability, variable lease payments that depend on an index or rate are measured using the index or rate as of the remeasurement date. The Board decided that a lessee should remeasure variable lease payments that depend on an index or a rate when the lessee remeasures the lease liability for another reason since it would not be logical to use an outdated index or rate in remeasuring the lease payments [842-10-35-5, ASU 2016-02.BC237]

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2. Including modifications that:

   – grant the lessee an additional right-of-use not included in the original contract (and that modification is not accounted for as a separate contract)

   – change the term of an existing lease (e.g. extend or reduce the lease term), other than through the exercise of an extension or termination option included in the original contract

   – change the consideration in the contract only

6.7.60 If a finance lease is modified and the modified lease is classified as an operating lease, the lessee accounts for (in the manner of a rent prepayment or a lease incentive) the difference between:

- the carrying amount of the right-of-use asset immediately after remeasurement as a result of the modification; and
- the carrying amount of the right-of-use asset that would result from applying the initial measurement guidance for an operating lease right-of-use asset to the modified lease. [842-10-25-14]

Lease modifications in connection with the refunding of tax-exempt debt

6.7.70 In a tax-exempt debt financing structure in which the facility transfers to the user of such facility by lease (e.g. tax exempt debt financing of construction of a plant or hospital), the lease may serve as collateral to the tax-exempt debt and the lease payments are essentially the same, as to both amount and timing, as those required by the tax-exempt debt. A lease modification resulting from a refunding by the lessor of tax-exempt debt (including an advance refunding) should be accounted for in the same manner as any other lease modification. For example, if the perceived economic advantages of the refunding are passed through to the lessee in the form of reduced lease payments, the lessee should recognize the amount of remeasurement of the lease liability for the modified lease as an adjustment to the corresponding right-of-use asset. [842-10-55-16]

Master lease agreements

6.7.80 Under a master lease agreement, the lessee may gain control over the use of additional underlying assets during the term of the agreement. If the agreement specifies a minimum number of units or dollar value of equipment, a lessee does not apply the lease modification guidance when it gains control over the use of those additional underlying assets. Rather the lessee will identify the separate lease components and allocate the consideration in the contract to those components (see chapter 4). [842-10-55-17]

6.7.90 When the master lease agreement permits the lessee to gain control over the use of additional underlying assets but does not require the lessee to do so, the lessee's taking control over the use of additional underlying assets is accounted for as a lease modification. [842-10-55-18]

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Example 6.16
Modification that adds an additional right of use

Scenario 1: Modification is accounted for as a separate contract

6.7.100 Assume the same facts as in Examples 6.4 and 6.8, in which Lessee LE leases office space from Lessor LR. At the beginning of Year 7, LE and LR modify their contract to grant LE the right to use an additional floor of office space in the same building as the current office space LE leases from LR for four years (making the non-cancellable period coterminous with that of the original office space lease), with an option to renew the new space lease for five years (consistent with the option LE has to renew the original office space lease). The new office space is the same size as the original office space and is similar in all significant respects.

6.7.110 The lease payments for the new office space are 5 percent lower each year than the lease payments for the original office space – the lease payments for the original office space continue to be considered market rentals for office space of that size and characteristics.

6.7.120 Because of its existing relationship with LE, LR was able to obtain this lease without incurring any marketing or commission costs and was able to forego costs such as those for a credit check since LE is already a tenant in good standing.

6.7.130 LE (and LR) conclude that this modification should be accounted for as a separate contract (i.e. separate from the original contract that granted LE the right to use the original office space). This conclusion is based on the following.

- The modification grants LE an additional right of use – i.e. the right to use an additional floor of office space.
- The increase in the lease payments for the additional office space is commensurate with the stand-alone price for the right to use that office space *based on the circumstances of this contract*. That is, even though the lease payments for the new office space are 5 percent below market rentals, the lower lease payments are reflective of sharing with LE the benefit of LR not having to incur origination costs to obtain this lease – i.e. as noted in 6.7.120, LR did not have to market the property or pay a broker's commission to obtain the new office space lease and did not have to incur other common origination costs.

6.7.140 Therefore, in accounting for the new office space lease, LE does not undertake any accounting for the original office space lease. LE accounts for the new office space lease just as it would any other new lease.

Scenario 2: Modification is not accounted for as a separate contract

6.7.150 Assume the same facts as in Scenario 1, except that the lease payments are discounted 20 percent from those in the original office space lease, the payments for which are still considered to be market rentals.

6.7.160 LE (and LR) conclude that this modification should *not* be accounted for as a separate contract. Even though, consistent with Scenario 1, the modification grants LE an additional right of use, the increase in the lease payments resulting from the additional right of use is not commensurate with the stand-alone price for that

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additional right of use, even after considering the factors outlined in Scenario 1 as to the particular circumstances of obtaining this additional lease. The discount from market rentals cannot be considered entirely attributable to the origination costs LR will not have to incur to obtain the new office space lease.

6.7.170 In this scenario, because the new office space lease is commencing immediately, and both leases have the same lease term, it does not matter whether LE accounts for the original office space lease and the new office space lease as separate lease components. However, if the new office space lease commenced at the beginning of Year 8, rather than at the beginning of Year 7, LE would separately account for the two lease components (original office space and new office space), remeasuring the original lease component for the modification (i.e. for the change in the lease payments that will result from allocating a portion of those lease payments to the new office space lease) as of the effective date of the modification. LE would recognize and measure the new office space lease at the commencement date for that lease.

Scenario 3: Blend and extend

6.7.180 Assume the same basic facts as in Scenario 2, except that the right to use the new office space is for a non-cancellable period of nine years from the effective date of the modification and, as part of the modification, the right to use the original office space is made coterminous with the new office space – i.e. LE also commits to lease the original office space for nine years from the effective date of the modification. In addition, the lease payments for the original office space are reduced to match those for the additional office space.

6.7.190 At the beginning of Year 7 of the original lease (which is the effective date of the modification in this example), the carrying amount of the right-of-use asset and the lease liability were (see Example 6.8):

– Lease liability:	$57,306
– Right-of use asset:	$53,350

6.7.200 At the effective date of the modification, the following facts are relevant.

– Rate implicit in the lease:	Not readily determinable
– LE's incremental borrowing rate:	9%
– Residual value guarantee:	None
– Options:	There are no lessee or lessor options in the contract
– Transfer of ownership:	No
– Fair value of the combined office space:	$840,000
– Remaining economic life of the office space:	29 years
– Additional initial direct costs incurred:	$1,000

6.7.210 Because LE's right to use the new office space commences on the effective date of the modification, LE is not required to account for the original office space and the new office space as separate lease components. LE concludes that the single, modified lease component in the contract (for two floors of office space for nine years) is an operating lease.

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6.7.220 The lease liability for the modified lease is $184,674 (the present value of the nine annual lease payments, discounted at 9%). Therefore, LE increases its existing lease liability by $127,368 ($184,674 - $57,306). The offset to that adjustment is to the existing right-of-use asset. LE accounts for the initial direct costs incurred in connection with the modification in the same manner as it would for a new lease. Therefore, LE recognizes the additional $1,000 in initial direct costs that it incurs as an addition to its remeasured right-of-use asset.

6.7.230 Consequently, LE records the following journal entry at the effective date of the modification.

	Debit	Credit
Right-of-use asset	128,368	
Lease liability		127,368
Cash (initial direct costs)		1,000
To recognize the lease modification		

6.7.240 From the effective date of the modification, LE accounts for the modified lease in the same manner as for any other lease; see Example 6.8 for an example of subsequent accounting for an operating lease.

Example 6.17
Modification that extends the lease term only

6.7.250 Assume all of the same facts as in Example 6.12 (remeasurement resulting from a change in the lease term), *except that*, instead of there being a remeasurement event at the end of Year 6, assume the lease did not contain a renewal option and the lease is *modified* at the end of Year 6 to extend the total lease term from 10 years to 15 years.

6.7.260 Assume the terms for the extension agreed through the modification and the terms of the renewal option in Example 6.12 are the same. That is, Lessee LE and Lessor LR modify the lease to add an additional period of five years to the lease. Lease payments during the extension period start at $19,523 and increase 3% annually, all payable in arrears. There are no initial direct costs, lease incentives, or other payments between LE and LR as a result of the modification.

Separate contract analysis

6.7.270 Because the modification increases the lease term only (i.e. it does not grant LE an additional right-of-use), the modification cannot be accounted for as a separate contract.

Accounting for the modification and accounting for the lease post-modification

6.7.280 The accounting for the modification and the accounting for the modified lease after the modification in this example is the same as the accounting for the remeasurement and the accounting for the lease after the remeasurement in Example 6.12. Therefore, see that example for the journal entries recorded to remeasure the lease liability and the right-of-use asset, as well as the accounting that results post-modification.

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Example 6.18
Partial lease termination

6.7.290 This example continues Examples 6.4 and 6.8, in which Lessee LE entered into a lease with Lessor LR to lease office space for a 10-year term. The terms and conditions are the same. Accordingly the subsequent accounting for the lease in this example is the same as that illustrated in Example 6.8, absent lease reassessments or modifications. Also assume that the lease was for 10,000 square feet of space.

6.7.300 At the end of Year 6, LE and LR modify the lease for the remaining four years to reduce the lease to only 7,500 square feet of the original space and to reduce the remaining annual lease payments by $3,500 for each of the remaining four years. In conjunction with the partial termination, LE also agrees to pay LR a termination fee of $1,000.

6.7.310 Lease classification for the lease does not change as a result of the modification (i.e. it remains an operating lease since the modification reduces both the lease term and the lease payments).

6.7.320 LE remeasures the lease liability at the effective date of the modification based on a remaining lease term of four years, the remeasured lease payments (which decreased by $3,500 per year as compared to the original terms of the lease), and LE's incremental borrowing rate at the modification date, which is 11%. The remeasured lease liability is $45,210 (a $12,096 or 21.11% decrease from the pre-modification liability).

Scenario 1: Remeasuring the right-of-use asset based on the change in lease liability

6.7.330 The decrease of 21.11% in the lease liability reflects the early termination of the right to use 2,500 square feet of space (or 25% of the original space), the change in the lease payments, and the change in the discount rate for the lease.

6.7.340 LE decreases the carrying amount of the right-of-use asset immediately prior to the modification (which equaled $53,350) by 21.11% to reflect the partial termination of the lease. This results in a reduction in the right-of-use asset of $11,261. LE records the following entry related to the partial lease termination at the end of Year 6.

	Debit	Credit
Lease liability	12,096	
Loss on partial lease termination	165	
Right-of-use asset		11,261
Cash		1,000
To recognize lease modification		

Scenario 2: Remeasuring the right-of-use asset based on the remaining right of use

6.7.350 LE determines the proportionate decrease in the carrying amount of the right-of-use asset based on the remaining right-of-use asset (7,500 square feet representing 75% of the original right-of-use asset).

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6.7.360 Accordingly, LE decreases the carrying amount of the right-of-use asset by $13,338 (25% x premodification right-of-use asset of $53,350) and the carrying amount of the lease liability by $14,327 (25% x premodification lease liability of $57,306), which results in an adjusted lease liability balance of $42,979. The following journal entry is recorded.

	Debit	Credit
Lease liability	14,327	
Loss on partial lease termination	11	
Right-of-use asset		13,338
Cash		1,000
To recognize lease modification		

6.7.370 LE then recognizes the difference between the remaining lease liability of $42,979 and the remeasured lease liability of $45,210 (determined in the introduction to this example), or $2,231, as an adjustment to the right-of-use asset reflecting the change in the consideration paid for the lease and the revised discount rate.

	Debit	Credit
Right-of-use asset	2,231	
Lease liability		2,231
To recognize lease modification		

KPMG observation – Lease modifications versus lease remeasurements resulting from reassessments

6.7.380 The decisions by the Board to consider the lease term an attribute of the lease and to require a reassessment of lease classification for lease modifications that are not accounted for as a separate contract substantially aligns the lease modification guidance with the lease reassessment guidance. This minimizes accounting differences between the two models that could have created structuring opportunities. [ASU 2016-02.BC177]

Comparison with current US GAAP

Modification guidance is substantially changed from current US GAAP

6.7.390 The lease modification guidance in Topic 842 is substantially different from, and more extensive than, the guidance on lease modifications in current US GAAP. There is virtually no parallel between the two sets of guidance such that entities should take careful note of the new modifications guidance and not assume that anything done with respect to modifications under current US GAAP applies under Topic 842.

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6.8 Financial statement presentation (Step 9)

6.8.10 The following table summarizes the financial statement presentation requirements applicable to lessees, which are specified in detail in 6.8.20–110. [842-20-45-1 – 45-5]

	Balance sheet	Income statement	Statement of cash flows
Finance leases	**ROU assets** – separate line item; or – within another line item, separate from where operating lease ROU assets are presented **Lease liabilities** – separate line item; or – within another line item, separate from where operating lease liabilities are presented	**ROU asset amortization** – consistent with presentation of depreciation or amortization of similar assets **Interest expense on lease liability** – consistent with presentation of other interest expense	**Principal repayments** – Financing activities **Interest payments** – In accordance with Topic 230 (typically, in operating activities) **Variable lease payments** – Operating activities
Operating leases	**ROU assets** – separate line item; or – within another line item, separate from where finance lease ROU assets are presented **Lease liabilities** – separate line item; or – within another line item, separate from where finance lease liabilities are presented	**Lease expense** – included in lessee's income from continuing operations (operating expense)	**Lease payments** – Operating activities, unless payments are for costs to put another asset in service **Variable lease payments** – Operating activities

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Balance sheet

6.8.20 A lessee presents in the balance sheet (or discloses in the notes) the following.

- Finance lease right-of-use assets and operating lease right-of-use assets separately from each other and from other assets.
- Finance lease liabilities and operating lease liabilities separately from each other and from other liabilities. [842-20-45-1]

6.8.30 Right-of-use assets and lease liabilities are classified as current or noncurrent in a classified balance sheet in the same manner as any other nonfinancial assets and financial liabilities. [842-20-45-1]

6.8.40 If a lessee does not present finance lease and operating lease right-of-use assets and lease liabilities separately in the balance sheet, it discloses the line items in which the right-of-use assets and lease liabilities are included. [842-20-45-2]

6.8.50 A lessee is prohibited from presenting:

- finance lease right-of-use assets in the same line as operating lease right-of-use assets; and
- finance lease liabilities in the same line item as operating lease liabilities. [842-20-45-3]

6.8.60 Operating lease liabilities are presented as operating liabilities, rather than debt. [ASU 2016-02.BC14, BC264]

Income statement

6.8.70 For finance leases, a lessee presents the interest expense on the lease liability and the amortization of the right-of-use asset in a manner consistent with how the entity presents other interest expense and depreciation or amortization of similar assets, respectively. They are not required to be presented as separate line items. [842-20-45-4(a)]

6.8.80 For operating leases, a lessee presents lease expense in income from continuing operations. [842-20-45-4(b)]

6.8.90 Topic 842 does not indicate in which line item in the income statement a lessee should present variable lease payments not included in the lease liability. However, the Basis for Conclusions states that variable lease payments not included in lease liabilities should be classified within operating activities in the statement of cash flows *because the corresponding lease cost will be presented in income from continuing operations*, rather than something else (e.g. interest expense for finance leases). [ASU 2016-02.BC271]

Statement of cash flows

6.8.100 A lessee classifies cash flows from leasing transactions as follows.

- Repayments of the principal portion of the lease liability arising from finance leases within financing activities.
- Interest on the lease liability arising from finance leases in accordance with Topic 230 (statement of cash flows).

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– Payments arising from operating leases within operating activities unless the lease payments represent costs to bring another asset to the condition and location necessary for its intended use (i.e. investing activities).

– Variable lease payments and short-term lease payments not included in the lease liability within operating cash flows. [842-20-45-5]

6.8.110 The initial recognition of a lease liability and right-of-use asset is a non-cash transaction that is not included in the statement of cash flows but separately disclosed with other non-cash transactions. [842-20-50-4(g)(2)]

KPMG observation – Basis for the presentation requirements in the balance sheet

6.8.120 The Board decided that finance lease right-of-use assets, operating lease right-of-use assets, finance lease liabilities, and operating lease liabilities should either be presented as separate line items in the balance sheet or disclosed in the notes to the financial statements. Lessees will also disclose the line items in which those amounts are included if they do not separately present them in the balance sheet. [ASU 2016-02.BC262–BC264]

6.8.130 These requirements are about ensuring that financial statement users get the benefit of what the Board believes is the primary improvement to US GAAP resulting from Topic 842: the recognition of right-of-use assets and lease liabilities for all leases other than short-term leases. The Board wanted users to be able to identify the amounts and where they are included in the balance sheet. [ASU 2016-02.BC262]

6.8.140 The requirement not to include finance lease right-of-use assets and lease liabilities in the same line items as their operating lease counterparts is primarily a function of Board members' understanding that some view finance leases and operating leases as two different types of transactions – one being more similar to a purchase of the underlying asset; the other being simply a rental of another entity's owned asset. [ASU 2016-02.BC263]

KPMG observation – Presentation of operating lease liabilities

6.8.150 The Board chose to characterize operating lease liabilities as operating in nature, rather than debt. Therefore, when considering how to present these liabilities in the balance sheet, entities might consider a presentation similar to what they do for other discounted financial liabilities that are considered operating in nature, such as restructuring liabilities and asset retirement obligations. [ASU 2016-02.BC264]

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7 Lessor accounting

How the standard works

Topic 842 does not make extensive changes to lessor accounting. A lessor will classify leases using criteria similar to current US GAAP, as (1) sales-type, (2) direct financing, or (3) operating leases. Once classified, the accounting model applied to each type of lease is also substantially similar to the lessor accounting model under current US GAAP.

	Balance sheet	Income statement	Cash flow statement
Sales-type and direct financing leases	– Recognize net investment in lease – Derecognize underlying asset	– Selling profit (loss) at lease commencement[1] – Interest income over lease term	– Cash received from leases as operating cash flows
Operating leases	– Continue to recognize underlying asset	– Lease income generally on straight-line basis over lease term	– Cash received from leases as operating cash flows

Note 1:

Selling profit is recognized over the lease term for direct financing leases.

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7.1 An overview

7.1.10 As the following table shows, many of the key concepts and definitions underlying the lessor accounting model are substantially similar to current US GAAP.

Key concept or definition	Meaning in Topic 842
Net investment in the lease	Lease receivable + unguaranteed residual asset
Lease receivable	PV of the lease payments + PV of guaranteed portion of estimated residual value
Unguaranteed residual asset	PV of unguaranteed portion of estimated residual value
Commencement date (section 5.1)	Date on which the lessor makes the underlying asset available for use by the lessee; date of initial recognition and measurement of a lease
Lease term (section 5.3)	Non-cancellable period of the lease + periods covered by lessee option to extend that lessee is reasonably certain to exercise + periods subsequent to lessee termination option that lessee is reasonably certain *not* to exercise + periods covered by a lessor-controlled option to extend or not to terminate
Lease payments (section 5.4)	Undiscounted fixed (including in-substance fixed) payments + optional payments that are reasonably certain to be paid
Discount rate for the lease (section 5.6)	Rate implicit in the lease
Rate implicit in the lease (section 5.6)	Discount rate that balances the following equation. PV of lease payments + PV of estimated residual value = Fair value of the underlying asset + capitalizable initial direct costs

7.1.20 Despite the overall similarities between the lessor accounting guidance in current US GAAP and the lessor accounting guidance in Topic 842, there are some important changes that lessors should be aware of as they implement Topic 842. Despite not wanting to fundamentally change lessor accounting, the Board made a number of changes for one or more the following reasons:

- to align the new lessor accounting guidance with the new lessee accounting guidance;
- to align the new lessor accounting guidance with certain aspects of Topic 606; and/or
- to improve and/or simplify lessor accounting for a long-standing complexity or absence of guidance in current US GAAP.

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7.1.30 The following table summarizes the key changes to the lessor accounting model from current US GAAP. The frequency with which a specific change will arise and the impact of each change when it does arise is not necessarily the same for each of the changes in the table. We have provided our current expectation about the frequency with which each change will arise and the impact we expect the change to have when it does. These are general expectations; the frequency with which each of these changes will arise, and the impact they have when they do, will vary by lessor. For some of the changes below, the frequency of occurrence and/or impact of the change will be so specific to the facts and circumstances that no general expectation is provided.

Key change	Summary
Changes in lease classification between sales-type and direct financing (section 7.2)	Sales-type leases and direct financing leases are no longer differentiated by whether there is manufacturer/dealer profit or loss. Instead, they will be differentiated by whether the lessor transfers substantially all of the risks and benefits of ownership of the underlying asset to only the lessee or to the lessee *and* an unrelated third party.
Frequency Impact	– The changes will result in many current direct financing leases being classified as sales-type leases under Topic 842.
Frequency Impact	– A smaller number of current sales-type leases will be classified as direct financing leases under Topic 842.
Recognition of selling profit (section 7.3.1) Frequency Impact	If selling profit arises from a direct financing lease, it will be deferred and recognized over the lease term.
Narrowed definition of initial direct costs (section 5.5) Frequency Impact	Initial direct costs include only those incremental costs of a lease that would not have been incurred if the lease had not been executed. Some costs (e.g. legal fees and allocated internal costs) that an entity capitalizes as initial direct costs under current US GAAP will be expensed when incurred under Topic 842. For some lessors, this may result in recognizing more expenses before the lease commences and higher margins on lease income earned over the lease term.

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Key change	Summary
Allocation of consideration in the contract to lease and non-lease (e.g. service) components (section 4.4) Frequency: Lessor specific Impact: Lessor specific	Lessors will apply the transaction price allocation guidance in Topic 606, which includes specific guidance on allocating bundled discounts and variable consideration that will be new to lessors.
Executory costs (4.2.20–30) Frequency Impact	Executory costs that do not represent payments for a good or service (e.g. payments to reimburse the lessor for property taxes or insurance) will be allocated to the lease and non-lease components in the same manner as all other payments in the contract; they will not be excluded from lease accounting as they are under current US GAAP.
Collectibility (section 7.6) Frequency Impact	Leases with collectibility uncertainties will no longer be precluded from sales-type lease classification; and Topic 842 includes specific guidance about lease income recognition when collectibility of the lease payments, plus any amounts necessary to satisfy residual value guarantees, is not probable.
Leases with significant variable payments (section 7.2) Frequency Impact	Leases with predominantly variable payments may be classified as sales-type or direct financing leases, which will result in significantly different accounting compared to current US GAAP.
Lease modifications (section 7.7) Frequency Impact: Depends on facts and circumstances	Topic 842 includes guidance on lease modifications that is substantially different from current US GAAP; it was developed to more closely align lessor modification accounting with the contract modification accounting applicable to sellers of goods or services under Topic 606. Lease classification is reassessed on a lease modification that is not accounted for as a separate contract. The lessor accounting for a lease modification depends on the classification of the original *and* the modified lease.

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Key change	Summary
Leveraged leases (section 7.5) Frequency Impact	Leveraged lease classification and accounting is eliminated by Topic 842 for all leases that commence on or after the effective date of Topic 842. Lessors will continue to account for leveraged leases that commence prior to the effective date in accordance with current US GAAP, unless the lease is modified on or after the effective date.

7.2 Lease classification

7.2.10 A lessor determines lease classification for each separate lease component, which is the unit of account in applying Topic 842 (see section 4.1), at the lease commencement date. [842-10-25-1]

7.2.20 Lease classification is only reassessed if the lease is modified and the modification is not accounted for as a separate contract (see section 7.7) [842-10-25-1]

7.2.30 The lease classification tests can be grouped into two parts.

- **Part A.** These tests determine whether a lease is a sales-type lease and are the same as the classification tests for lessees. The outcome of these tests is either (1) the lease is a sales-type lease, or (2) further testing is required (Part B) to classify the lease.
- **Part B.** These tests determine whether the lease is an operating lease or a direct financing lease. [842-10-25-2 – 25-3]

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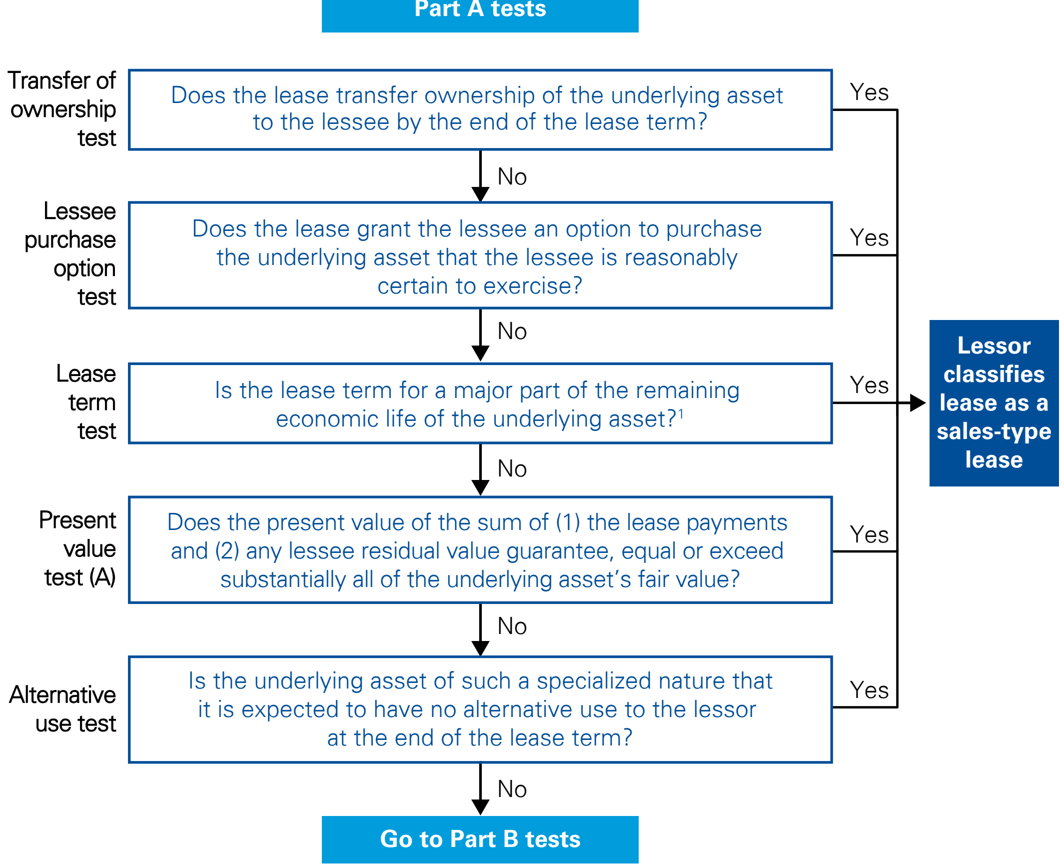

Note 1:

If the commencement date is at or near the end of the underlying asset's economic life, this test does not apply.

7.2.40 Because the Part A lease classification tests are the same for lessors as they are for lessees, our discussion of the application of those tests is mostly in section 6.2 (in the chapter dealing with lessees).

7.2.50 However, there are two additional points relevant to lessors in applying the Part A classification tests.

- The lessor determines the present value of the lease payments and residual value guarantees using the rate implicit in the lease (see section 5.6) – i.e. unlike lessees, a lessor always uses the rate implicit in the lease.
- In determining the rate implicit in the lease for lease classification purposes, a lessor assumes that no initial direct costs will be deferred if, at the commencement date, the fair value of the underlying asset is different from its carrying amount. [842-10-25-4]

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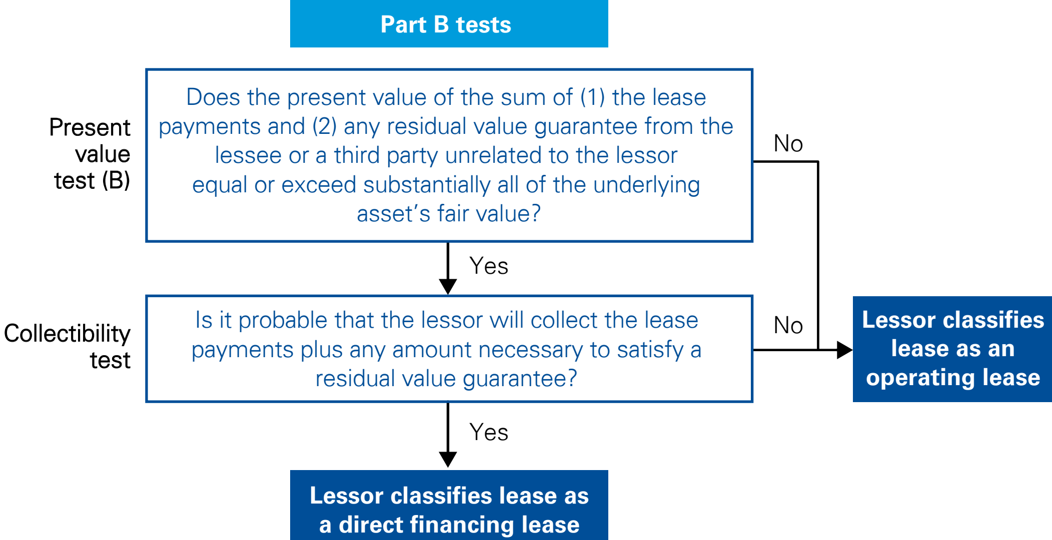

7.2.60 The difference between the present value test in Part A, and the present value test in Part B, is the inclusion in Part B of a residual value guarantee provided by a third party unrelated to the lessee or the lessor (in addition to any residual value guarantee provided by the lessee in the Part A present value test). Consistent with the present value test in Part A, a lessor may use a threshold of 90 percent or more when determining whether the sum of the present value of (1) the lease payments and (2) any residual value guarantees amount to 'substantially all' of the fair value of the underlying asset. Section 6.2 provides additional discussion about 'substantially all'.

7.2.70 The Part B tests focus on whether substantially all of the lessor's risk in the lease is credit risk. When the lessor effectively converts its risk in the nonfinancial residual asset to credit risk (e.g. through a residual value guarantee provided by an unrelated third party or through a combination of residual value guarantees provided by the lessee and an unrelated third party) and collectibility of the lease payments (plus any amount necessary to satisfy the residual value guarantee(s) provided to the lessor) is probable, the lease is a direct financing lease. Otherwise, it is an operating lease.

7.2.80 Under a portfolio residual value guarantee, the lessor is economically assured of receiving a minimum residual value for a portfolio of underlying assets that are subject to separate leases, but not for each individual asset. Any excess of an asset's residual value over the guaranteed amount is offset against shortfalls in residual value that exist in other assets in the portfolio. [842-10-55-9]

7.2.90 Residual value guarantees of a portfolio of underlying assets preclude a lessor from determining the amount of the guaranteed residual value of any individual underlying asset within the portfolio. Consequently, such amounts are ignored when evaluating the present value test for lease classification purposes.[1] [842-10-55-10]

Note 1:

It is unclear presently whether the Board intended for this provision related to lease classification to also apply to lessees.

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US GAAP different from IFRS – IFRS 16 does not distinguish between sales-type and direct financing leases

7.2.100 Consistent with current IFRS, IFRS 16 does not distinguish between sales-type and direct financing leases. Lessors will account for their leases as either finance or operating leases, like they do today. In most respects, the two classification system (finance or operating) for lessors under current IFRS and the four classification system (sales-type, direct financing, leveraged, or operating) for lessors under current US GAAP does not result in substantial lessor accounting differences. Similarly, it is not expected that the two classification system for lessors under IFRS 16 and the three classification system for lessors under Topic 842 will result in substantial lessor accounting differences going forward. [IFRS 16.61–66]

Comparison with current US GAAP

7.2.110 In general, the lease classification guidance in Topic 842 is likely to result in operating lease classification for most leases classified as operating leases under current US GAAP.

7.2.120 The following table summarizes the key differences in lease classification between current US GAAP and Topic 842 applicable to lessors. [842-10-25]

Current US GAAP	Topic 842
Sales-type lease	
Results when the lease meets: – any one of the criteria in paragraph 840-10-25-1; – both of the criteria in paragraph 840-10-25-42; and – the fair value of the underlying asset does not equal its carrying amount.	Results when the lease passes any one of the five tests in 7.2.30, regardless of whether the fair value of the underlying asset equals the carrying amount of the underlying asset.
Effect Many leases classified as direct financing leases under current US GAAP will be classified as sales-type leases under Topic 842; however, the accounting effect of that difference in classification will typically be insignificant. In contrast, relatively few leases classified as sales-type leases under current US GAAP will be classified as direct financing leases under Topic 842; but the accounting effect will be significant for those leases, because the selling profit, which is recognized at lease commencement under current US GAAP, will be deferred and recognized over the lease term instead (see section 7.3.1).	

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Current US GAAP	Topic 842
Direct financing lease	
Results when the lease meets: – any one of the criteria in paragraph 840-10-25-1; – both of the criteria in paragraph 840-10-25-42; and – the fair value of the underlying asset equals its carrying amount.	Results when the lease is not a sales-type lease, but the Part B tests are both passed (see diagram in 7.2.50).
Effect The same as discussed for sales-type leases.	

Current US GAAP	Topic 842
Leveraged leases	
Results when the lease meets: – the criteria to be classified as a direct financing lease; and – three additional specified criteria in paragraph 840-10-25-43(c).	Leveraged lease classification and accounting no longer exists prospectively from the effective date of Topic 842 (see section 13.6).
Effect Leases that commence on or after the effective date of Topic 842 that would be classified as leveraged leases under current US GAAP will be accounted for differently. In addition, any grandfathered leveraged leases that are modified on or after the effective date are no longer accounted for as leveraged leases after the modification date.	

Current US GAAP	Topic 842
Real estate leases	
Real estate leases are subject to classification requirements different from other leases. For example, a real estate lease can only be a sales-type lease if ownership is transferred to the lessee.	Real estate leases no longer have special rules; they are subject to the same guidance as all other leases.
Effect Lease classification for real estate leases under Topic 842 will differ more significantly from current US GAAP than for other leases. More real estate leases will likely be classified as sales-type or direct financing leases under Topic 842.	

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Current US GAAP	Topic 842
Collectibility uncertainties	
If collectibility of the minimum lease payments is not reasonably predictable, the lease is classified as an operating lease. An exception is when the underlying asset is real estate and ownership transfers to the lessee.	Collectibility uncertainties do not preclude a lease from being classified as a sales-type lease. However, a lease cannot be classified as a direct financing lease if the collectibility test is failed (see diagram in 7.2.50).
Effect Some leases currently classified as operating leases because of collectibility uncertainties will be classified as sales-type leases under Topic 842. For a discussion of collectibility considerations for lessors, see section 7.6.	

Current US GAAP	Topic 842
Unreimburseable costs	
If there are important uncertainties as to the amount of unreimburseable costs that the lessor will incur under the lease, the lease is classified as an operating lease. An exception is a lease of real estate that transfers ownership to the lessee.	There is no similar lease classification test in Topic 842.
Effect Some leases currently classified as operating leases because of failing to meet this criterion will be classified as sales-type or direct financing leases under Topic 842. This includes some leases that are currently classified as operating leases under this criterion because a significant portion of the payments for the lease are variable.	

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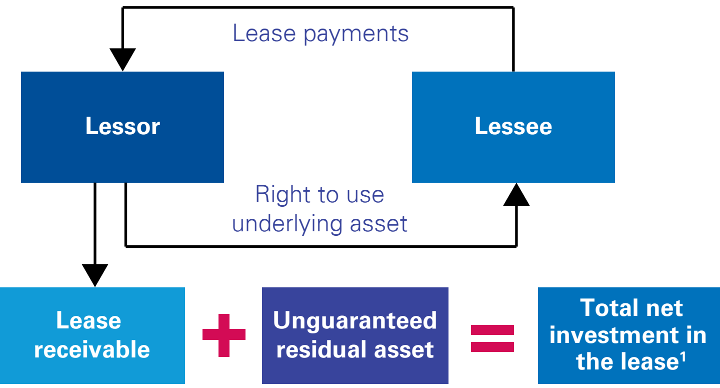
7.3 Sales-type and direct financing leases

7.3.1 An overview

7.3.10 For sales-type and direct financing leases, a lessor recognizes a net investment in the lease in its balance sheet and derecognizes the underlying asset. [842-30-25-1, 25-7,40-1]



Note 1:

If the lease is a direct financing lease, any selling profit is deferred and the deferred selling profit reduces the net investment in the lease.

7.3.20 For a **sales-type lease**, the lessor's net investment in the lease comprises:

- a lease receivable (see 7.3.50); and
- an unguaranteed residual asset for the lessor's interest in the underlying asset's estimated future value at the end of the lease term that is not guaranteed by either:
  - the lessee; or
  - another third party unrelated to the lessor. [842-30-30-1]

7.3.30 For a **direct financing lease**, the lessor's net investment in the lease comprises (is):

- a lease receivable and an unguaranteed residual asset (calculated in the same way as for a sales-type lease);
- reduced by any selling profit on the lease, which is deferred and recognized over the lease term; it is not recognized at lease commencement as it is for a sales-type lease. [842-30-25-8, 30-2]

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7.3.40 The selling profit or selling loss on the lease is:

– the lower of: (1) the fair value of the underlying asset or (2) the sum of the lease receivable + any prepaid lease payments;

– minus the carrying amount of the underlying asset, net of any unguaranteed residual asset;

– minus any initial direct costs (see section 5.5) of the lessor that are deferred (i.e. capitalized) – see 7.3.60. [842 Glossary]

7.3.2 Initial recognition and measurement

7.3.50 For a sales-type lease or a direct financing lease, the lessor initially measures the lease receivable at the present value of the following, discounted at the rate implicit in the lease (see section 5.6):

– future lease payments receivable over the lease term; and

– any portion of the estimated residual value at the end of the lease term that is guaranteed (either by the lessee or by a third party unrelated to the lessor). [842-30-30-1(a), 30-2]

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7.3.60 At lease commencement, a lessor recognizes any selling profit (loss) and initial direct costs as follows. [842-30-25-1, 25-7 – 25-8, 30-1 – 30-2]

<table>
<tr><th>Sales-type lease</th><th>Direct financing lease</th></tr>
<tr><th colspan="2">Selling profit</th></tr>
<tr><td>Recognize at lease commencement</td><td>Defer as a reduction of the net investment in the lease</td></tr>
<tr><th colspan="2">Selling loss</th></tr>
<tr><td colspan="2">Recognize at lease commencement</td></tr>
<tr><th colspan="2">Initial direct costs</th></tr>
<tr><td>– If the fair value of the underlying asset does not equal its carrying amount:
» Expense at lease commencement.
» Exclude from determination of the rate implicit in the lease (see Example 7.2, Scenario 1)
– If the fair value of the underlying asset equals its carrying amount:
» Defer and include in the net investment in the lease[1]
» Include in determination of the rate implicit in the lease (see Example 7.2, Scenario 2)</td><td>– Defer and include in the net investment in the lease[1]
– Include in determination of the rate implicit in the lease</td></tr>
</table>

Note 1:

The rate implicit in the lease is defined in such a way that the initial direct costs eligible for deferral are included automatically in the net investment in the lease; there is no need to add them separately.

7.3.70 A lessor initially measures the unguaranteed residual asset as the present value of the amount that the lessor expects to derive from the underlying asset following the end of the lease term that is *not* guaranteed by the lessee or any other third party unrelated to the lessor, discounted using the rate implicit in the lease. [842-30-30-1(b), 30-2]

7.3.80 Notwithstanding the above general guidance on the initial recognition and measurement of a sales-type lease, an exception arises if collectibility of the lease payments and any lessee residual value guarantee is not probable. For a discussion of the accounting that applies under the exception, see section 7.6. [842-30-25-3 – 25-6]

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7.3.3 Subsequent accounting

7.3.90 After the lease commencement date, the lessor measures the net investment in the lease by:

- increasing the carrying amount to reflect interest income resulting from amortization of the lease receivable and accretion of the unguaranteed residual asset (and recognition of deferred selling profit, if any, for direct financing leases); and
- reducing the carrying amount to reflect lease payments received. [842-30-35-1]

7.3.100 The lessor uses the effective interest method to both (1) amortize the lease receivable and (2) accrete the unguaranteed residual asset to its estimated future value at the end of the lease term.

7.3.110 A lessor only remeasures its net investment in the lease after initial measurement if the lease is modified and that modification is not accounted for as a separate contract (see section 7.7). [842-30-35-2]

7.3.120 After the lease commencement date, the lessor recognizes:

- interest income on the net investment in the lease, as described in 7.3.90;
- variable lease payments as income in profit or loss in the period in which the changes in facts and circumstances on which those payments are based occur; and
- impairment of the net investment in the lease, as described in 7.3.130. [842-30-25-2, 25-9]

Impairment of the net investment in the lease

7.3.130 The lessor assesses its entire net investment in the lease for impairment, and recognizes any impairment loss, in accordance with the impairment guidance for financial instruments. A lessor does *not* separately evaluate the unguaranteed residual asset for impairment (except in accordance with 7.3.140), or review the estimated residual value of the underlying asset as lessors do under current US GAAP. When determining the loss allowance for a net investment in the lease, the lessor considers the collateral relating to the net investment in the lease. The collateral represents the cash flows that the lessor would expect to derive from the underlying asset during the remaining lease term (e.g. from the sale or re-lease of the asset for the remainder of the lease term) and excludes the cash flows that the lessor would expect to derive from the underlying asset after the end of the lease term (e.g. cash flows from re-leasing the asset after the end of the lease term). [842-30-35-3]

Sale of the lease receivable

7.3.140 If the lessor sells the lease receivable and retains an interest in the unguaranteed residual asset, the lessor no longer accretes the unguaranteed residual asset to its estimated future value over the lease term. The lessor reports any remaining unguaranteed residual asset at its carrying amount at the date of the sale of the lease receivable, and applies Topic 360 (property, plant, and equipment) to determine whether the unguaranteed residual asset is impaired. [842-30-35-4]

Accounting for the underlying asset at the end of the lease term

7.3.150 At the end of the lease term, the lessor reclassifies the net investment in the lease to the appropriate asset category in accordance with other US GAAP, measured at the carrying amount of the net investment in the lease. The lessor accounts for the underlying asset in accordance with other US GAAP. [842-30-35-5]

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Accounting for lease terminations

7.3.160 If a sales-type or direct financing lease is terminated before the end of the lease term, the lessor:

- tests the net investment in the lease for impairment;
- reclassifies the net investment in the lease to the appropriate asset category in accordance with other US GAAP, measured at the sum of the carrying amount of the lease receivable (less amounts still expected to be received by the lessor) and the residual asset; and
- accounts for the underlying asset in accordance with other US GAAP. [842-30-40-2]

7.3.170 If a lease agreement is replaced by a new lease agreement with a new lessee, the lessor accounts for the termination of the original lease (see 7.3.160) and accounts for the new lease in same manner as it would any other new lease.

Example 7.1
Recognition of selling profit for a direct financing lease

7.3.180 Lessor LR leases a non-specialized machine to Lessee LE for three years. The following facts are relevant at the lease commencement date.

Lease payments:	Fixed payments of $10,500 per year in arrears
Renewal/purchase options:	None
Transfer of ownership:	No
Fair value of machine:	$40,000
Carrying amount of machine:	$36,000
Remaining economic life of machine:	5 years
Estimated future residual value:	$12,500
Residual value guarantee (third party other than LE):	$9,200
Rate implicit in the lease:	4.29%

7.3.190 In addition:

- At the commencement date, the present value of the future lease payments is 93% of the fair value of the machine (with the residual value guarantee), and 72% of the fair value of the machine (without the residual value guarantee).
- There are no prepaid lease payments and LR has not incurred any initial direct costs.

Lease classification

7.3.200 In this example, the lease is a direct financing lease as a result of the third-party (non-lessee) residual value guarantee, which is included in the present value test in Part B (see diagram in 7.2.50).

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Initial measurement

7.3.210 At the commencement date, LR records the following entry.

	Debit	Credit
Lease receivable[1]	37,091	
Unguaranteed residual asset[2]	2,909	
Property, plant, and equipment		36,000
Deferred profit[3]		4,000
To recognize direct financing lease		

Notes:

1. Present value of: contractual lease payments ($10,500 x 3) + residual value guarantee ($9,200), discounted at 4.29%.
2. Present value of unguaranteed residual asset of $3,300 ($12,500 - $9,200), discounted at 4.29%.
3. Fair value of underlying asset ($40,000) - carrying amount ($36,000). This is the same as the difference between the lease receivable ($37,091) and the carrying amount of the machine, net of the unguaranteed residual asset ($33,091).

End of Year 1

7.3.220 LR records the following entry at the end of Year 1.

	Debit	Credit
Cash	10,500	
Unguaranteed residual asset[1]	125	
Deferred profit[2]	1,637	
Lease receivable[3]		8,909
Interest income[4]		3,353
To recognize interest, accretion, and deferred selling profit in Year 1		

Notes:

1. Accretion of unguaranteed residual asset ($2,909 × 4.29%).
2. Total lease income of $3,353 ($36,000 × 9.31%) - interest on lease receivable ($1,591) - accretion of unguaranteed residual asset ($125). 9.31% is the discount rate that would have been required at lease commencement for the lease receivable + the unguaranteed residual asset to equal $36,000.
3. Cash payment of $10,500 - interest on lease receivable of $1,591 ($37,091 × 4.29%).
4. Accretion of unguaranteed residual asset ($125) + interest on lease receivable ($1,591) + release of deferred profit ($1,637). Alternative calculation: $36,000 × 9.31%.

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Effect on the financial statements

7.3.230 The following table summarizes the amounts arising in LR's balance sheet (in which LR presents its net investment in the lease, rather than the components in the table) and income statement.

Balance sheet					Income statement			
End of year	Lease receivable	Unguar. resid. asset	Deferred profit[1]	Net invest. in lease	Interest on receivable[2]	Residual accretion[2]	Earned profit[3]	Total income[3]
0	$37,091	$2,909	($4,000)	$36,000	$ –	$ –	$ –	$ –
1	28,182	3,034	(2,363)	28,853	1,591	125	1,637	3,353
2	18,891	3,164	(1,015)	21,040	1,209	130	1,348	2,687
3	9,200	3,300	–	12,500	809	136	1,015	1,960
	Totals				**$3,609**	**$391**	**$4,000**	**$8,000**

Notes:

1. Subsequent to lease commencement, deferred selling profit recognition = total income - interest on the lease receivable - unguaranteed residual asset accretion.
2. Interest on the lease receivable and unguaranteed residual asset accretion are calculated using the rate implicit in the lease that is derived by using the machine's fair value at lease commencement of $40,000 as the initial investment (4.29%).
3. Total income, including release of deferred profit, is allocated so that it is recognized at a constant rate equal to the discount rate derived by using the machine's carrying amount at lease commencement ($36,000) as the initial net investment (9.31%).

End of lease

7.3.240 LR records the following entry at the end of the lease.

	Debit	Credit
Property, plant, and equipment	12,500	
Net investment in the lease		12,500
To recognize termination of direct financing lease		

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Example 7.2
Accounting for initial direct costs in a sales-type lease

Scenario 1: Fair value of underlying asset does not equal its carrying amount

7.3.250 Lessor LR leases a commercial truck to Lessee LE for five years. The following facts are relevant at the lease commencement date.

– Lease payments:	Fixed payments of $10,500 per year in arrears; none are prepaid
– Renewal/purchase options:	None
– Transfer of ownership:	No
– Fair value of truck:	$56,000
– Carrying amount of truck:	$53,000
– Total economic life of truck:	12 years
– Remaining economic life of truck:	6 years
– Estimated future residual value:	$15,000
– Initial direct costs:	$400

Lease classification

7.3.260 In this example, the lease is a sales-type lease because the lease term of five years represents a major part (i.e. 83%) of the underlying asset's remaining economic life (see diagram in 7.2.30).

Calculation of rate implicit in the lease

7.3.270 At lease commencement, the fair value of the truck is different from its carrying amount. Therefore, the initial direct costs will be expensed at lease commencement and the rate implicit in the lease is determined based on the fair value of the underlying asset, *without regard to initial direct costs*. The rate implicit in the lease is therefore 5.68%, determined as follows.

Year	Initial investment	Lease payments	Residual value	Net receipts/ payments
0	**$(56,000)**	$ -	$ -	$(56,000)
1		10,500	-	10,500
2		10,500	-	10,500
3		10,500	-	10,500
4		10,500	-	10,500
5		10,500	15,000	25,500
			Rate	**5.68%**

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Scenario 2: Fair value of underlying asset equals its carrying amount

7.3.280 Assume the same facts as Scenario 1, except that, at the lease commencement date, coincidentally the truck has a fair value and a carrying amount to LR of $56,000.

7.3.290 In this scenario, because the fair value of the truck equals its carrying amount at lease commencement, the initial direct costs of $400 are considered when determining LR's implicit rate, and are deferred as part of the net investment in the lease as a result of the implicit rate determined. The rate implicit in the lease is therefore 5.45%, determined as follows.

Year	Initial investment	Lease payments	Residual value	Net receipts/ payments
0	**$(56,400)**	$ -	$ -	$(56,400)
1		10,500	-	10,500
2		10,500	-	10,500
3		10,500	-	10,500
4		10,500	-	10,500
5		10,500	15,000	25,500
			Rate	**5.45%**

Comparing Scenarios 1 and 2

7.3.300 Including the initial direct costs of $400 when determining the rate implicit in the lease in Scenario 2 results in deferring the initial direct costs and recognizing them in net income through lower interest income over the lease term as compared to Scenario 1 (in which the initial direct costs are expensed at lease commencement).

KPMG observation – Asymmetric measurement of the lessor's lease assets and the lessee's lease liability

7.3.310 The measurement of the lessor's lease receivable will differ from the measurement of the lessee's lease liability in many cases. The following are just some of the reasons for a difference.

- The **lessor's** lease receivable includes the present value of any residual value guarantee (whether obtained from the lessee or another third party unrelated to the lessor). The **lessee's** lease liability includes only the present value of amounts that it is probable of owing to the lessor under a residual value guarantee that it provides.
- The **lessor** always uses its implicit rate as the discount rate for the lease. The **lessee** typically uses its incremental borrowing rate as the discount rate for the lease because the information it would need to determine the lessor's implicit rate is generally not readily determinable (see KPMG observation at 5.6.140).
- In addition to the fact that the amount of initial direct costs for the lessee and the lessor will typically differ, the **lessor** will either expense initial direct costs at lease

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commencement or include such amounts in its net investment in the lease – i.e. because the initial direct costs are deferred through the implicit rate, they are included in both the lease receivable and the unguaranteed residual asset. In contrast, the **lessee** includes initial direct costs in the measurement of its right-of-use asset, rather than as part of its lease liability.

7.3.320 Other measurement differences will arise in practice due to information asymmetry; for example, different assessments as to whether it is reasonably certain that the lessee will exercise a renewal or a purchase option.

KPMG observation – Selling profit deferred for direct financing leases at lease commencement and recognized over the lease term

7.3.330 Direct financing leases exist in Topic 842 because the Board concluded that a lease is not a sales-type lease unless the customer, in effect, obtains control of – i.e. the ability to direct the use of, and obtain substantially all the remaining benefits from – the underlying asset as a result of the lease. This customer perspective is consistent with the customer perspective of a sale in Topic 606. The Board considered that it would be inappropriate, and would potentially create structuring opportunities for entities that are typically sellers (rather than lessors), to recognize selling profit even if control does not pass to the customer by structuring a sale as a sales-type lease. [ASU 2016-02.BC95]

7.3.340 However, the Board still recognized that a lessor might effectively convert its risk arising from ownership of the underlying asset (i.e. asset risk) into credit risk. It concluded that the most faithful representation of the lessor's involvement in a lease in that case is to recognize a *financial* net investment in the lease and financial (interest) income on that net investment. [ASU 2016-02.BC96]

KPMG observation – Selling loss recognized at lease commencement for sales-type and direct financing leases

7.3.350 Even though a lessor defers selling *profit* arising from a direct financing lease under Topic 842, it recognizes at lease commencement any selling *loss* on a direct financing lease. If the lessor considers other applicable guidance (e.g. the long-lived asset or inventory impairment guidance), that guidance would generally result in recognition of a loss on the underlying asset. For example, the pricing in the lease might be evidence that the cash flows to be derived from the underlying asset will be less than its carrying amount, resulting in the recognition of an impairment. Therefore, the approach of recognizing a selling loss up-front is consistent with the idea that the presence of the selling loss might just be indicative of an existing impairment. [ASU 2016-02.BC98]

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KPMG observation – Net investment in the lease assessed for impairment under financial instruments guidance

7.3.360 A lessor is required to assess the entire net investment in the lease for impairment using the impairment guidance for financial instruments. Although the unguaranteed residual asset does not meet the definition of a financial asset, the Board thought it would be complex and provide little benefit to users to require entities to separately assess the components of the net investment for impairment – i.e. assess the lease receivable in accordance with the financial instruments impairment guidance and the unguaranteed residual asset in accordance with long-lived assets impairment guidance. [ASU 2016-02.BC310]

7.3.370 Additionally, to be classified as a sales-type lease or a direct financing lease, the unguaranteed residual asset will generally be small in comparison to the lease receivable. Or, in some cases, there may be no unguaranteed residual asset at all; for example, if the lease is classified as a sales-type lease because it transfers ownership of the underlying asset to the lessee, or grants the lessee a purchase option that the lessee is reasonably certain to exercise. Because most of the net investment in the lease will comprise the lease receivable (i.e. a financial asset), it was deemed appropriate for a lessor to assess the entire net investment in the lease for impairment based on the guidance for financial instruments. [ASU 2016-02.BC311]

7.3.380 When determining the loss allowance for the net investment in the lease, a lessor considers the collateral related to the lease receivable. This is because it represents cash flows that the lessor would expect to derive from the underlying asset during the remaining lease term. When a lessee defaults on its lease payments, however, the lessor retains its rights to that collateral. Therefore, it would be unusual for the lease receivable to be impaired when the residual asset is not also impaired. This further supports the Board's decision to require assessment of the entire net investment in the lease for impairment, rather than to assess each component separately. [ASU 2016-02.BC311]

KPMG observation – No requirement for lessors to reassess key lease estimates and judgments

7.3.390 Unlike lessees, lessors do *not* reassess key lease estimates and judgments after lease commencement (e.g. lease classification, lease term, the likelihood of the lessee to exercise of a purchase option, or the discount rate on sales-type and direct financing leases) unless the lease is modified and that modification is not accounted for as a separate contract (see section 7.7). The Board decided not to subject lessors to the same reassessment requirements as lessees primarily because of its decision to substantially retain lessor accounting under current US GAAP. This simplifies lessor accounting compared to lessee accounting and may limit volatility in the lessor's financial statements. Excluding lessors from the reassessment requirements also helps to align the lessor accounting guidance in Topic 842 with the guidance in current US GAAP. [ASU 2016-02.BC314]

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7.3.400 However, while lessors will not reassess key *lease* estimates and judgments, in some cases a lessor will be required to reassess estimates of variable consideration that relates to a non-lease component of the contract if that variable consideration is part of the 'consideration in the contract' (see section 4.3).

KPMG observation – Leases with significant variable lease payments

7.3.410 For leases with significant variable lease payments (e.g. in some renewable energy arrangements), the undiscounted sum of the following may be less than the underlying asset's fair value and/or carrying amount at lease commencement: (1) the lease payments, and (2) the estimated residual value of the underlying asset at the end of the lease term. In that case, sales-type lease classification for these leases, which could occur based on the lease term compared to the remaining economic life of the asset or the specialized nature of the asset, would require loss recognition at lease commencement if one assumes that the discount rate for the lease must be positive, even if the lessor expects the lease to ultimately be profitable.

7.3.420 Topic 842 requires the lessor to use the rate implicit in the lease as the discount rate for the lease – i.e. to measure its net investment in the lease. That rate is defined in a way that generally requires the present value of (1) the lease payments, and (2) the estimated residual value of the underlying asset at the end of the lease term, to be no less than the underlying asset's fair value at lease commencement. For leases with significant variable lease payments, following that definition could mean that the lessor would be required to use a negative discount rate. Doing so would mean that no loss would be recognized at lease commencement unless the fair value of the underlying asset is less than its carrying amount.

7.3.430 It is not clear whether the Board considered the possibility (or expected) that discount rates could be negative based on the definition of the rate implicit in the lease. In addition, it is not clear to what extent the fact that Topic 606 may require up-front loss recognition in arrangements with significant variable (or contingent) consideration even if the seller expects the arrangement to ultimately be profitable factored into the Board's consideration of these leases. We expect the accounting for these transactions to generate further debate during the implementation period given the interplay between sales-type lease accounting and the revenue recognition guidance in Topic 606, and the current ambiguity around the Board's intent about lessor discount rates in these leases.

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US GAAP different from IFRS – Different treatment of selling profit for direct financing leases

7.3.440 Lessors applying IFRS 16 recognize a profit or loss at commencement for a finance lease equal to the difference between the fair value and carrying amount of the underlying asset. IFRS 16 does not differentiate between finance leases that are classified as such only as a result of third-party residual value support (e.g. third-party residual value guarantees or buy-back agreements) and those that are classified as finance leases for other reasons. [IFRS 16.71]

7.3.450 As outlined in 7.2.60, third-party residual value support can result in a lease being classified as a direct financing lease, but not as a sales-type lease, under Topic 842. Any selling profit on a direct financing lease is deferred at lease commencement and recognized over the lease term. Consequently, for leases classified as direct financing leases under Topic 842, there will be a difference in lessor accounting between IFRS and US GAAP when there is selling profit that results from the lease.

7.3.460 Example 7.1 (Topic 842) and the corresponding IFRS solution in 7.3.480–490 illustrate the different accounting that would result in those scenarios. Practically, however, this difference in the guidance between IFRS 16 and Topic 842 may not result in a significant IFRS/US GAAP accounting difference because most leases that include third-party residual value support (namely, those of financial intermediaries who purchase the underlying asset contemporaneously with lease commencement) do not give rise to selling profit.

7.3.470 The FASB believes its differing accounting treatment for sales-type leases and direct financing leases substantially aligns the requirements for recognition of up-front profit in a lease with the requirements for recognition of a sale in Topic 606. The IASB decided that its central decision to significantly limit lessor accounting changes overrode any conceptual questions about whether leases that achieve finance lease accounting only through third-party involvement are consistent with the sale principle in IFRS 15, which focuses on the customer *obtaining* control of the asset, rather than on the seller's *transferring* of control. [IFRS 16.71(c)]

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Comparison of lessor accounting between Topic 842 and IFRS 16

7.3.480 Using the fact pattern in Example 7.1 (Topic 842), the following table summarizes the amounts arising in Lessor LR's balance sheet (in which LR presents its net investment in the lease, rather than the components in the table) and income statement.

Balance sheet				Income statement			
End of year	Lease receivable	Unguar. resid. asset	Net investment in lease	Interest on receivable	Residual accretion	Earned profit[1]	Total income
0	$37,091	$2,909	$40,000	$ –	$ –	$4,000	$4,000
1	28,182	3,034	31,216	1,591	125		1,716
2	18,891	3,164	22,055	1,209	130		1,339
3	9,200	3,300	12,500	809	136		945
	Totals			**$3,609**	**$391**	**$4,000**	**$8,000**

Note 1:

Earned selling profit calculated in the same manner as deferred selling profit under Topic 842 (see 7.3.40).

7.3.490 As illustrated above, the timing of profit recognition and the periodic rate of return on LR's net investment in the lease may be significantly different for some direct financing leases under US GAAP compared to IFRS finance leases (and US GAAP sales-type leases).

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Comparison with current US GAAP – Sales-type and direct financing leases

The concept of deferred selling profit does not exist in current US GAAP

7.3.500 Under current US GAAP, any selling profit in a lease that meets one of the criteria in paragraph 840-10-25-1 and both criteria in paragraph 840-10-25-42 is recognized at lease commencement. Selling profit is never deferred as it will be for a direct financing lease under Topic 842.

While the population of initial direct costs is changed, the accounting for initial direct costs is unchanged

7.3.510 Section 5.5 discusses that the definition of initial direct costs is substantially narrowed from that in current US GAAP. As a result, many entities will recognize significant origination costs for a lease as incurred that they do not recognize as incurred currently. Lessors in that situation will recognize greater margins on their lease income earned over the lease term (e.g. operating lease income or interest income on their direct financing leases) and potentially on their selling profit earned at lease commencement – i.e. if a sales-type lessor incurs origination costs that are expensed at lease commencement under current US GAAP (at the same time selling profit or loss is recognized), but are expensed when incurred under Topic 842.

7.3.520 However, the accounting for those costs that meet the definition of initial direct costs under Topic 842 is substantially consistent with the accounting for those costs that meet the definition of initial direct costs in current US GAAP (see section 7.3.1).

7.3.530 However, there is a *mechanical* difference in the accounting.

- Under current US GAAP, initial direct costs for direct financing leases are recognized as an asset and that asset is amortized to income together with the unearned income so as to produce a constant periodic rate of return on the net investment in the lease – i.e. using the effective interest method. [840-30-30-11]
- Under Topic 842, the rate implicit in the lease is such that initial direct costs eligible for deferral are included automatically in the net investment in the lease; there is no need to add them separately.

7.3.540 The result is that the rate implicit in the lease is the same as the constant periodic rate of return on the net investment in the lease. Although the accounting for initial direct costs under Topic 842 is mechanically different from current US GAAP, that changed methodology does not affect total assets or periodic net income.

7.3.550 Lessor accounting for initial direct costs for operating leases is consistent with current US GAAP – i.e. recognize initial direct costs as a separate asset and amortize to expense over the lease term on the same basis as lease income (see 7.4.10). [840-20-25-16, 35-2]

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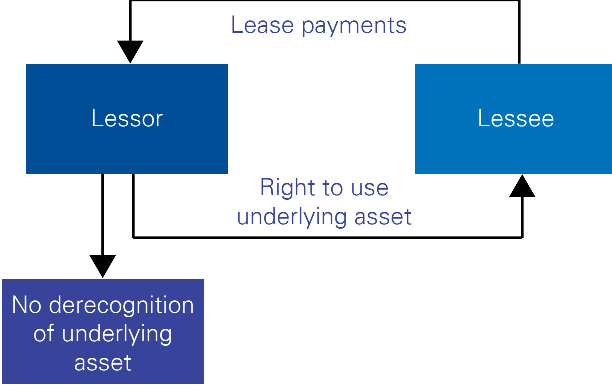
7.4 Operating leases

7.4.10 For operating leases, at the commencement date:

- The lessor continues to recognize the underlying asset and depreciate it over its estimated useful life.
- The lessor continues to measure the underlying asset in accordance with other US GAAP, including testing for impairment in accordance with the guidance on impairment or disposal of long-lived assets.
- Lease payments under the contract are recorded as receivables only when they are due and payable by the lessee. Consequently, there is no interest income recognition.
- Lease income is recognized on a straight-line basis unless another systematic and rational basis is more representative of the pattern in which income is earned from the underlying asset.
- Variable lease payments are recorded as income in profit or loss in the period in which the changes in facts and circumstances on which those payments are based occur.
- Initial direct costs are initially deferred and recognized as expense over the lease term on the same basis as lease income. [842-30-25-10 – 25-11, 30-4]



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KPMG observation – Operating lease accounting substantially unchanged from current US GAAP

7.4.20 Lessor accounting for operating leases is (in broad terms) substantially the same as operating lease accounting under current US GAAP.

7.4.30 However, operating lease income under Topic 842 may not always be the same as that recognized under current US GAAP. A difference is most likely to arise because of changes to the guidance on identifying and separating components of a contract, and allocating consideration in the contract to lease and non-lease components (see chapter 4). For example, differences in the separation and allocation guidance can affect the amount of lease and non-lease income recognized; this will result, in some cases, from lessors applying the allocation guidance in Topic 606. In addition, lessors may also see effects resulting from Topic 606 on their revenue recognition for non-lease components – i.e. potentially how they recognize revenue for some services or supply arrangements that accompany the lessor's leases.

KPMG observation – Operating leases give rise to lease receivables that will not be recognized

7.4.40 The Board concluded that all leases, including operating leases, give rise to a lease receivable for the lessor. When the lessor makes the underlying asset available for use by the lessee, the lessor has fulfilled its obligation to transfer the right to use that asset to the lessee – the lessee controls the right of use and has a liability to make lease payments. Accordingly, the lessor has a lease receivable. The lessor controls that right to payment (e.g. it can decide to sell or securitize that right). [ASU 2016-02.BC75]

7.4.50 In deciding not to substantially change lessor accounting (and therefore to not require lessors to recognize those lease receivables), the Board made a cost-benefit decision that the conceptual merits for a substantial change to lessor accounting did not provide sufficient benefits to financial statement users (i.e. investors and analysts, bankers, etc.) to justify the costs to lessors of enacting that change. [ASU 2016-02.BC88–BC90]

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7.5 Leveraged leases

7.5.10 Leveraged leasing transactions typically provide significant tax and financial reporting benefits for lessors applying US GAAP. Leveraged leases usually involve capital intensive assets such as airplanes and power plants that are leased for extended periods (e.g. 25 years or more). However, these transactions have become more infrequent in recent years due to changes in interest rates and investment tax incentives.

7.5.20 Topic 842 eliminates leveraged lease accounting for leases that commence on or after the effective date. Instead, a lessor accounts for all leases as sales-type, direct financing, or operating leases. Leveraged leases that *commence* prior to the effective date of Topic 842 are not subject to its requirements – i.e. leveraged lease accounting continues. However, leveraged leases that are *modified* after the effective date of Topic 842 are subject to Topic 842 at the effective date of the modification – i.e. grandfathering is terminated. [842-10-65-1(z); 842-50]

7.5.30 The exercise of a renewal option by the lessee 'that it was not previously reasonably assured to exercise' is considered a lease modification. If this occurs, the lease no longer is a leveraged lease and the lessor applies Topic 842 to the lease from the date of exercise – i.e. the lease loses its grandfathered status. [842-50-15-1]

7.5.40 The exercise of a lessee renewal option that is in the lease contract, regardless of whether the lessee was reasonably certain to exercise that option, is not considered a lease modification under any other circumstance in Topic 842.

KPMG observation – Decision to grandfather leveraged leases

7.5.50 The Board's decision to eliminate leveraged lease accounting was intended to reduce complexity in the lessor accounting requirements and to converge with IFRS, which has no specialized accounting for leveraged leases (see 7.5.70).

7.5.60 However, the Board decided to grandfather leveraged leases that commence prior to the effective date of Topic 842, on the basis that the costs for lessors to unwind their accounting would exceed the benefit to financial statement users of doing so. This decision requires lessors with leveraged leases to retain their existing systems and controls for those transactions until the leases are terminated, which may be several decades. Therefore, lessor accounting for similar leases may differ solely depending on whether the lease commences shortly before or shortly after the effective date. As a result, the decision to grandfather existing leveraged leases may make it difficult for financial statement users to compare the financial statements of those lessors to those of other lessors prepared under US GAAP and IFRS. [ASU 2016-02.BC397]

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US GAAP different from IFRS – No leveraged lease guidance under IFRS

7.5.70 Current IFRS does not include guidance on leveraged leases; therefore, the IASB did not consider whether to retain such accounting or grandfather any existing leases subject to that accounting. Because IFRS does not have leveraged lease accounting, the FASB's decision to grandfather existing leveraged leases (which are often very long-term leases) will perpetuate the existing lessor accounting difference between IFRS and US GAAP for many years to come.

7.6 Collectibility

7.6.10 This section discusses how a lessor assesses collectibility for different types of leases, and the accounting implications.

7.6.20 A lessor does not reassess lease classification unless the lease is modified and that modification is not accounted for as a separate contract (see section 7.7). Therefore, changes in the assessment of collectibility after the commencement date do not affect the classification of the lease, regardless of whether the change is positive (i.e. collectibility becomes probable) or negative (i.e. collectibility is determined to no longer be probable). For example, a lease that was classified as an operating lease at lease commencement solely because of collectibility issues is not reclassified as a direct financing lease if collectibility subsequently becomes probable. [842-10-25-3(b)(2), 842-30-55-25 – 55-30, 55-40 – 55-43]

Sales-type leases

7.6.30 The collectibility of the lease payments and any amount necessary to satisfy a lessee residual value guarantee is assessed *after* a lease has been classified as a sales-type lease. The collectibility assessment does not affect the classification of the lease, but it can change the accounting outlined in section 7.3.

7.6.40 If collectibility of the lease payments, plus any amount necessary to satisfy a *lessee* residual value guarantee, is not probable at the commencement date, the lessor does *not* derecognize the underlying asset. Instead, the lessor recognizes lease payments received, including variable lease payments, as a deposit liability until the earlier of either of the following:

1. collectibility of the lease payments/lessee residual value guarantee becomes probable; or
2. either:
   - » the contract has been terminated, and the lease payments received from the lessee are nonrefundable; or
   - » the lessor has repossessed the underlying asset, has no further obligation under the contract to the lessee, and the lease payments received are nonrefundable. [842-30-25-3]

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7.6.50 At the date that criterion (1) is met, the lessor: [842-30-25-4]

- derecognizes the carrying amount of the underlying asset;
- derecognizes the carrying amount of any deposit liability;
- recognizes a net investment in the lease on the basis of the remaining lease payments and the remaining lease term, using the rate implicit in the lease determined at the *lease commencement date;* and
- recognizes selling profit (loss), calculated as:

7.6.60 At the date that criterion (2) is met, the lessor derecognizes the carrying amount of any deposit liability, with a corresponding amount recognized as lease income. [842-30-25-5]

7.6.70 If collectibility is subsequently assessed as probable for a sales-type lease (i.e. after it was initially assessed as not probable at lease commencement), in accounting for that lease subsequent to the collectibility reassessment, the lessor uses the rate implicit in the lease determined at the lease commencement date. [842-30-25-4(c)]

7.6.80 If collectibility is probable at the commencement date for a sales-type lease, the lessor does not reassess whether collectibility is probable after the commencement date. Subsequent changes in the credit risk of the lessee are accounted for in accordance with the impairment guidance applicable to the net investment in the lease (see 7.3.130). [842-30-25-6]

Other leases

7.6.90 If collectibility is probable at the commencement date for a direct financing lease, the lessor does not reassess whether collectibility is probable after the commencement date. Subsequent changes in the credit risk of the lessee are accounted for in accordance with the impairment guidance applicable to the net investment in the lease (see 7.3.130). [842-30-25-6]

7.6.100 If collectibility of the lease payments plus any amount necessary to satisfy a residual value guarantee (provided by the lessee *or* another unrelated third party) is *not* probable at the commencement date:

- The lease cannot be classified as a direct financing lease (see diagram in 7.2.50), and is therefore an operating lease.
- Cumulative lease income is limited to the lesser of (a) the income that would be recognized in accordance with the guidance applicable to all operating leases, or (b) the amount of the lease payments, including variable lease payments, that have been collected from the lessee. [842-30-25-12]

7.6.110 If the assessment of collectibility changes after the commencement date, any difference between (a) and (b) is recognized as a current-period adjustment to lease income. [842-30-25-13]

7.6.120 Topic 842 includes examples that illustrate the accounting requirements for lease payments in which collectibility is not probable at the commencement date for a sales-type lease and an operating lease. [842-30-55-25 – 55-30, 55-40 – 55-43]

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KPMG observation – Collectibility reassessment requirements will require ongoing effort

7.6.130 Topic 842 includes ongoing monitoring efforts for lessors with respect to collectibility. These include all of the following.

- For any lease for which collectibility of the lease payments and amounts necessary to satisfy a residual value guarantee is *not* probable at lease commencement, the lessor continually reassesses whether collectibility becomes probable.
- If the lease with collectibility concerns is a sales-type lease, the lessor monitors for either of the two specified events in 7.6.40 that would permit income recognition even in the absence of a conclusion that collectibility is probable.
- For operating leases only, the lessor monitors whether collectibility *remains* probable after lease commencement.

7.6.140 The following is a summary of how collectibility is assessed for different leases.

Type of lease	Collectibility probable at commencement?	After initial recognition
Sales-type	✔	No ongoing monitoring of collectibility; perform impairment test of net investment in lease (see 7.3.130).
	✘	Ongoing monitoring of collectibility.
Direct financing[1]	✔	No ongoing monitoring of collectibility; perform impairment test of net investment in lease (see 7.3.130).
Operating	✔	Ongoing monitoring of collectibility.
	✘	Ongoing monitoring of collectibility.

Note 1:

A lease cannot be classified as a direct financing lease if collectibility is not probable at lease commencement.

7.6.150 Because lessors are not required to reassess collectibility in the same way as under current US GAAP, additional processes or controls may need to be implemented to monitor for changes in collectibility and/or the occurrence of events that would trigger lease income recognition in relation to sales-type leases.

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KPMG observation – Collectibility guidance for sales-type leases designed to prevent structuring opportunities

7.6.160 The guidance that applies to sales-type leases when collectibility of the lease payments, plus any amounts necessary to satisfy a lessee residual value guarantee, is not probable is similar to that applied by sellers of goods under Topic 606. The lessor guidance was developed in this manner to ensure that sellers of goods cannot circumvent the collectibility guidance in Topic 606 – i.e. recognize revenue earlier than would be permitted by Topic 606 – by structuring them as sales-type leases.
[ASU 2016-02.BC104]

7.6.170 In contrast, because in the Board's view operating leases and direct financing leases are not similar to sales of the underlying asset, the Board concluded that the relevant collectibility guidance did not need to align with Topic 606. Instead, the guidance is mostly consistent with the collectibility guidance in current US GAAP.

US GAAP different from IFRS – IFRS 16 does not include collectibility guidance

7.6.180 Current IFRS does not include collectibility guidance for lessors. Given that the IASB wanted to limit changes to lessor accounting as much as possible, the IASB decided that it was not necessary to introduce collectibility guidance specific to lessors into IFRS 16.

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Comparison with current US GAAP

Effects of collectibility uncertainties on lessor accounting

7.6.190 The following table summarizes the effects of collectibility uncertainties on lessor accounting under Topic 842 compared with current US GAAP based on what the classification of the lease would be if there were no collectibility uncertainties. [840-10-25-42(a)]

Current US GAAP	Topic 842
Sales-type lease	
– Lease classified (and accounted for) as an operating lease. – No restriction on cumulative lease income to lease payments (and variable lease payments) received (but applied by some in practice).	– No effect on lease classification. – Underlying asset not derecognized. – No lease income recognized; lease payments (and variable lease payments) received recognized as a deposit liability.
Direct financing lease	
– Lease classified (and accounted for) as an operating lease. – No restriction on cumulative lease income to lease payments (and variable lease payments) received (but applied by some in practice).	– Lease classified (and accounted for) as an operating lease. – Cumulative lease income restricted to lease payments (and variable lease payments) received.
Operating lease	
– Lease classified (and accounted for) as an operating lease. – No restriction on cumulative lease income to lease payments (and variable lease payments) received (but applied by some in practice).	– Lease classified (and accounted for) as an operating lease. – Cumulative lease income restricted to lease payments (and variable lease payments) received.
Leveraged lease	
– Lease classified (and accounted for) as an operating lease. – No restriction on cumulative lease income to lease payments (and variable lease payments) received (but applied by some in practice).	– N/A

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Collectibility issues generally more punitive to lessors under Topic 842

7.6.200 The accounting result of collectibility issues will generally be more punitive under Topic 842 than it is under current US GAAP. Consider both of the following.

- The requirement to recognize lease payments (and variable lease payments) as a deposit liability for sales-type leases both results in later lease income recognition than under current US GAAP *and* results in the recognition of liabilities by the lessor when the lease payments (and variable lease payments) that have been received are non-refundable.
- The provision limiting cumulative lease income on operating leases with collectibility concerns to the lease payments (and variable lease payments) that have been received will, for the same operating lease, generally result in delayed income recognition as compared with current US GAAP, which does not include a similar *requirement* when collectibility of the minimum lease payments is not reasonably predictable.

Reassessing collectibility

7.6.210 Topic 842 includes ongoing monitoring efforts for lessors with respect to collectibility that were not required under current US GAAP. Additional processes or controls may need to be implemented by lessors to monitor for changes in collectibility and/or the occurrence of events that would trigger lease income recognition in relation to sales-type leases.

7.7 Lease modifications

7.7.10 A lease modification is a change to the terms and conditions of a contract that results in a change in the scope of or the consideration for a lease; for example, a change that adds or terminates the right to use one or more underlying assets or extends or shortens the contractual lease term. [842 Glossary]

7.7.20 A lease modification includes a change to the terms and conditions of the contract that contains the lease if that contract modification changes the 'consideration in the contract', and therefore changes the lease payments (see section 5.4) – i.e. changes the consideration for the lease.

7.7.30 The effective date of a lease modification is the date that the modification is approved by both the lessee and the lessor. [842 Glossary]

7.7.40 A key question that drives the accounting for a modification is whether the modification should be accounted for as a separate contract.

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7.7.50 A modification is accounted for as a separate contract (see Example 6.16) when it both:

- grants the lessee an additional right of use that was not included in the original contract (e.g. the right to use an additional asset); and
- the lease payments increase commensurate with the stand-alone price for the additional right of use, as adjusted for the circumstances of the particular contract. [842-10-25-8]

7.7.60 An increase to the lease term (e.g. a modification changing the lease term from four to six years) does not grant the lessee an additional right of use. [842-10-25-11]

7.7.70 If a lease is modified and that modification is *not* accounted for as a separate contract, the entity reassesses the classification of the lease as of the effective date of the modification, based on the modified terms and conditions and the facts and circumstances as of that date (e.g. the fair value and remaining economic life of the underlying asset at that date). The accounting for lease modifications not accounted for as a separate contract depends on the classification of the modified lease. [842-10-25-9]

7.7.80 When a lessee exercises an option to extend a lease (including by electing not to exercise a termination option), to terminate a lease, or to purchase the underlying asset, the lessor accounts for the exercise of that option as a lease modification. [842-10-35-3]

7.7.90 While not stated in the guidance, we believe that the Board did not intend for a lessor to account for the exercise of an extension option already factored into the lessor's accounting; for example, an extension option the lessor previously concluded the lessee was reasonably certain to exercise, as a lease modification. Therefore, we believe that the guidance in 7.7.80 would apply only when the lessee exercises an option it was not reasonably certain to exercise. The 'modification' that results from the exercise of a termination option or a purchase option is effectively one that terminates the lease. That is, a lease no longer exists once the lessee has either terminated the lease or has purchased the underlying asset.

Operating lease modifications

7.7.100 If an operating lease is modified and the modification does not result in a separate contract, the lessor accounts for the modification as if the original lease is terminated, and a new lease commences on the effective date of the modification. [842-10-25-15]

Original lease	Modified lease	Requirements
Operating →	Operating	Lessor includes any prepaid or accrued lease rentals relating to the original lease in the lease payments for the modified lease.
Operating →	Sales-type or direct financing	Lessor derecognizes any deferred rent liability or accrued rent asset and adjusts the selling profit (loss) accordingly, which is deferred in the case of a direct financing lease.

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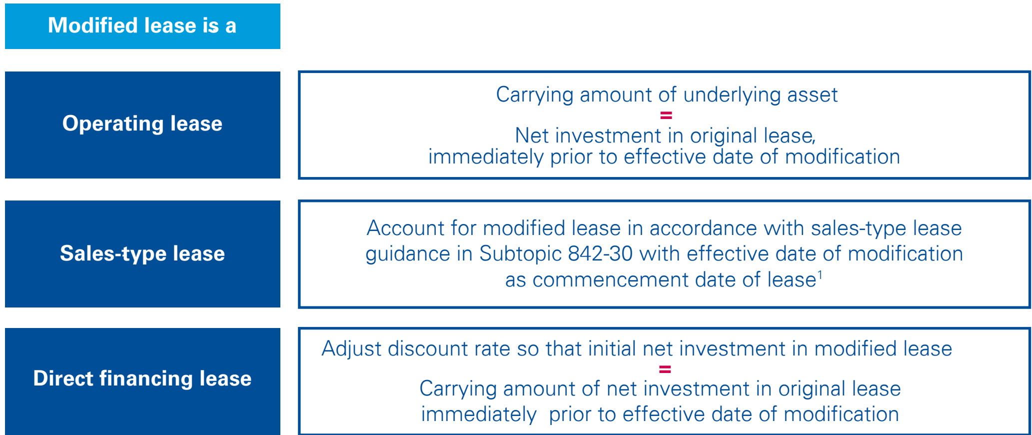
Direct financing lease modifications

7.7.110 Lessor accounting for a direct financing lease modification that does not result in a separate contract can be summarized as follows. [842-10-25-16]



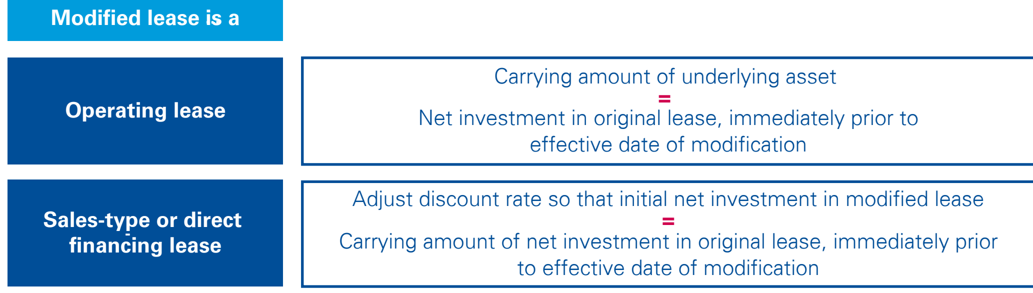
Note 1:

In calculating the selling profit (loss) on the lease (see 7.3.40):

- the fair value of the underlying asset is its fair value at the effective date of the modification; and
- the carrying amount of the underlying asset is the carrying amount of the net investment in the original lease immediately before the effective date of the modification.

Sales-type lease modifications

7.7.120 Lessor accounting for a sales-type lease modification that does not result in a separate contract can be summarized as follows. [842-10-25-17]



7.7.130 Topic 842 includes various examples illustrating the accounting requirements for lessor modifications. [842-10-55-190 – 55-209]

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Example 7.3

Modification accounting – Operating lease remains an operating lease

Original lease

7.7.140 Lessee LE enters into a four-year lease with Lessor LR to lease a new crane for use in a construction project that LE expects will take four years to complete. LR also agrees to maintain the crane throughout the lease term.

– Payments:	Fixed payments of $60,000 per year in arrears
– Renewal/purchase options:	No
– Transfer of ownership:	None
– Fair value of crane:	$500,000
– Remaining economic life of crane:	15 year

7.7.150 The lease is an operating lease; it does not meet any of the criteria to be classified as a sales-type or direct financing lease.

7.7.160 LR is required to allocate the consideration in the contract to the separate lease and non-lease components based on each component's stand-alone selling price (see chapter 4). LR allocates the consideration in the contract as follows.

Component	Stand-alone price	Allocation	Calculation
Crane lease	$230,000	$220,800	(230,000/250,000) x 240,000
Maintenance	20,000	19,200	(20,000/250,000) x 240,000
	$250,000	**$240,000**	

7.7.170 Total consideration in the contract allocated to the lease component is $220,800, and therefore the lease payments equal $220,800. LR will recognize annual lease income of $55,200 ($220,800 ÷ 4 years). LR will account for the non-lease component in accordance with Topic 606.

Lease modification

7.7.180 At the beginning of Year 4, the construction project is projected to take three more years to complete, and LE and LR agree to extend the original lease by two years – i.e. the original four-year lease is extended to six years. The additional two years were not an option when the original lease was negotiated. The modification alters LE's right to use the crane, but it does not grant LE an additional right of use (see 7.7.40). Therefore, LR does not account for the modification as a separate contract.

7.7.190 At the effective date of the modification – i.e. at the beginning of Year 4 when LE and LR agree to the modification – the annual payments increase to $70,000, which includes the annual maintenance services. Total consideration in the modified contract for the remainder of the lease term is now $210,000 ($70,000 × 3 years). The modified lease continues to be classified as an operating lease based on the remaining lease

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term (3 years) as compared to the remaining economic life of the crane (12 years) and the fair value of the crane ($375,000).

7.7.200 For simplicity, assume that the stand-alone selling prices for a three-year lease and the related maintenance services at the beginning of Year 4 are the same as the stand-alone selling prices for the original four-year lease and the original four years of maintenance services. LR reallocates the remaining consideration in the modified contract at the effective date of the modification as follows.

Component	Stand-alone price	Allocation	Calculation
Crane lease	$230,000	$193,200	(230,000/250,000) x 210,000
Maintenance	20,000	16,800	(20,000/250,000) x 210,000
	$250,000	**$210,000**	

7.7.210 The remaining consideration in the contract allocated to the lease component is $193,200, and therefore the remaining lease payments for the modified lease equal $193,200. Consequently, LR will recognize annual lease income of $64,400 ($193,200 ÷ 3 years) for the three years remaining on the lease. LR will continue to account for the non-lease component in accordance with Topic 606.

Example 7.4

Modification accounting – Sales-type lease remains a sales-type lease

Original lease

7.7.220 Lessee LE enters into a 15-year lease for a passenger aircraft with Lessor LR. The following facts are relevant at the commencement date.

– Lease payments:	Fixed payments of $1 million per year in arrears
– Renewal/purchase options:	None
– Transfer of ownership:	No
– Fair value and carrying amount of aircraft:	$10 million
– Remaining economic life of aircraft:	17 years
– Estimated future residual value:	$2 million
– Rate implicit in the lease:	6.76%

7.7.230 At the commencement date, the lease term is for the major part (i.e. ≥ 75%) of the remaining economic life of the aircraft (it represents 88%). In addition, the present value of the lease payments is $9.25 million, or 93% of the fair value of the aircraft. That is, the present value of the lease payments amounts to substantially all of the fair value of the aircraft (i.e. ≥ 90%). Accordingly, the lease is classified as a sales-type lease (see diagram in 7.2.30).

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Lease modification

7.7.240 At the beginning of Year 3, LE decides to gradually phase this aircraft model out of its fleet. LE asks LR to renegotiate the terms of the lease and LR agrees to a modification. The following facts are relevant at the effective date of the modification.

– Remaining lease term:	8 years
– Remaining lease payments:	Fixed payments of $1.025 million per year in arrears
– Renewal/purchase options:	None
– Transfer of ownership:	No
– Fair value of aircraft:	$9.35 million
– Carrying amount of net investment in the lease:	$9.33 million
– Estimated future residual value:	$5.5 million
– Residual value guarantee (lessee):	$5 million
– Rate implicit in the lease:	6.94%

7.7.250 The present value of the lease payments, plus the present value of the guaranteed residual value, is $9.06 million, or 97% of the fair value of the aircraft. Because the sum of (a) the present value of the lease payments and (b) the present value of the lessee residual value guarantee continues to equal or exceed substantially all the fair value of the aircraft, the lease continues to be a sales-type lease (see diagram in 7.2.30).

7.7.260 On the effective date of the modification, LR carries forward the balance of the net investment in the lease from immediately before the effective date of the modification of $9.33 million as the opening balance of the net investment in the modified lease.

7.7.270 To retain the same net investment in the lease even through the lease payments, the lease term, and the estimated residual value have all changed, LR adjusts the discount rate for the lease from the rate implicit in the modified lease of 6.94% to 6.98%. This adjusted rate of 6.98% is used to calculate interest income on the net investment in the lease throughout the remaining term of the modified lease and will result, at the end of the modified lease term, in a net investment balance that equals the estimated residual value of the underlying asset (guaranteed + unguaranteed) of $5.5 million.

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Example 7.5

Modification accounting – Direct financing lease becomes an operating lease

Original lease

7.7.280 Lessee LE enters into a four-year lease for a piece of new, non-specialized equipment with Lessor LR. The following facts are relevant at the lease commencement date.

– Lease payments:	Fixed payments of $17,000 per year in arrears
– Renewal/purchase options:	None
– Transfer of ownership:	No
– Fair value and carrying amount of equipment:	$80,000
– Remaining economic life of equipment:	12 years
– Estimated future residual value:	$24,000
– Residual value guarantee (third party):	$18,000
– Rate implicit in the lease:	5.01%

7.7.290 In addition, both LE and the third-party residual value guarantor (unrelated to LR) are creditworthy counterparties.

7.7.300 The lease does not meet any of the criteria to be classified as a sales-type lease (see diagram in 7.2.30). Therefore, the lease is classified as a direct financing lease because the sum of (a) the present value of the lease payments ($60,264) and (b) the present value of the third-party residual value guarantee ($14,802) is substantially all (94%) of the fair value of the equipment ($75,066 ÷ $80,000), and collectibility of the lease payments, plus any amount from the third party necessary to satisfy the residual value guarantee, is probable.

7.7.310 At the lease commencement date, LR recognizes the following entry.

	Debit	Credit
Lease receivable	75,066	
Unguaranteed residual asset	4,934	
Property, plant, and equipment		80,000
To recognize direct financing lease		

7.7.320 At the end of Year 1, LR receives a lease payment of $17,000 from LE and recognizes interest income of $4,009 ($80,000 × 5.01%). Therefore, the carrying amount of the net investment in the lease is $67,009 ($80,000 + $4,009 - $17,000).

Lease modification

7.7.330 At the beginning of Year 3, LE and LR agree to modify the lease to extend the term by two years – i.e. the original four-year lease is extended to six years total.

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The following facts are relevant at the effective date of the modification.

– Lease payments:	Fixed payments of $17,000 per year in arrears
– Renewal/purchase options:	None
– Transfer of ownership:	No
– Fair value of equipment:	$65,000
– Carrying amount of net investment in the lease:	$53,368
– Estimated future residual value:	$16,000
– Residual value guarantee:	None
– Rate implicit in the lease:	9.88%

7.7.340 The modified lease does not transfer title of the equipment to LE, and it does not meet any of the other criteria to be classified as a sales-type lease or the criteria to be classified as a direct financing lease (see diagrams in 7.2.30 and 7.2.50). Therefore, the modified lease is classified as an operating lease and, at the effective date of the modification, LR derecognizes the net investment in the lease, and recognizes the equipment at that amount.

	Debit	Credit
Property, plant, and equipment	53,368	
Net investment in the lease		53,368
To reclassify direct financing lease as operating lease		

7.7.350 Because collectibility of the lease payments is still probable (i.e. LE remains a creditworthy counterparty), LR will recognize the $68,000 ($17,000 × 4 years) in lease payments on a straight-line basis over the four-year remaining term of the modified lease. LR will also recognize depreciation on the equipment.

KPMG observation – Lessor versus lessee modifications guidance

7.7.360 The lessee and lessor modifications guidance is not aligned either conceptually or mechanically. For example, the lessee modifications guidance is based on the view that time periods within a lease are not distinct from each other, that the lessor transfers a 'good' (i.e. a right-of-use asset) at lease commencement. In contrast, the lessor modifications guidance is based on the cost-benefit decision to account for most leases as executory contracts (see KPMG's observation at 7.4.40–50), and therefore each period within a lease (e.g. each day, month, year) is distinct from those periods that precede it. The fact that the supplier (lessor) and customer (lessee) modification models are not symmetrical is consistent with the fact that the core lessee and lessor accounting models are not symmetrical within Topic 842. Instead, the Board concluded, for both conceptual and operational reasons, that the lessor modifications guidance should be premised on the contract modifications guidance in Topic 606. [ASU 2016-02.BC179]

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KPMG observation – Lessor modifications guidance substantially aligns with new revenue recognition standard

7.7.370 The generally prospective accounting for lessor lease modifications, including the guidance on when to account for a modification as a separate contract, is substantially aligned with the contract modifications guidance in Topic 606, which also accounts prospectively for modifications in which the remaining goods or services to be transferred after the modification are distinct from those transferred prior to the modification. Similarly, Topic 606 accounts for a modification that adds one or more distinct goods or services as a separate contract if the increase in the transaction price is commensurate with the stand-alone selling price for the additional distinct good(s) or service(s). [ASU 2016-02.BC179]

7.7.380 Aligning the modifications guidance will make accounting for modifications to contracts that include lease and non-lease components simpler than if the guidance was not aligned (which it is not under current US GAAP). [ASU 2016-02.BC179]

KPMG observation – Non-cancellable period of the lease not fixed at lease commencement

7.7.390 We are aware of certain lease arrangements for which the non-cancellable period of the lease (see section 5.3) is not fixed or determinable at lease commencement. For example:

- a lessor may enter into an agreement whereby it will lease multiple underlying assets to the lessee, but the non-cancellable period for all of the underlying assets does not become fixed until the last one is deployed and that final date of deployment is unknown when earlier underlying assets are made available for the lessee's use; or
- the non-cancellable period of the lease may be for the duration of a project whose timeline is uncertain at the commencement date.

7.7.400 Section 4.3 discusses potential measurement issues that might arise when there are multiple commencement dates for leases in a single contract (or multiple contracts that are combined for accounting purposes – see section 4.7). However, Topic 842 does not address for lessors how to account for changes in the lease term after lease commencement that are not the result of a modification (including the exercise of a lessee extension or termination option).

7.7.410 While Topic 842 is clear that lessors do not reassess the lease term after lease commencement as lessees do (e.g. as a result of a significant event or significant change in circumstances – see section 6.6), there is no guidance in Topic 842 about how a lessor should address circumstances such as the examples in 7.7.390. Public Board discussions and FASB/IASB staff papers concerning reassessments all centered on when, if ever, a lessor should reassess lessee options to extend or terminate a

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lease. Those discussions and staff papers did not discuss circumstances in which the non-cancellable period of the lease was not known at lease commencement.

7.7.420 We believe that the Board did not intend for a lessor not to update an initial assessment of the lease term that was made at lease commencement when the non-cancellable period of the lease was not known at that time. To not update the lease term for this finalization of a key fact (i.e. the non-cancellable period of the lease), including undertaking an assessment of lessee extension or termination options based on the determination of that key fact after the commencement date, could result in counter-intuitive accounting results. For example, the lessor might recognize lease income over a period unrelated to even the non-cancellable period of the lease.

7.7.430 Consequently, we believe that a lessor *should* update its assessment of the lease term at the point in time the non-cancellable period of the lease becomes known when that occurs after lease commencement.

US GAAP different from IFRS – Modifications to finance leases

7.7.440 Under IFRS 16, for a modification to a finance lease that is not accounted for as a separate lease, a lessor accounts for the modification as follows.

- If the lease would have been classified as an operating lease had the modification been in effect at the inception date, the lessor:
  - » accounts for the lease modification as a new lease from the effective date of the modification; and
  - » measures the carrying amount of the underlying asset as the net investment in the lease immediately before the effective date of the lease modification.
- Otherwise, the lessor applies the requirements of IFRS 9 (financial instruments). [IFRS 16.80]

7.7.450 In contrast, the guidance in Topic 842 for lessor modifications to sales-type and direct financing leases is prescriptive and is unrelated to the guidance for financial instruments (which is itself not converged with IFRS 9). Consequently, the accounting for equivalent modifications to sales-type/direct financing (IFRS: finance) leases that are not accounted for as separate contracts (IFRS: leases) will differ.

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Comparison with current US GAAP – Modifications

Lessor modifications guidance substantially changed from current US GAAP

7.7.460 The Board received feedback that the lessor lease modification requirements under current US GAAP are overly complex. Topic 842 introduces more detailed, operable, and understandable guidance for how a lessor should account for a lease modification, including illustrative examples. Many will likely welcome the new guidance, because it will help to address significant practice issues that have become common in changing economic circumstances, and because it is substantially aligned with Topic 606. [840-10-25-51 – 25-52, 840-30-35-26 – 35-30]

Operating lease modifications that do not change the lease classification

7.7.470 Topic 842 will account for modifications to an operating lease that (1) is not accounted for as a separate contract and (2) does not change lease classification in a manner substantially similar to lessor accounting for modifications of this nature under current US GAAP.

7.8 Financial statement presentation

7.8.10 A lessor is required to present the following items arising from lease contracts in the scope of Topic 842.

Balance sheet

Sales-type and direct financing leases

7.8.20 Present the lessor's net investment in sales-type and direct financing leases separately from other assets. The lessor's net investment is subject to the same classification considerations as other assets in a classified balance sheet – i.e. current versus non-current. See 12.3.20 for the note disclosures required for the components of the total net investment in sales-type and direct financing leases – i.e. the carrying amount of lease receivables, unguaranteed residual assets, and any deferred selling profit on direct financing leases. [842-30-45-1 – 45-2]

Operating leases

7.8.30 Present the underlying asset and related depreciation expense using other US GAAP (e.g. Topic 360), as applicable. [842-30-45-6]

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Income statement

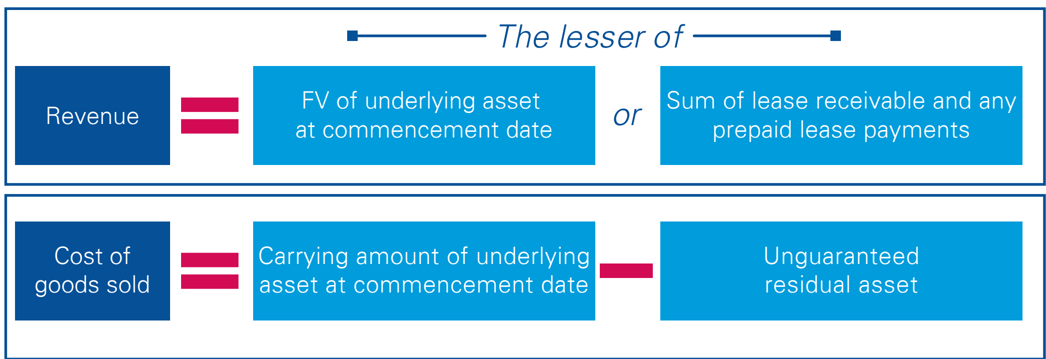
All leases

7.8.40 If a lessor does not separately present lease income, it discloses the line items in the income statement in which it includes lease income. [842-30-45-3]

Sales-type and direct financing leases

7.8.50 Present selling profit or loss recognized at lease commencement in a manner that best reflects the lessor's business model.

– If the lessor uses leases as an alternative to selling (e.g. many manufacturers and dealers), the lessor presents profit or loss at lease commencement on a gross basis as separate line items (e.g. as revenue and cost of goods sold). Revenue and costs of goods sold is recognized as follows.



– If the lessor uses lease arrangements for the purpose of financing, the lessor presents profit or loss at lease commencement on a net basis in a single line item (e.g. as a gain within other income). [842-30-45-4]

Statement of cash flows

7.8.60 Classify all cash receipts from leases as cash flows from operating activities. [842-30-45-5, 45-7]

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US GAAP different from IFRS – IFRS 16 does not include lessor cash flow presentation guidance

7.8.70 IFRS 16 does not prescribe how lessors must classify cash receipts from leases. Consistent with current practice under US GAAP, under current IFRS, some lessors classify cash receipts from finance leases as cash flows from investing activities. Because IFRS 16 does not change the current IFRS (IAS 17) lessor cash flow presentation guidance, it is likely some lessors will continue to classify cash receipts from finance leases as cash flows from investing activities, which Topic 842 does not permit.

Comparison with current US GAAP – Presentation

Cash receipts from sales-type/direct financing leases

7.8.80 Topic 842 requires classification of all cash receipts from leases as cash flows from operating activities. Current US GAAP does not contain explicit cash flow guidance for lessors. Consequently, some lessors with leases that will be classified as sales-type or direct financing leases under Topic 842 currently classify cash receipts from those leases as cash flows from investing activities. Entities that follow that practice under current US GAAP will not be able to continue to do so under Topic 842.

New lessor presentation requirements generally consistent with current US GAAP

7.8.90 In other respects, the lessor financial statement presentation requirements in Topic 842 are substantially the same as those in current US GAAP.

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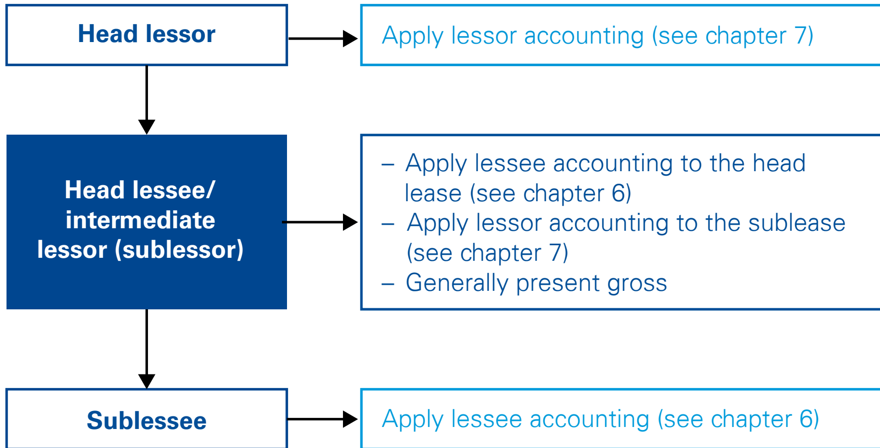
8 Subleases

How the standard works

The following chart summarizes the accounting for each party to a lease and sublease transaction.



We expect that most subleases under Topic 842 will be classified as operating leases by sublessors.

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8.1 General requirements

8.1.10 A sublease is a transaction in which an underlying asset is re-leased by the lessee (head lessee, or sublessor) to a third party (sublessee), and the original lease (head lease) between the lessor (head lessor) and the lessee remains in effect. [842 Glossary]

8.1.20 The sublessor and sublessee classify a sublease with reference to the underlying asset subject to the lease, rather than with reference to the right-of-use asset. This means that, in determining the classification of the sublease, the sublessor and the sublessee consider:

- the term of the sublease as compared to the remaining economic life of the underlying asset – rather than, for example, the remaining term of the head lease; and
- the present value of the sum of the sublease payments and any residual value guarantee provided by the sublessee as compared to the fair value of the underlying asset – rather than the fair value of the head lease right-of-use asset. [842-10-25-6]

Head lessor

8.1.30 The head lessor continues accounting for the lease as it did before (see chapter 7), whether the head lessee enters into a sublease, or sells or transfers the head lease to a third party (see chapter 7). [842-30-35-7]

8.1.40 If the head lease agreement is replaced by a new agreement with a new lessee, the head lease is considered terminated, and the new lease classified and accounted for as a separate transaction. [842-30-40-3]

Sublessee

8.1.50 A sublessee classifies and accounts for the sublease as it would any other lease (see chapter 6). From the sublessee's perspective, the fact that the lease is a sublease has no effect on its accounting for the lease. Practically, this is because a sublessee likely will not know the terms and conditions of the head lease, and on some occasions may not even know that the lease is a sublease, making it difficult to apply the lease classification guidance with reference to the head right-of-use asset.

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8.2 Accounting by the sublessor

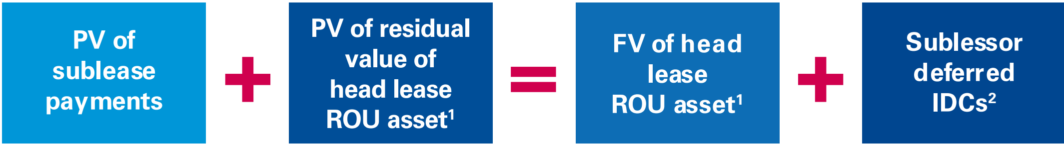
8.2.10 The head lease and the sublease will generally be accounted for separately – i.e. as two separate units of account. This is because, even if the contracts are entered into at or near the same date, the sublessee is generally a third party unrelated to the head lessor. Two or more contracts are potentially combined under Topic 842 only if they are entered into at or near the same time and with the same counterparty (or a related party of the counterparty) – see section 4.7. [ASU 2016-02.BC115]

8.2.20 In accounting for the sublease, the sublessor follows these steps.

Step 1:	Determine the discount rate for the sublease.
Step 2:	Determine the classification of the sublease.
Step 3:	Account for the sublease.

Discount rate for the sublease

8.2.30 The sublessor in a sublease transaction uses the rate implicit in the sublease to determine classification of the sublease, and to measure the net investment in the sublease if it is classified as a sales-type or direct financing lease. The rate implicit in the sublease is the rate that balances the following equation. [842-20-35-15]



Notes:

1. The residual value and the fair value of the head lease right-of-use asset are estimated as of the sublease commencement date.
2. These are initial direct costs that relate to the sublease. They do not include the sublessor's initial direct costs of the head lease.

8.2.40 However, if the rate implicit in the lease cannot be readily determined, a sublessor may use the discount rate established for the head lease; for example, the sublessor's incremental borrowing rate at the commencement date of the head lease. [842-20-35-15]

Classification of the sublease

8.2.50 The classification of the sublease as an operating or a finance lease is determined in the same manner as any other lease (see chapter 7). [842-10-25-2 – 25-3]

Account for the sublease

8.2.60 The sublease is accounted for as an operating, sales-type, or direct financing lease in the same manner as any other operating, sales-type, or direct financing lease (see chapter 7).

8.2.70 The accounting for the head lease depends on whether the sublessor is relieved of its primary obligation under that lease (see 8.2.80–110).

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Sublessor not relieved of its primary obligation under the head lease

8.2.80 If the sublessor is not relieved of its primary obligation under the head lease, the sublessor accounts for the head lease in one of the following ways depending on the classification of the sublease: [842-20-35-14]

- **Sublease is an operating lease.** The sublessor:
  - continues to account for the head lease as it did before sublease commencement (see chapter 6); and
  - continues to assess the head lease right-of-use asset for impairment (see section 6.5). However, if the lease cost of the head lease for the term of the sublease exceeds the sublease income anticipated for that same period, this is an indicator that the carrying amount of the head lease right-of-use asset may not be recoverable.
- **Sublease is a sales-type or a direct financing lease.** The sublessor:
  - derecognizes the head lease right-of-use asset using the guidance in Subtopic 842-30 on the derecognition of underlying assets by lessors in sales-type and direct financing leases (see section 7.3);
  - beginning at sublease commencement, increases the lease liability to reflect interest on the lease liability each period using the effective interest method, and reduces the lease liability to reflect the lease payments made during the period; and
  - assesses its net investment in the sublease for impairment using the financial instruments impairment guidance (see section 7.3.3).

Sublessor relieved of its primary obligation under the head lease

8.2.90 If the sublessor is relieved of its primary obligation under the head lease, the head lease is considered terminated, and the sublessor derecognizes the head lease right-of-use asset and head lease liability, with the difference recognized as profit or loss. [842-20-40-3]

8.2.100 Any consideration paid or received on termination that was not already included in the lease payments is included in the calculation of the profit or loss recognized on lease termination. Such consideration might arise, for example, if the lease term of the head lease did not reflect the lessee exercising a termination option. [842-20-40-3]

8.2.110 If a sublease is a termination of the head lease and the head lessee is secondarily liable, the sublessor (as head lessee) recognizes the guarantee obligation using the guidance in Topic 405. Whether or not explicit consideration was paid for that guarantee, the head lessee becomes a guarantor. The guarantee obligation is initially measured at fair value, and that amount reduces (increases) the profit (loss) recognized on lease termination. [842-20-40-3, 405-20-40-2]

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Example 8.1

Classification and accounting for a sublease transaction by a sublessor

8.2.120 Sublessor SR leased a non-specialized warehouse for designing paint schemes for cars that it manufactures.

Head lease

8.2.130 The following facts about the head lease (operating lease) at the commencement date are relevant.

– Noncancellable lease term:	15 years
– Renewal options:	15 years (3 options of 5 years each)
– Purchase option/transfer of ownership:	None
– Residual value guarantee:	None
– Lease payments:	Fixed payments of $30,000 per year in arrears, with a 3% increase each year after Year 1
– Present value of lease payments:	$349,914
– Fair value of warehouse:	$500,000
– Remaining economic life of warehouse:	30 years
– SR's incremental borrowing rate:	6% (rate implicit in the lease not available)

Sublease

8.2.140 At the end of Year 2 of the lease, SR acquires on-line design software that eliminates its need for the warehouse. SR subleases the warehouse to Sublessee SE for the remainder of the head lease term, but SR is not relieved of its primary obligation to the head lessor under the head lease.

8.2.150 The following additional facts about the sublease at the sublease commencement date are relevant.

– Non-cancellable lease term:	13 years
– Renewal options:	None
– Purchase option/transfer of ownership:	None
– Residual value guarantee:	None
– Lease payments:	Fixed payments of $32,000[1] per year in arrears, with a 3% increase each year after Year 1
– Present value of lease payments:	$332,257
– Fair value of warehouse:	$505,000
– Rate implicit in the sublease:	Not readily determinable[2]

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Notes:

1. The anticipated sublease income exceeds SR's head lease cost for the period of the sublease because of an increase in market rents during the first two years of the head lease.
2. The rate implicit in the sublease is not readily determinable, because the fair value of the head lease right-of-use asset is not readily determinable.

Step 1: Determine the discount rate for the sublease

8.2.160 Because the rate implicit in the sublease is not readily determinable, SR uses the discount rate it established for the head lease: 6%.

Step 2: Determine lease classification of the sublease

8.2.170 SR classifies the sublease as an operating lease, based on the following (see section 7.2):

– there is no transfer of ownership and there is no option for SL to purchase the warehouse;
– the sublease term represents only 46% (i.e. not a major part) of the remaining economic life of the warehouse – i.e. of the underlying asset, not the right-of-use asset; this is calculated based on a sublease term of 13 years, and a remaining economic life of the warehouse at sublease commencement of 28 years;
– the present value of the sublease payments represents only 66% (i.e. not substantially all) of the fair value of the warehouse at sublease commencement; and
– the warehouse is not highly specialized.

Step 3: Account for the sublease

8.2.180 In this example, SR is not relieved of its primary obligation to the head lessor. The accounting is therefore as follows.

– Because the sublease is classified as an operating lease, SR does not make any accounting entries for the sublease of the warehouse to SE at the sublease commencement date.
– Because sublease income anticipated during the sublease term exceeds SR's expected lease cost for the head lease over that same period of time, the execution of the sublease is not an indicator that the head lease right-of-use asset may be impaired.
– Absent additional events (e.g. a change to the head lease term resulting from a reassessment or a modification to the head lease *or* the sublease), SR will continue to account for the head lease throughout the remainder of the head lease term as if it had not entered into the sublease.
– SR will account for the sublease as it would for any other operating lease for which it is the lessor.

8.2.190 To see the calculations supporting this example, and the effect of the accounting on the financial statements compared to IFRS, see 8.2.420–440.

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KPMG observation – Sublease classification

8.2.200 A sublessor classifies a sublease with reference to the underlying asset, not the right-of-use asset arising from the head lease. The Board determined that applying the lease classification guidance with reference to the underlying asset would be more operational for sublessors because, for example, it may be difficult to determine the fair value of the right-of-use asset in the head lease. [ASU 2016-02.BC116]

8.2.210 The Board also reasoned that classifying a sublease with reference to the underlying asset would result in more consistent lease classification outcomes for similar leases. For example, if sublease classification were determined on the basis of the remaining economic life of the head lease right-of-use asset, it would be difficult to understand and explain the following when the same underlying asset is being leased, under potentially similar terms, and with similar periods of use: why the head lessor (or any other lessor) would classify the head lease as an operating lease, while the sublessor might classify the sublease as a sales-type or direct financing lease. [ASU 2016-02.BC116]

8.2.220 The sublease classification requirements in Topic 842 will generally result in operating lease classification for most subleases.

KPMG observation – Determining the rate implicit in the sublease

8.2.230 Topic 842 does not provide explicit guidance for determining the rate implicit in a sublease; however, we believe that the definition of the rate implicit in the lease and the specific guidance in Topic 842 means that the rate would be calculated as outlined in 8.2.30. In addition, we believe that the rate implicit in a sublease will often not be 'readily determinable' because determining the fair value of a right-of-use asset may be difficult and highly subjective in many cases. Therefore, in classifying and accounting for the sublease, a sublessor will likely use the discount rate for the head lease.

8.2.240 Topic 842 is not explicit as to whether the Board intended for the sublessee to use the sublessor's implicit rate in determining the discount rate for the lease if that rate is readily determinable. However, we expect that the rate implicit in the sublease will almost never be 'readily determinable' for a sublessee. This is because the sublessee would need to have insight into all of the following to determine that rate:

- the fair value of the sublessor's right-of-use asset, which will likely be impossible to determine in most cases because the sublessee will likely not know the terms and conditions of the head lease;
- the sublessor's estimated residual value of the head lease right-of-use asset, which it will likely not have; and
- the sublessor's initial direct costs resulting from the sublease, which the sublessee will likely not know unless the sublessor provides that information to the sublessee.

8.2.250 Consequently, we believe that a sublessee will, in virtually all if not all cases, use its incremental borrowing rate as the discount rate for the sublease.

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KPMG observation – Sublease presentation by sublessors

8.2.260 Topic 842 does not provide explicit guidance on the presentation of the net investment in a sales-type or direct financing sublease for sublessors. The standard simply says that sublessors apply the lessor accounting requirements of Subtopic 842-30. This indicates that sublessors are required to present their net investment in subleases separately from other assets on the balance sheet. But it is not clear whether an entity's net investment in sales-type and direct financing subleases should be presented separately from its net investment in sales-type and direct financing leases for which it is the head lessor.

8.2.270 Determining the appropriate presentation – i.e. presenting the entity's net investment in sales-type and direct financing subleases separately from the entity's net investment in sales-type and direct financing head leases – may depend on the extent of the differences in risks between the two types of net investment. However, we expect these instances to be infrequent, because the number of entities with sales-type or direct financing head leases and sales-type or direct financing subleases may be small *and* because we believe that relatively few subleases for any entity will be sales-type or direct financing subleases.

KPMG observation – Terms of the sublease require changes to the accounting for the head lease

Initial assessment of the sublease

8.2.280 Two parties may enter into a sublease where the non-cancellable period of the sublease, or the sublease term (i.e. including one or more optional periods), exceeds the lease term for the head lease. The act of entering into the sublease is a significant event within the control of the sublessor that directly affects the assessment of the lease term. Therefore, the sublessor will update the head lease term to be at least equal to the sublease term. See section 6.6.1 for additional examples of events that would trigger a reassessment of the lease term. [842-10-55-28]

8.2.290 Similarly, if the head lease includes a lessee option to purchase the underlying asset, the terms of the sublease provide that option to the sublessee, and the sublessee is reasonably certain to exercise that option, the sublessor would update its accounting for the head lease to reflect that it is reasonably certain to exercise its purchase option to fulfill the contract with the sublessee.

Sublease reassessments

8.2.300 Topic 842 requires sublessors to apply the lessor accounting guidance to the sublease. Under Topic 842, lessors do not reassess the lease term or lessee purchase options after the commencement date unless the lease is modified (and that modification is not accounted for as a separate contract). Therefore, we believe that sublessors would not be required to monitor for any changes to the *sublessee's*

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facts or circumstances in accounting for the head lease. Rather, consistent with any other lease for which it is a lessee (i.e. not subject to a sublease), the sublessor would only reassess its accounting for the head lease upon the occurrence of a significant event or change in circumstances within *its* control. For example, while the sublessor may be aware of the sublessee constructing significant leasehold improvements or making significant customizations to the underlying asset, because the sublessee's actions in doing so are not within the sublessor's control, they would not trigger a reassessment.

8.2.310 A sublessor will, however, need to monitor for changes in the amount it is probable of owing to the head lessor under any residual value guarantee it has provided to the head lessor.

US GAAP different from IFRS – Sublease classification

8.2.320 IFRS 16 requires a sublessor to classify a sublease in one of two ways.

- The sublease is classified as an operating lease if the sublessor accounts for the head lease applying the recognition and measurement exemption applicable to short-term leases;
- Otherwise, a sublessor classifies a sublease by reference to the right-of-use asset arising from the head lease (rather than by reference to the underlying asset). This means that, in determining classification of the sublease, the sublessor and the sublessee consider:
  - » the term of the sublease compared to the remaining term of the head lease (rather than the remaining economic life of the underlying asset); and
  - » the present value of the sum of the sublease payments and any residual value guarantee provided by the sublessee compared to the fair value of the right-of-use asset (rather than the fair value of the underlying asset). [IFRS 16.B58]

8.2.330 In contrast, Topic 842 requires an entity (i.e. a sublessee and sublessor) to classify a sublease by reference to the underlying asset. Because of these differences, most subleases under Topic 842 will be classified as operating leases, while most subleases under IFRS 16 will be classified as finance leases.

8.2.340 There also is no specific guidance in IFRS 16 on classifying subleases by sublessees because there is only one type of lease for lessees (i.e. a finance lease) – see 6.2.490–510.

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Rate implicit in a sublease

8.2.350 Under IFRS 16, consistent with Topic 842:

- a sublessor uses the rate implicit in the sublease as the discount rate for the sublease, *if it is readily determinable*, to measure its net investment in the sublease; and
- if the rate implicit in the sublease is not readily determinable, which will usually be the case, a sublessor may use the discount rate established for the head lease. [IFRS 16.68]

8.2.360 However, unlike Topic 842, if a sublessor uses the discount rate for the head lease, IFRS 16 requires the sublessor to adjust the discount rate established for the head lease for any initial direct costs associated with the sublease. IFRS 16 does not further explain or illustrate how that adjustment is made.

Example 8.2
Sublease differences from IFRS 16

8.2.370 Continuing Example 8.1, Sublessor SR accounts for the **sublease** as follows under IFRS 16.

Step 1: Determine the discount rate for the sublease

8.2.380 Consistent with Example 8.1, because the rate implicit in the sublease is not readily determinable, SR uses the discount rate for the head lease. There are no initial direct costs incurred in relation to the sublease; therefore, no adjustment to the head lease discount rate is required in applying IFRS 16.

Step 2: Determine lease classification of the sublease

8.2.390 The sublease is classified as a finance lease under IFRS 16 because it conveys to the sublessee substantially all of the risks and rewards of the right-of-use asset – the sublease is for the entire remaining term of the head lease.

Step 3: Account for the sublease

8.2.400 At the commencement date of the sublease, SR:

- derecognizes the right-of-use asset relating to the head lease that it transfers to Sublessee SE and recognizes the net investment in the sublease;
- recognizes any difference between the carrying amounts of the right-of-use asset and the net investment in the sublease in profit or loss; and
- continues to recognize the lease liability relating to the head lease, which represents the lease payments owed to the head lessor.

8.2.410 During the term of the sublease, SR recognizes both interest income on the sublease and interest expense on the head lease.

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Comparison of sublease accounting between Topic 842 and IFRS 16

8.2.420 The following calculations are based on Example 8.1 (Topic 842) and Example 8.2 (IFRS 16), and illustrate in detail the solutions under the respective standards.

From lease head commencement through sublease commencement (at end of Year 2) – Balance sheet comparison for head lease

	ROU asset		Lease liability
	FASB	IASB	FASB and IASB
Balance at head lease commencement	$349,914	$ 349,914	$349,914
ROU asset amortization/lease liability reduction first two years	(32,946)	(46,656)	(19,450)
Derecognize ROU asset at sublease commencement	–	(303,258)	–
Balance immediately after sublease commencement	**$316,968**	**$ –**	**$330,464**

Journal entry at sublease commencement

8.2.430 Under Topic 842, because the sublease is classified as an operating lease, Sublessor SR does not make any accounting entries for the sublease of the warehouse to Sublessee SE at the sublease commencement date.

8.2.440 Under IFRS 16, SR makes the following entry to recognize the sublease as a finance lease at the end of Year 2:

	Debit	Credit
Lease receivable[1]	332,257	
ROU asset		303,258
Profit or loss (gain)		28,999
To recognize finance sublease		

Note 1:

There is no unguaranteed residual right-of-use asset because the sublease is for the entire term of the original lease.

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From sublease commencement to end of sublease term – Balance sheet comparison

End of Year	FASB ROU asset (head lease)	IASB Lease receivable (sublease)	FASB and IASB Lease liability (head lease)
2	$316,968	$332,257	$330,464
3	299,598	320,192	318,465
4	281,508	306,444	304,791
5	262,597	290,882	289,313
6	242,758	273,368	271,894
7	221,874	253,754	252,387
8	199,819	231,883	230,634
9	176,459	207,587	206,469
10	151,649	180,687	179,714
11	125,234	150,992	150,180
12	97,048	118,300	117,664
13	66,910	82,393	81,950
14	34,629	43,042	42,810
15	–	–	–

From sublease commencement to end of sublease term – Income statement comparison

	FASB			IASB			
End of Year	Sublease income	Head lease expense	Net income (loss)	Gain (loss) on sublease	Interest income (sublease)	Interest expense (head lease)	Net income (loss)
2	$ –	$ –	$ –	$28,999	$ –	$ –	$28,999
3	38,443	(37,198)	1,245	–	19,935	(19,828)	107
4	38,443	(37,198)	1,245	–	19,212	(19,108)	104
5	38,443	(37,198)	1,245	–	18,387	(18,287)	100
6	38,443	(37,198)	1,245	–	17,453	(17,359)	94
7	38,443	(37,198)	1,245	–	16,402	(16,314)	88
8	38,443	(37,198)	1,245	–	15,225	(15,143)	82
9	38,443	(37,198)	1,245	–	13,913	(13,838)	75
10	38,443	(37,198)	1,245	–	12,455	(12,388)	67
11	38,444	(37,198)	1,246	–	10,841	(10,783)	58
12	38,444	(37,197)	1,247	–	9,060	(9,011)	49
13	38,444	(37,197)	1,247	–	7,098	(7,059)	39
14	38,444	(37,197)	1,247	–	4,944	(4,916)	28
15	38,444	(37,197)	1,247	–	2,582	(2,568)	14
Total	**$499,764**	**$(483,570)**	**$16,194**	**$28,999**	**$167,507**	**$(166,602)**	**$29,904**

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Comparison with current US GAAP – Classification and accounting for subleases by sublessors

8.2.450 In practice, subleases are very common. Applying Topic 842 will not have a significant effect on the sublessor's accounting for the sublease; for example, sublease classification and sublease income recognition are going to be effectively unchanged from current US GAAP. In addition, the sublessor's accounting for the head lease will be substantially unchanged for *finance* leases; under both current US GAAP and Topic 842, the sublessor continues to recognize the finance lease asset unless the sublessor is relieved of its primary obligation under the head lease. However, the sublessor's recognition of a right-of-use asset and lease liability for a head operating lease is a substantial change to the sublessor's accounting for the head operating lease from current US GAAP. [840-30-35-12]

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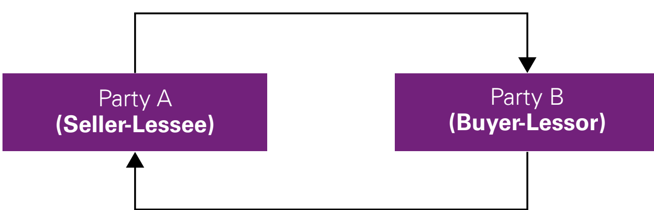
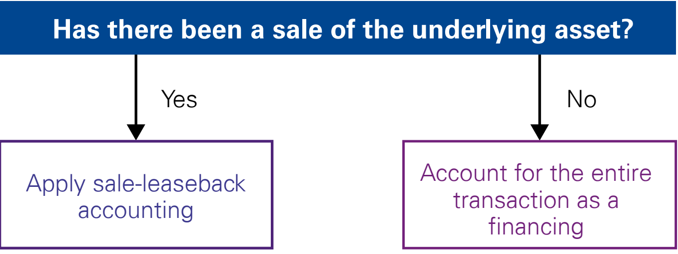
9 Sale-leaseback accounting

How the standard works

In a sale-leaseback transaction, one entity (the seller-lessee) transfers an asset to another entity (the buyer-lessor) and then leases that asset back from the buyer-lessor.



The driver of the accounting is whether a sale (seller-lessee) and purchase (buyer-lessor) has occurred. This determination is made by each party applying the guidance in Topic 606 for determining whether (1) there is a contract between the parties, and (2) a customer has obtained control of a good.



If a lessee controls the underlying asset, including an underlying asset that is under construction in a so-called build-to-suit arrangement, before the commencement date of the lease, it is a sale-leaseback transaction. This means that the lessee recognizes the underlying asset on-balance sheet (e.g. during construction in a build-to-suit arrangement).

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9.1 Determining whether a sale/purchase has occurred

9.1.10 For a sale (and purchase) to occur in the context of a sale-leaseback transaction, the following conditions need to be met:

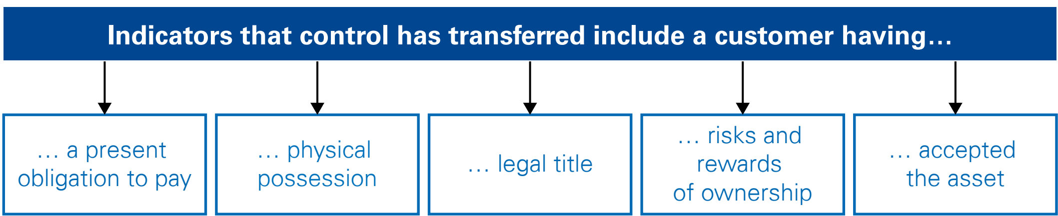
– there is a contract between the parties based on the contract identification guidance in Topic 606; and

– the seller-lessee has transferred control of the asset to the buyer-lessor based on the guidance on satisfying performance obligations in Topic 606. [842-40-25-1, 606-10-25-1 – 25-8, 25-30]

Control principle in Topic 606

Control of an asset refers to the ability to direct the use of, and obtain substantially all of the remaining benefits from, the asset. Control includes the ability to prevent other entities from directing the use of, and obtaining the benefits from, an asset.

9.1.20 The following are indicators that control has transferred in accordance with the control principle. [606-10-25-30]



9.1.30 The existence of the leaseback does not, by itself, preclude an entity from concluding that control of the underlying asset has been transferred to the buyer-lessor. However, the buyer-lessor has not obtained control of the underlying asset if:

– the leaseback results in a lease that would be classified as a finance lease (by the seller-lessee) or as a sales-type lease (by the buyer-lessor); or

– the contract contains a substantive seller-lessee repurchase option with respect to the transferred asset, *unless* the option:

  » is exercisable only at the fair value of the asset on the exercise date; and

  » there are alternative assets, substantially the same as the transferred asset, readily available in the marketplace. [842-40-25-2 – 25-3]

9.1.40 If a contract exists and the buyer-lessor obtains control of the underlying asset, the transaction is accounted for as a sale and a leaseback by both the seller-lessee and the buyer-lessor. [842-40-25-4]

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9.1.50 If the transfer of the asset to the buyer-lessor is not a sale, both parties to the transaction account for the transfer of the underlying asset as a financing arrangement – i.e. as a 'failed sale' by the seller-lessee, and as a 'failed purchase' by the buyer-lessor. The accounting for failed sale-leaseback transactions is discussed in section 9.3. [842-40-25-5]

9.1.60 The term 'readily available' is used in multiple places within Topic 842, and we believe that its use is intended to be consistent throughout the standard. Accordingly, in the context of the seller-lessee repurchase option criterion (see 9.1.30), we believe that the test is whether another asset, substantially the same, is available for purchase separately from the buyer-lessor or from other suppliers.

9.1.70 In some cases, an entity enters into a sale-leaseback transaction in which the asset is either:

- subject to an existing operating lease; or
- subleased or intended to be subleased by the seller-lessee to another entity under an operating lease – i.e. the entity is or will be a sublessor. [842-40-55-18]

9.1.80 The existence of a sublease does not, by itself, prevent the buyer-lessor from obtaining control of the asset – i.e. from concluding that a sale/purchase has occurred – and also does not prevent the seller-lessee from controlling the asset before its transfer to the buyer-lessor. The seller-lessee is subject to the same requirements for determining whether the transfer of the asset is a sale with or without the sublease. [842-40-55-19]

9.1.90 A seller-lessee residual value guarantee of the transferred asset does not automatically preclude a conclusion that a sale/purchase has occurred. However, it is a relevant consideration in determining whether the buyer-lessor has obtained control of the asset. This is because a seller-lessee residual value guarantee may suggest that the buyer-lessor has not taken on the significant risks and rewards of ownership of the asset, which is one of the indicators to consider in evaluating whether a customer has obtained control of an asset in Topic 606 (see 9.1.20). [842-40-55-21, 606-10-25-30]

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Example 9.1

Determining whether a sale/purchase has occurred

9.1.100 Seller-Lessee SL enters into a contract (that meets the contract identification criteria in Topic 606) with Buyer-Lessor BL for the sale-leaseback of a machine. The machine has a remaining economic life of five years, and its fair value is $100,000. Title to the machine transfers to BL, and payment of the transaction price for the machine is payable to SL at commencement of the leaseback.

Scenario 1: Seller-lessee repurchase option does not preclude sale/purchase accounting

9.1.110 In addition to the basic facts in 9.1.100, the following facts are relevant.

– Leaseback term:	3 years
– Leaseback payments:	Fixed payments of $28,000 per year in arrears
– SL's incremental borrowing rate[1]:	7%
– Expected residual value:	$30,000
– Residual value guarantee:	None
– Purchase option:	Fair value of machine at date of exercise

Note 1:

The rate implicit in the lease is not readily determinable.

9.1.120 In addition:

- The machine is produced widely such that there are alternative machines, substantially the same as the transferred machine, readily available in the marketplace.
- The leaseback would not be classified as a finance lease by SL, or as a sales-type lease by BL, applying the relevant criteria for lease classification – see section 6.2 (lessees) and section 7.2 (lessors).

9.1.130 Both SL and BL conclude that there is a sale/purchase of the machine:

- the leaseback is not classified as a finance/sales-type lease; and
- SL's repurchase option does not preclude sale/purchase accounting, because:
  - » the strike price is the fair value of the machine on the exercise date; and
  - » there are alternative machines, substantially the same as the transferred machine, readily available in the marketplace.

9.1.140 Lastly, the transfer of control indicators in Topic 606 indicate that control of the asset transfers to BL at commencement of the leaseback. That is because, even though SL retains physical possession of the machine, the following occur at commencement:

- title transfers to BL;
- SL has a present right to payment of the transaction price for the machine; and

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- BL assumes the significant risks and rewards of ownership – e.g. BL is now responsible for (or will benefit from) any changes in the residual value of the transferred machine.

Scenario 2: Seller-lessee repurchase option results in failed sale/purchase

9.1.150 The facts in this scenario are the same as in Scenario 1, except that the machine has been designed and modified specifically for Seller-Lessee SL's commercial needs. Therefore, there are no alternative assets substantially the same as the transferred machine readily available in the marketplace.

9.1.160 In this scenario, no sale/purchase of the asset occurs. SL's repurchase option precludes sale/purchase accounting for both SL and Buyer-Lessor BL. In addition, while stated not to be the case in *this* scenario, in a similar scenario the specialized design and modification of the machine *could* lead to a conclusion that the machine will have no alternative use to BL at the end of the leaseback term, and therefore that the leaseback is a finance/sales-type lease (also resulting in a failed sale/purchase).

Scenario 3: Seller-lessee residual value guarantee

9.1.170 Assume the same facts as in Scenario 1, except that:

- Seller-Lessee SL guarantees $20,000 of the expected $30,000 expected residual value of the machine; and
- SL does not have a repurchase option.

9.1.180 Consistent with Scenario 1, even though SL retains physical possession of the machine, the following occur at commencement:

- title transfers to Buyer-Lessor BL; and
- SL has a present right to payment.

9.1.190 These indicators provide evidence that BL has obtained control of the machine. However, the significant residual value guarantee provided by SL calls into question whether BL has the significant risks and rewards of ownership, an indication that control may not have transferred to BL. While BL can potentially obtain the rewards of ownership, the residual value guarantee substantially limits BL's risk. Because of the significant residual value guarantee provided by SL, which results in conflicting control indicators, there is judgment in determining whether control of the machine transfers to BL at commencement of the leaseback.

9.1.200 In this scenario, ultimately both SL and BL conclude that a sale/purchase has occurred. They base their respective decisions on the following.

- BL can direct the use of the machine in the same way as any other lessor can direct the use of an asset subject to a lease – e.g. it can sell the asset (subject to the leaseback); and
- BL can obtain substantially all of the remaining benefits related to the machine – it is entitled to either the entirety of the proceeds from a sale, or to the cash payments from the leaseback and the residual benefits of the machine after the leaseback term.

9.1.210 In making this determination, the parties assign greater weight to the benefits that BL obtains from the asset than the risk protection from the residual value guarantee provided by SL. For further discussion, see KPMG's observation at 9.1.310–330.

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Scenario 4: Leaseback is a finance/sales-type lease

9.1.220 In addition to the basic facts in 9.1.100, the leaseback term is for *four* years.

9.1.230 Because the leaseback term is for the major part of the remaining economic life of the machine (four-year lease term compared to five-year remaining economic life), the leaseback would be classified as a finance lease by SL, and as a sales-type lease by BL. Therefore, no sale (from the perspective of SL) or purchase (from the perspective of BL) occurs. Instead, both parties will account for the transaction as a financing arrangement (see section 9.3).

KPMG observation – Leaseback does not preclude sale/purchase accounting

9.1.240 The Board's decision that the presence of the leaseback does not, in isolation, prevent the buyer-lessor from obtaining control of the underlying asset appears to potentially conflict with the following in Topic 606 (and the basis for conclusions to ASU 2014-09):

- defining control of an asset as the ability to direct the use of, and obtain substantially all of the remaining benefits from, the asset; and
- the Board's description of the ability to direct the use of an asset as the customer's right to deploy that asset in its activities, to allow another entity to deploy that asset in its activities, or to restrict another entity from deploying that asset. [606-10-25-25, ASU 2014-09.BC120]

9.1.250 Following that guidance, it appears that the buyer-lessor in a sale-leaseback transaction does not obtain the ability to direct the use of the asset (as defined in Topic 606) until the end of the leaseback term.

9.1.260 Consequently, the Board's decision appears to be based largely on its view that a lessor's accounting for a lease should not differ solely because it purchased the underlying asset from the lessee rather than from a third party. The Board observed that a sale-leaseback scenario is not substantively different from many lessor scenarios in which the lessor purchases the underlying asset from a third party only after the terms and conditions of the lease are agreed with the lessee. In those scenarios, similar to a sale-leaseback transaction, the lessor may not take possession of the underlying asset prior to commencement of the lease (i.e. it may be delivered directly to the lessee) *and* it has no ability to direct its use until after the end of the lease term. [ASU 2016-02.BC352(a)]

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KPMG observation – Finance/sales-type leaseback

9.1.270 The Board concluded that in a finance/sales-type lease, the lessee in effect obtains control of the underlying asset – i.e. rather than solely a right to control the use of the underlying asset. Therefore, the Board decided that it would be inappropriate to account for a sale and finance/sales-type leaseback transaction as a sale and a leaseback, because that would be akin to permitting recognition of a gain by the seller-lessee on a round-trip sale – i.e. the buyer-lessor would obtain control of the asset only to immediately transfer control of the asset back to the seller-lessee. Instead, the Board decided that no sale from the seller-lessee to the buyer-lessor occurs in the first place. [ASU 2016-02.BC67, BC352(b)]

KPMG observation – Repurchase options

Approach different from Topic 606

9.1.280 The Board's decision to permit sale/purchase accounting in a sale-leaseback transaction when the seller-lessee has a repurchase option in some, limited circumstances appears to represent a departure from the Board's stated aim of recognizing a sale/purchase only when the requirements for a sale in Topic 606 are met. This is because Topic 606 precludes accounting for a transaction as a sale if the seller has any substantive option to repurchase the good sold, regardless of the strike price or the nature of the good – i.e. whether or not there are alternative assets substantially the same as the transferred asset readily available in the marketplace. [ASU 2016-02.BC352(c)]

9.1.290 The Board's decision to permit sale/purchase accounting in those limited circumstances reflects the discomfort that some Board members had with a seller-lessee recognizing a liability for the consideration received from the buyer-lessor solely because it has the *option* to reacquire the asset and may only do so by paying its fair value when the option is exercised. Other Board members, when reaching this decision, noted that the basis for conclusions to ASU 2014-09 also appears to at least suggest that a repurchase option permitting the seller to repurchase an asset that is readily available in the marketplace at its then-prevailing fair value does not constrain a customer in its ability to direct the use of, and obtain substantially all the benefits from, the asset. [ASU 2014-09.BC425]

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Assessing whether assets are substantially the same – implications for real estate and other assets

9.1.300 For a seller-lessee repurchase option not to preclude sale/purchase accounting, there must be alternative assets, substantially the same as the transferred asset, readily available in the marketplace. The basis for conclusions, as well as the Board's discussion of this requirement at a public meeting, are instructive as to the intended application of this criterion:

- The basis for conclusions and the Board's discussion suggest that Board members do not think that real estate assets can be substantially the same as each other. In the Board's view, no two real estate assets occupy the same unique space; therefore, even if two real estate assets are similar (e.g. in size, design, function), they are not substantially the same. Consequently, it appears that the Board's intent is that *any* seller-lessee repurchase option for a real estate asset will preclude sale/purchase accounting in a sale-leaseback transaction.
- In communicating its intent with respect to real estate, the Board appears to have signaled that 'substantially the same' is a high threshold. An asset, whether or not real estate, that is merely 'similar' to another asset is not substantially the same as that asset. Judgment will be required to determine whether two non-real estate assets are substantially the same, but in general we believe that those two assets will have to be nearly identical (e.g. the same make and model). [ASU 2016-02.BC352(c)]

KPMG observation – Conflicting transfer of control indicators

9.1.310 The Board observed that substantial judgment may be required in determining whether a sale/purchase has occurred. This is because the transfer of control evaluation in Topic 606 is largely indicator-based (see 9.1.20) and, in a sale-leaseback transaction, those indicators will almost always provide conflicting evidence. For example, while the buyer-lessor will typically obtain title to the asset and have a present obligation to pay the seller-lessee for that asset, the seller-lessee typically retains physical possession of the asset. The indicator about customer acceptance may frequently not be applicable. Consequently, the indicator that the 'customer has the significant risks and rewards of ownership of the asset' may often receive significant attention in the evaluation, because it is the indicator that may be most likely to vary from transaction to transaction. For example, a significant seller-lessee residual value guarantee of the asset may suggest that the buyer-lessor does not have the significant risks *and* rewards of ownership of the asset. In that case, the control indicators would be split. [606-10-25-25, 25-30, ASU 2016-02.BC353]

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9.1.320 Particularly when the indicators provide conflicting evidence, we believe that it is important to consider that, while Topic 606 provides five indicators to consider in determining when a buyer obtains control of an asset, it also requires entities to consider the overall control *principle* (see 9.1.10).

9.1.330 We believe that consideration of the control principle may suggest that the absence of exposure to risks (e.g. because of a seller-lessee residual value guarantee) is less important than the ability to obtain the remaining benefits from the asset. In that case, the buyer-lessor's ability to obtain the remaining benefits from the asset (e.g. to sell the asset, subject to the leaseback, and obtain all of the proceeds from that sale) may provide more persuasive evidence about whether a sale/purchase has occurred than whether the seller-lessee has provided protection against some of the risks of ownership (e.g. decreases in the market value of the asset). This is illustrated in Example 9.1, Scenario 3.

KPMG observation – Seller-lessee and buyer-lessor might reach different conclusions

9.1.340 It is possible that a seller-lessee and a buyer-lessor in a sale-leaseback transaction will not come to the same conclusion about whether a sale/purchase has occurred. This could occur for any of the following reasons:

- Different judgments or estimates (e.g. as to discount rate for the lease) result in the two entities reaching different conclusions about whether the leaseback is a finance lease (lessee) or a sales-type lease (lessor).
- Different judgments about the nature of the asset (e.g. whether assets substantially the same as the transferred assets are readily available in the marketplace) could result in different conclusions about the effect of a seller-lessee repurchase option.
- The two entities could reach different conclusions about whether a sale/purchase has occurred in applying the control indicators. [ASU 2016-02.BC352(c), BC353]

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US GAAP different from IFRS – Sale-leaseback transactions

Effect of repurchase options

9.1.350 While, in some limited circumstances under Topic 842, a seller-lessee option to repurchase the transferred asset will not preclude sale/purchase accounting, *any* substantive seller-lessee repurchase option will preclude sale/purchase accounting under IFRS 16. [IFRS 16.99, BC262(c), IFRS 15.BC427]

Effect of leaseback classification

9.1.360 Topic 842 precludes sale/purchase accounting in the context of a sale-leaseback transaction if the leaseback would be classified as a finance lease by the seller-lessee (or as a sales-type lease by the buyer-lessor). IFRS 16 includes no similar prohibition. Rather, under IFRS 16, the more significant the leaseback (e.g. the leaseback is classified as a finance lease by the buyer-lessor), the less of the gain from the sale of the asset the seller-lessee will recognize at the time of sale. [IFRS 16.99–100, BC264]

Comparison with current US GAAP – Sale-leaseback transactions

Different sale-leaseback accounting for real estate versus other assets eliminated

9.1.370 Current US GAAP has different guidance for sale-leaseback transactions of real estate versus other assets. Under Topic 842, the same guidance applies to all sale-leaseback transactions, regardless of whether the underlying asset is real estate. [840-40-25-9 – 25-18]

Sale-leaseback accounting now easier to achieve for real estate; more difficult for other assets

9.1.380 Sale-leaseback transactions in the US involving equipment often contain an option for the seller-lessee to repurchase the equipment. Such options generally do not result in a failed sale under Topic 840 unless the repurchase option is a bargain repurchase option. Topic 842 will make it more difficult for many equipment sale-leaseback transactions to qualify for sale-leaseback accounting. [840-40-25-9 – 25-18]

9.1.390 Conversely, current US GAAP results in a failed sale for real estate sale-leaseback transactions if the seller-lessee has any continuing involvement (including a repurchase option at any strike price) with the real estate other than a normal leaseback. Failed sales are common in real estate sale-leaseback transactions as a result. Because Topic 842 supersedes the current US GAAP continuing involvement provisions, and the sale requirements in Topic 606 are generally considered to be less onerous, it will generally be easier for real estate sale-leaseback transactions to qualify for sale-leaseback accounting under Topic 842 than under current US GAAP. However, a seller-lessee repurchase option will generally still preclude sale-leaseback accounting for a real estate sale-leaseback transaction (see KPMG observation at 9.1.300). [840-40-25-9 – 25-18]

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No 'failed purchase' accounting

9.1.400 When the transfer of the asset does not qualify as a sale/purchase based on the relevant guidance in Topic 606, Topic 842 will require the buyer-lessor to account for a sale-leaseback transaction as a 'failed purchase' (see section 9.3). In contrast, current US GAAP never requires the buyer-lessor to account for a failed purchase, even if the seller-lessee accounts for the transaction as a failed sale.

Sale-leaseback accounting is not prohibited for capital (finance) leasebacks

9.1.410 Current US GAAP does not prohibit a seller-lessee from concluding that a sale has occurred in the context of a sale-leaseback transaction solely because the seller-lessee would classify the leaseback as a capital lease. [840-40-25-2]

9.2 Accounting for a sale-leaseback transaction

9.2.10 When a sale/purchase occurs in the context of a sale-leaseback transaction, at the point in time that the buyer-lessor obtains control of the asset (under Topic 606), the seller-lessee:

- recognizes the transaction price (i.e. the sale price) as determined in accordance with the guidance on determining the transaction price in Topic 606, adjusted for any off-market terms; and
- derecognizes the carrying amount of the underlying asset. [842-40-25-4(a), 606-10-25-30, 32-2 – 32-7]

9.2.20 Subject to any adjustment for off-market terms, this results in recognition of the full amount of the gain or loss on the sale of the asset.

9.2.30 A seller-lessee accounts for the leaseback under the lessee accounting model (see chapter 6). [842-40-25-4(a)(3)]

9.2.40 A buyer-lessor accounts for the:

- purchase of the underlying asset in a sale-leaseback transaction consistent with the guidance that would apply to any other purchase of a nonfinancial asset (subject to any off-market adjustment) – i.e. without the presence of a leaseback; and
- leaseback under the lessor accounting model (see chapter 7). [842-40-25-4(b)]

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9.2.1 Determining whether the sale price is off-market

9.2.50 Unless the sale-leaseback transaction is between related parties (see 9.2.90), the sale/purchase is accounted for at fair value. Therefore, both the seller-lessee and the buyer-lessor need to assess whether the transaction is at fair value – i.e. at market terms. [842-40-30-1]

9.2.60 In making its assessment as to whether the transaction is at fair value, an entity uses the formula that is more readily determinable:

- the sale price of the asset versus the fair value of the asset; or
- the present value of the lease payments versus the present value of market rental payments. [842-40-30-1]

9.2.70 A sale-leaseback transaction is not off-market solely because the sale price or the leaseback payments include a significant variable component. In determining whether the sale price is at fair value, the entity considers those variable payments that it reasonably expects to receive (or make) on the basis of all reasonably available information (e.g. historical, current, and/or forecast). For the seller-lessee, this includes estimating any variable consideration to which it expects to be entitled under the guidance on estimating variable consideration (*before* consideration of the constraint on variable consideration) in Topic 606. [842-40-30-3, 606-10-32-5 – 32-9]

9.2.80 Sale-leaseback transactions are generally interdependent and negotiated as a package. Consequently, the parties could negotiate off-market terms for either the sale or the leaseback, and recoup the difference through the other part of the transaction – i.e. through a negotiated sales price above fair value and lease payments above market rates, or vice versa. Although the two formulas in 9.2.60 may give different results, the Board decided that either comparison is an acceptable way to identify whether the accounting for the transaction needs to be adjusted due to the presence of off-market terms. However, the decision about which comparison to use is not a free choice; entities are required to maximize the use of observable prices and information, which is consistent with using the comparison that is more readily determinable. [ASU 2016-02.BC363–BC364]

9.2.90 If the sale-leaseback transaction is between related parties, neither the seller-lessee nor the buyer-lessor makes any adjustment for off-market terms. Instead, the entity discloses the off-market nature of the transaction (see 12.3.10). [842-40-30-4]

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KPMG observation – Gain recognition consistent with that for any nonfinancial asset

9.2.100 The Board concluded that if the sale and the leaseback are at market terms, the transfer of control of the asset (i.e. the sale) to the buyer-lessor is separate and distinct from the buyer-lessor's transfer of a right to use that asset to the seller-lessee. Consequently, the presence of the leaseback should neither preclude the sale of the asset, nor alter the accounting for that sale (except as necessary to adjust for off-market terms). [ASU 2016-02.BC359–BC360]

KPMG observation – Related party transactions

9.2.110 The Board decided that recognizing sale-leaseback transactions between related parties based on contractual terms is consistent in concept with the Board's decision that an entity should account for a related party lease in accordance with its enforceable terms and conditions of that lease. An entity should not account for the transaction in accordance with a subjective determination of its economic substance. [ASU 2016-02.BC362]

9.2.2 Adjusting the gain or loss for off-market terms

9.2.120 If, based on the evaluation in section 9.2.1, the sale-leaseback transaction is not at fair value the entity – whether the seller-lessee or the buyer-lessor – adjusts the sale price so that the transaction is recognized at fair value:

- **Deficit.** If the sale price is less than fair value, an adjustment is made to increase the sale price of the asset. The corresponding debit is recognized as a rent prepayment.
- **Excess.** If the sale price is greater than fair value, an adjustment is made to decrease the sale price of the asset. The corresponding credit is recognized as additional financing provided by the buyer-lessor to the seller-lessee. [842-40-30-2]

9.2.130 When there is an excess and additional financing is recognized, both the seller-lessee and the buyer-lessor allocate a portion of each contractual lease payment to both the lease and the additional financing.

- The amount allocated to each by the seller-lessee is the amount necessary to ensure that the lease liability and the additional financial liability both equal zero at the end of the lease term.
- The amount allocated to each by the buyer-lessor is the amount necessary to reduce its financial asset and any net investment in a direct financing leaseback to zero at the end of the lease term. [842-40-30-1 – 30-2, 55-23 – 55-30]

9.2.140 Operating lease cost (seller-lessee) or income (buyer-lessor) is determined based on the total amount of the contractual payments allocated to the lease.

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9.2.3 Accounting for the leaseback

9.2.150 When a sale-leaseback transaction qualifies for sale/purchase accounting, both the seller-lessee and the buyer-lessor account for the leaseback in the same manner as any other lease – see chapter 6 (lessees) and chapter 7 (lessors). [842-40-25-4]

Example 9.2

Gain recognized by seller-lessee in a sale-leaseback transaction

9.2.160 Seller-Lessee SL sells a building to Buyer-Lessor BL and leases it back. The following facts are relevant at the point in time that BL takes control of the building:

– Carrying amount of building:	$1.5 million
– Sale price (and fair value[1]) of the building:	$2.5 million
– Lease term:	4 years
– Lease payments:	Fixed payments of $325,000 per year in arrears
– SL's incremental borrowing rate[2]:	10%
– Lease incentives/initial direct costs:	None

Notes:

1. Based on recent sale prices of comparable buildings in the area, which are more readily determinable than market rentals for the four-year leaseback.
2. The rate implicit in the lease is not readily determinable.

9.2.170 As illustrated in the entries below, SL recognizes the full amount of the gain on the sale of the building, consistent with how it would recognize the gain resulting from the sale of any other nonfinancial asset.

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	Debit	Credit
Cash	2,500,000	
Building		1,500,000
Gain on sale[1]		1,000,000
To recognize sale in sale-leaseback transaction		
ROU asset[2]	1,030,206	
Lease liability[3]		1,030,206
To recognize leaseback in sale-leaseback transaction		

Notes:

1. Sale price ($2.5 million) - carrying amount of the building ($1.5 million).
2. Lease liability ($1,030,206) + prepaid rent (nil) + initial direct costs (nil) - lease incentives (nil).
3. Four payments of $325,000 (paid in arrears), discounted at 10%.

US GAAP different from IFRS – Partial (IFRS 16) versus full (Topic 842) gain recognition

9.2.180 Both Topic 842 and IFRS 16 require the seller-lessee and the buyer-lessor to adjust the sale price of the asset for off-market terms and determine the amount of that adjustment similarly. Both standards also require the buyer-lessor to account for the purchase of the asset in the same manner as any other purchase of a nonfinancial asset. [IFRS 16.100(b), 101–102]

9.2.190 However, Topic 842 and IFRS 16 differ as to how much gain or loss should be recognized by the seller-lessee at the point in time that the buyer-lessor obtains control of the asset. Under Topic 842, the seller-lessee recognizes the full amount of any difference between the sale price (as adjusted for any off-market terms) and the carrying amount of the asset as a gain or loss at the time of sale. In contrast, under IFRS 16, the seller-lessee recognizes only the portion of that gain or loss that relates to the residual asset that the lessor controls at the end of the leaseback (the rights transferred to the buyer-lessor). [IFRS 16.100, IE11, BC266]

9.2.200 IFRS 16 calculates the partial gain or loss as follows.

(Adjusted Sale Price - Carrying Amount) ÷ Fair Value of the Asset × (Fair Value of the Asset - Present Value of the Leaseback Payments)

9.2.210 Example 9.2 demonstrates the accounting under Topic 842, which can be compared to the IFRS 16 gain calculation in 9.2.220–230.

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Comparison of sale-leaseback accounting between Topic 842 and IFRS 16

9.2.220 Using the fact pattern in Example 9.2 (Topic 842), Seller-Lessee SL would recognize the following entry under IFRS 16.

	Debit	Credit
Cash	2,500,000	
ROU asset	618,124	
Building		1,500,000
Lease liability		1,030,206
Gain on sale		587,918

9.2.230 The differences between this journal entry under IFRS 16 and the journal entry under Topic 842 are the calculations of the following.

– The **right-of-use asset** retained through the leaseback of the office building is a proportion of its previous carrying amount: ($1,500,000/$2,500,000) x $1,030,206 = $618,124.

– SL recognizes only the portion of the **gain on sale** that relates to the rights transferred to BL: ($2,500,000 - $1,500,000) ÷ $2,500,000 x ($2,500,000 - $1,030,206) = $587,918.

Comparison with current US GAAP – Gain/loss recognition different

Accounting for a gain or loss on a sale-leaseback transaction

9.2.240 The ability to recognize a gain immediately on recognition of a sale-leaseback transaction is a change from current US GAAP. Under current US GAAP, the recognition of any gain or loss on the sale of the underlying asset in a sale-leaseback transaction depends on the rights retained by the seller-lessee. These thresholds are illustrated by the following table. [840-40-25.3 – 25.5]

Minor	More than minor, but less than substantially all	Substantially all
0% – 10%	10% – 90%	90% – 100%

9.2.250 Under current US GAAP, gains or losses realized by a seller-lessee are accounted for as follows.

– Transactions resulting in a realized **loss** by the seller-lessee:

  » Fair value of underlying asset < Carrying amount of underlying asset = Recognize the loss immediately.

  » Fair value of underlying asset > Carrying amount of underlying asset = Account for the loss as a prepayment of rent.

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- Transactions resulting in a realized **gain** by the seller-lessee (i.e. fair value > carrying amount):
  - When the seller-lessee retains only a *minor* portion of the right to the remaining use of the asset sold (i.e. < 10%), recognize the full gain immediately.
  - When the seller retains *more than a minor, but less than substantially all*, of the remaining use of the asset sold (i.e. between 10% and 90%):
    - Operating leasebacks: Recognize a gain to the extent that the profit on sale exceeds the present value of the minimum lease payments.
    - Capital leasebacks: Recognize a gain to the extent that the profit on the sale exceeds the carrying amount of the underlying asset on the date of sale.
- When the seller-lessee retains *substantially all* of the risks and benefits incidental to the ownership of the underlying asset (i.e. > 90%), defer and amortize any profit over the lease term. [840-40-25-3 – 25-4]

Related party transactions

9.2.260 Under current US GAAP, entities recognize the economic substance of a related party lease rather than its legal form, which includes evaluating the economic substance of sale-leaseback transactions. The requirement to evaluate related party sale-leaseback transactions solely based on their legal form is, therefore, a difference between current US GAAP and Topic 842. [840-10-25-26]

Example 9.3

Accounting for a sale-leaseback transaction with off-market terms

9.2.270 Assume the same facts as Example 9.2, except for the following.

- The building's observable fair value on the date of the sale is $2 million – i.e. the sale price exceeds the building's observable fair value by $500,000.
- The market rental payments are $198,800 per year – i.e. the present value of the contractual lease payments exceeds the present value of market rental payments by $400,037.
- Buyer-Lessor BL applies a discount rate of 10% to the additional financing provided to Seller-Lessee SL, determined in accordance with Subtopic 835-30 (imputation of interest).

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9.2.280 Because the terms of the transaction are not at market, both parties record an adjustment to recognize the transaction at fair value, as an initial step in accounting for the sale-leaseback transaction.

Seller-lessee accounting

9.2.290 SL uses the fair value of the asset to determine the extent to which the sale/purchase is off-market (see section 9.2.1), because the fair value of the asset is more readily determinable than market rentals for the leaseback. This means that:

- the gain on sale is calculated with reference to the fair value of $2 million; and
- the excess of $500,000 ($2.5 million - $2 million) is recognized as additional financing.

9.2.300 SL records the following journal entry when BL obtains control of the building.

	Debit	Credit
Cash	2,500,000	
Building		1,500,000
Financial liability[1]		500,000
Gain on sale[2]		500,000
To recognize sale in sale-leaseback transaction		
ROU asset[3]	530,206	
Lease liability[4]		530,206
To recognize leaseback in sale-leaseback transaction		

Notes:

1. Contractual sale price ($2.5 million) - fair value of the building ($2 million).
2. Adjusted sale price ($2 million) - carrying amount of the building ($1.5 million).
3. Lease liability ($530,206) + prepaid rent (nil) + initial direct costs (nil) - lease incentives (nil).
4. $1,030,206 (see Example 9.2) - off-market adjustment ($500,000).

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Comparison of sale-leaseback accounting between Topic 842 and IFRS 16

9.2.310 Using the fact pattern in Example 9.3 (Topic 842), Seller-Lessee SL would recognize the following entry under IFRS 16.

	Debit	Credit
Cash	2,500,000	
ROU asset	397,655	
Building		1,500,000
Lease liability		530,206
Financial liability		500,000
Gain on sale		367,449
To recognize sale-leaseback transaction		

9.2.320 The difference between this journal entry under IFRS 16 and the journal entry under Topic 842 is the calculation of the following.

- The **right-of-use asset** retained through the leaseback of the office building is a proportion of its previous carrying amount: ($1,500,000 ÷ $2,000,000) x $530,206 = $397,655.
- SL recognizes only the portion of the **gain on sale** that relates to the rights transferred to BL: ($2,000,000 - $1,500,000 ÷ $2,000,000 x ($2,000,000 - $530,206) = $367,449.

Comparison with current US GAAP – Leaseback classification

9.2.330 Under Topic 842, a leaseback cannot be classified as a finance lease for the seller-lessee or a sales-type lease (for the buyer-lessor). All leasebacks are classified as an operating lease by the seller-lessee, and as an operating lease or a direct financing lease by the buyer-lessor. There are no similar prohibitions on leaseback classification under current US GAAP. [840-40-25-2, 25-8]

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9.3 Accounting for failed sale-leaseback transactions

9.3.10 A failed sale-leaseback transaction occurs when the transaction does not meet the requirements for a sale under Topic 606 (see section 9.1). Instead, the transaction is accounted for as a financing transaction by both the seller-lessee and buyer-lessor.

- The seller-lessee recognizes any proceeds received from the buyer-lessor as a financial liability (financing method) and does not derecognize the transferred asset. The seller-lessee continues to depreciate the transferred asset.
- The buyer-lessor does not recognize the transferred asset and accounts for any proceeds paid to the seller-lessee as a receivable (financial asset). [842-40-25-5]

9.3.20 In applying the financing method, the seller-lessee adjusts the interest rate on its financial liability to ensure that:

- interest on the financial liability is not greater than the principal payments on the financial liability over the shorter of the lease term or the term of the financing – i.e. there is not negative accretion on the liability over the shorter of the lease term or the term of the financing; and
- the carrying amount of the underlying asset will not exceed the financing obligation at the earlier of (1) the end of the lease term, and (2) the date on which control of the underlying asset transfers to the buyer-lessor – i.e. there is not a built-in loss. [842-40-30-6]

9.3.30 Example 2 in Subtopic 842-40 demonstrates the accounting for a failed sale-leaseback transaction. [842-40-55-31 – 55-38]

9.3.40 A failed sale-leaseback transaction may not remain a failed transaction for the entire term of the leaseback. For example:

- the buyer-lessor may obtain control of the asset (and therefore complete the sale/purchase) before the end of the leaseback term if a seller-lessee repurchase option that precluded sale/purchase accounting expires; or
- the control guidance in Topic 606 may suggest that the buyer-lessor has not obtained control of the asset at the leaseback commencement date, but may suggest otherwise before the end of the leaseback term. [ASU 2016-02.BC369, 842-40-55-31 – 55-38]

9.3.50 If an initially failed sale-leaseback transaction qualifies for sale/purchase accounting before the end of the leaseback term:

- the seller-lessee derecognizes the remaining financial liability and the carrying amount of the asset, and recognizes a gain for the difference; and
- the buyer-lessor derecognizes its remaining financial asset and recognizes the transferred asset at that same amount. [842-40-55-31 – 55-38]

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9.3.60 Both parties then account for the remaining leaseback in accordance with the applicable lessee and lessor guidance from the date the sale/purchase is deemed to occur for accounting purposes. However, they both use the discount rate for the lease that would have been established at the contractual lease commencement date. This only matters for the buyer-lessor if the leaseback is a direct financing lease because a buyer-lessor cannot have a sales-type leaseback and will not recognize lease assets for an operating leaseback. [842-40-55-31 – 55-38]

9.3.70 Example 2 in Subtopic 842-40 indicates that the seller-lessee uses the lease commencement date discount rate because that rate more closely reflects the interest rate that would have been considered by the buyer-lessor in pricing the lease. [842-40-55-31 – 55-38]

KPMG observation – Failed sale-leaseback that later qualifies for sale-leaseback accounting

9.3.80 In Example 2 in Subtopic 842-40, neither the seller-lessee nor the buyer-lessor assesses the classification of the lease at the date that the transaction qualifies for sale-leaseback accounting. Although not stated explicitly, we believe that it was the Board's intention for the parties *not* to reassess lease classification. This is based on the following reasoning:

- The lease classification guidance in Topic 842 makes no mention of reassessing lease classification in the context of failed sale-leaseback transactions. That guidance provides that an entity should *only* reassess lease classification upon a modification of the lease or, for lessees, a change in the lease term or the assessment of a lessee purchase option.
- The sale-leaseback guidance requires ongoing reassessment of whether a failed sale-leaseback transaction qualifies for sale-leaseback accounting. A requirement to reassess lease classification in a scenario like that in Example 2 might also suggest that, if the sale-leaseback transaction failed because of the classification of the leaseback as a finance/sales-type lease, the parties would be required to continually reassess lease classification based on changing assumptions (e.g. changes in fair value of the asset) and the passage of time (e.g. changes in the remaining economic life of the asset). [842-10-25-1]

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US GAAP different from IFRS – Less guidance under IFRS for failed sale-leaseback transactions

9.3.90 IFRS 16 does not include some of the guidance about accounting for failed sale-leaseback transactions that Topic 842 does. Therefore, it is unclear whether there is either or both: (1) guidance in Topic 842 that may not be considered acceptable under IFRS 16 or (2) approaches that would appear to be permissible under IFRS 16 (i.e. because no guidance is specified) that would not be acceptable under Topic 842.

Adjusting the discount rate for failed sale-leaseback transactions

9.3.100 IFRS 16 does not include guidance similar to that discussed in 9.3.20 on adjusting the discount rate used by a seller-lessee, under certain circumstances, in accounting for a failed sale and leaseback transaction. A discount rate used by a seller-lessee in accordance with that guidance would be an acceptable application of IFRS 16 only if that discount rate would be acceptable under IFRS 9 (financial instruments). In contrast, it would seem clear that a discount rate not established in accordance with that discussed in 9.3.20 would not be acceptable under US GAAP.

Failed sale-leaseback transaction that later qualifies for sale-leaseback accounting

9.3.110 As outlined in the KPMG observation at 9.3.80, Example 2 in Subtopic 842-40 illustrates the accounting for a failed sale-leaseback transaction that later qualifies for sale-leaseback accounting. That example, which is authoritative under US GAAP, provides guidance that is not provided in IFRS 16 (including within the non-authoritative sections of IFRS 16 – i.e. the illustrative examples and the basis for conclusions). IFRS 16 does not provide guidance of the nature provided in Example 2 or paragraph BC369 of ASU 2016-02 about any of the following (in the scenario of a failed sale-leaseback transaction that later qualifies for sale-leaseback accounting):

- the sale price for the seller-lessee;
- the carrying amount of the purchased asset for the buyer-lessor; or
- the discount rate to use in accounting for the lease (i.e. Topic 842 stipulates use of the discount rate established at the contractual commencement date).

9.3.120 Therefore, there is at least the potential for diversity between entities applying Topic 842 and those applying IFRS 16.

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Comparison with current US GAAP

Seller-lessee accounting for 'failed' sale-leaseback transactions is generally consistent with current practice

9.3.130 Consistent with Topic 842, a failed sale-leaseback transaction under current US GAAP is generally accounted for as a financing transaction. However, unlike Topic 842, current US GAAP also permits use of the deposit method when the sale price of the underlying asset is paid to the seller-lessee over time. [840-40-25-11]

Adjusting the discount rate for failed sale-leaseback transactions

9.3.140 While practice under current US GAAP has developed in a manner similar to the guidance on adjusting the discount rate in a failed sale-leaseback transaction under Topic 842 (see 9.3.60), current US GAAP does not have explicit guidance of this nature.

9.4 Lessee control of the underlying asset

9.4.10 If the lessee controls the underlying asset before the commencement date of the lease, it is a sale-leaseback transaction and the accounting described in sections 9.2–9.3 applies. However, obtaining legal title alone, especially if title is obtained only momentarily, does not mean that the lessee controls the underlying asset before the commencement date. [842-40-55-1 – 55-2, 55-5]

KPMG observation – Effect of legal title on control consistent with Topic 606

9.4.20 The guidance in Subtopic 842-40 stipulating that having legal title to an asset, especially if that legal title is only obtained momentarily (often referred to as 'flash title') before it is transferred to another entity, does not mean a lessee controls the underlying asset before lease commencement is consistent with the guidance in Topic 606, which treats legal title only as an indicator of control and also provides specific guidance that obtaining flash title to a good does not mean an entity controls that good. [ASU 2016-02.BC400]

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9.4.1 Lessee involvement in the construction or design of the underlying asset

9.4.30 A lessee may enter into a lease in which the underlying asset needs to be constructed or redesigned for use by the lessee. Depending on the terms and conditions of the contract, the lessee may be required to make payments related to the construction or design of the asset. [842-40-55-3]

9.4.40 If a lessee incurs costs relating to the construction or design of an underlying asset before the commencement date, it applies other US GAAP (e.g. Topic 330 on inventory or Topic 360 on property, plant, and equipment) to account for such costs. However, costs relating to the construction or design of the underlying asset do not include payments made for the right to use the underlying asset (i.e. lease payments), regardless of the timing of those payments or the form of the consideration; for example, a lessee might contribute materials or labor for the construction or redesign of the underlying asset. [842-40-55-4]

9.4.50 If a lessee controls an underlying asset that is under construction (or redesign) before the commencement date of the lease, it is a sale-leaseback transaction and the accounting described in sections 9.2–9.3 applies. Any one (or more) of the following would demonstrate that the lessee controls an underlying asset that is under construction (or redesign) before the commencement date of the lease.

- The lessee has the right to obtain the partially-constructed underlying asset at any point during the construction period (e.g. by making a payment to the lessor).
- The lessor has an enforceable right to payment for its performance to date and the asset does not have an alternative use to the owner-lessor.
- The lessee legally owns (1) both the land and the property improvements that are under construction, or (2) the non-real estate asset (e.g. a ship or aircraft) that is under construction.
- The lessee controls the land on which the property improvements will be constructed (which includes where the lessee transfers the land to the owner-lessor, but that transfer does not qualify as a sale – e.g. because of a lessee repurchase option) and does not enter into a lease of the land prior to the beginning of the construction that, together with the renewal options, permits the lessor or another related party to lease the land for substantially all of the economic life of the property improvements.[1]
- The lessee is leasing the land on which the property improvements will be constructed, 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 prior to 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.[1] [842-40-55-5]

Note 1:

'Options' refers to all renewal options, regardless of whether it is reasonably certain that those options will be exercised. In other words, this criterion considers the maximum possible lease term, rather than the 'lease term' as defined in Topic 842 (see section 5.3). [842-40-55-40 – 55-44]

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9.4.60 The list in 9.4.50 is not all-inclusive. There may be other facts or circumstances that demonstrate that a lessee controls an underlying asset that is under construction before the commencement date.

9.4.70 Example 3 in Subtopic 842-40 includes an illustration in which the lessee controls the underlying asset that is under construction before the commencement date, as well as one in which the lessee does not control the underlying asset that is under construction before the commencement date. [842-40-55-6, 55-39 – 55-44]

Example 9.4

Determining whether lessee controls the underlying asset before the commencement date

9.4.80 Lessee LE and Owner-Lessor LR enter into a contract whereby LR will construct (whether itself or using subcontractors) a building to LE's specifications and lease that building to LE once construction is completed. The following facts are relevant.

– Economic life of building:	40 years
– Lease term:	20 years
– Lease payments:	Fixed payments of $500,000 per year in arrears, with a 3.5% increase each year after Year 1
– Cost overruns:	Agreed percentage payable by LE

9.4.90 In addition:

- LE does not legally own the building and does not have a right under the contract to obtain the building while it is under construction; for example, LE does not have the right to purchase the construction in process from LR.
- Although the building is being developed to LE's specifications, it is not so customized to LE that the building does not have an alternative use to LR.

Scenario 1: Lessee controls the building as it is being constructed

9.4.100 LE controls the land on which the building is to be constructed. As part of the contract, LE agrees to lease the underlying land to LR for 25 years, beginning at the end of the construction period. The contract does not permit LR to renew the land lease.

9.4.110 In this scenario, LE controls (i.e. is the accounting owner of) the building as it is being constructed, because:

- LE controls the land on which the building will be constructed; and
- the lease of the building does not both (1) grant LR the right to use the land *before* the beginning of the construction period, and (2) permit LR to use the land for substantially all of the economic life of the building (25 out of 40 years).

9.4.120 Because LE controls the building, both LE and LR apply the guidance on sale-leaseback transactions (see sections 9.2–9.3).

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Scenario 2: Lessee does not control the building as it is being constructed

9.4.130 LE leases the land on which the building is to be constructed. LE has a 20-year lease of the underlying land, and four seven-year renewal options – i.e. the lease has a maximum possible term of 48 years. Therefore, LE's lease of the underlying land, together with the renewal options, is for at least substantially all of the economic life of the building under construction.

9.4.140 LE enters into a sublease that gives LR the right to use the underlying land for 25 years, commencing immediately before the beginning of construction of the building. The sublease has two 10-year renewal options available to LR.

9.4.150 None of the circumstances outlined in 9.4.50 exists.

- LE is neither the legal nor the accounting owner of the land, and will not legally own the building while it is being constructed.
- LE does not have the right to obtain the building (e.g. by purchase) from LR during the construction period.
- The building has an alternative use to LR.
- While LE is leasing the land on which the building will be constructed, LE has subleased that land to LR prior to the start of construction for a term that, together with renewal options available to LR, is at least substantially all of the 40-year economic life of the building (45 years exceeds the 40-year economic life of the building).

9.4.160 In this scenario, there are no other circumstances that, individually or in combination, suggest that LE controls the building as it is being constructed. Therefore, LE does not control the building as it is being constructed.

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KPMG observation – Control of an underlying asset under construction derived from Topic 606

9.4.170 The Board observed that, in concept, the evaluation as to whether a lessee controls an underlying asset that is under construction is similar to the evaluation undertaken in the new revenue recognition standard (paragraph 606-10-25-27) to determine whether a performance obligation is satisfied over time. Under the guidance in Topic 606, a customer obtains control of a good as it is being produced (or modified), and therefore the entity satisfies its performance obligation to transfer that good over time, when either or both:

- The entity's performance creates or enhances an asset (e.g. work in process) that the customer controls as the asset is created or enhanced.
- The entity's performance does not create an asset with an alternative use to the entity, and the entity has an enforceable right to payment for performance completed to date.

9.4.180 We believe it was the Board's view that the evaluation of whether a lessee controls an underlying asset that is under construction (i.e. whether a customer controls an asset as it is being constructed that it will lease after the construction period) should be similar to the evaluation of whether a customer controls an asset as it is being constructed (or modified) that it will own after the construction period. [ASU 2016-02.BC400]

US GAAP different from IFRS – No IFRS implementation guidance on control of an underlying asset under construction

9.4.190 Topic 842 and IFRS 16 include substantially similar guidance with respect to the following.

- A lessee shall apply other US GAAP or IFRS in accounting for costs relating to the construction or design of an underlying asset. [IFRS 16.B44]
- Payments for the right to use an underlying asset are lease payments. [IFRS 16.B44]
- If a lessee controls the underlying asset before lease commencement, the arrangement is a sale-leaseback transaction. [IFRS 16.B46]
- Having legal title alone does not mean a lessee controls the underlying asset before the commencement date. [IFRS 16.B45]

9.4.200 However, IFRS 16 does not provide guidance specific to determining whether a lessee controls an underlying asset that is under construction before the commencement date (as Topic 842 does in paragraph 842-40-55-5 and in Example 3 in Subtopic 842-40). Entities applying IFRS 16 will be expected to apply only the control principle in paragraph B46 to all transactions. [IFRS 16.B43–B47]

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Comparison with current US GAAP – Lessee control over asset under construction guidance different from current US GAAP build-to-suit guidance

9.4.210 Topic 842 and current US GAAP both treat the lessee as the accounting owner of an underlying asset that is under construction in some circumstances and, in these situations, the transaction is subject to the sale-leaseback transactions guidance when construction of the asset is completed and the lease term commences. However, Topic 842 and current US GAAP determine whether the lessee is the accounting owner of an underlying asset that is under construction differently. [840-40-15-5]

9.4.220 Under current US GAAP, the lessee is the accounting owner of the asset during the construction period if the lessee either:

– takes on substantially all of the construction-period risks, determined through a 'maximum guarantee test'; or
– engages in one or more activities specifically outlined in the guidance as prohibited involvement. Such activities include, but are not limited to, indemnifying the owner-lessor or its lenders of pre-existing environmental risks (when the risk of loss is more than remote), taking title to the asset at any point during the construction period, or paying construction project costs directly (other than some limited exceptions).

9.4.230 Topic 842 eliminates the current build-to-suit guidance about determining whether a lessee controls the underlying asset during the construction period. Instead, it requires an evaluation of whether a lessee is the accounting owner of an underlying asset under construction based on whether it 'controls' that asset before the commencement date of the lease. [840-40-55-2 – 55-15]

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10 Income taxes

How the standard works

- Topic 842 does not contain tax accounting guidance and only minor, conforming amendments to Topic 740 were made as part of ASU 2016-02. These amendments do not change the basic requirements of Topic 740.
- The adoption of Topic 842 will likely impact an entity's calculation of deferred tax assets and liabilities even though tax laws may not be directly impacted. The following changes will have the most impact on an entity's accounting for deferred taxes.
  - For **lessees**, the recognition of right-of-use assets and lease liabilities for operating leases will require entities to recognize new deferred tax assets and deferred tax liabilities not previously recognized.
  - For **seller-lessees** in sale-leaseback transactions, a failed sale under Topic 842 could result in new deferred tax issues if the sale-leaseback transaction is accounted for as a sale and a leaseback for tax purposes.
  - For **lessors**, the deferral of selling profit for some direct financing leases could create new (or larger) deferred tax assets.
  - For **buyer-lessors** in sale-leaseback transactions, a failed purchase could result in new deferred tax issues if the sale-leaseback transaction is accounted for as a sale and a leaseback for tax purposes.
- In addition, Topic 842 may impact the computation of state and local income-based taxes as a result of changes to the apportionment formula.

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10.1 Deferred taxes

Comparison with current US GAAP – Mechanics of income tax accounting the same

10.1.10 A basic principle of Topic 740 (income taxes) is to recognize deferred taxes for the future tax consequences of events that are recognized in the financial statements or tax returns, but not yet in both. Future tax consequences result from differences between the tax basis and the financial statement carrying amounts of assets and liabilities. Basis differences that have future tax consequences are either taxable temporary differences (that will result in future taxable amounts) or deductible temporary differences (that will result in future deductible amounts). Deferred tax liabilities are recognized for taxable temporary differences and deferred tax assets are recognized for deductible temporary differences.

10.1.20 Topic 842, consistent with current US GAAP, will create book/tax differences. However, because Topic 842 results in the recognition of more assets and liabilities than current US GAAP, the adoption of Topic 842 may require entities to record new, or adjust existing, deferred tax assets and liabilities.

10.1.30 Under current US GAAP for operating leases, a lessee generally records a deferred tax asset for the accrued rent liability that exists, which equals the difference between the cumulative rent deductible for income tax purposes, sometimes based on the cash paid, and the cumulative rent recognized for book purposes (generally on a straight-line basis). Since the underlying asset is not recognized by the lessee for book purposes, nor is any right-of-use asset, the only temporary difference created is the difference between the rent expense recognized for tax purposes and book purposes. However, because Topic 842 requires recognition of a right-of-use asset and a lease liability that have no tax basis, deferred tax accounts will be established to recognize these basis differences.

10.1.40 Aside from this difference, while the amounts may change due to the new requirements of Topic 842 in comparison to current US GAAP, the mechanics of accounting for the income tax consequences of lease agreements remain substantially unchanged.

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Lessee considerations – operating leases

10.1.50 Under Topic 842, a lessee in an operating lease records a lease liability and a right-of-use asset (see section 6.3) on the commencement date (see section 5.1). For tax purposes, the lease will generally be a true tax lease (the income tax equivalent of an operating lease), in which a right-of-use asset and a lease liability are not recognized on the tax ledger. As a result, the operating lease gives rise to two separate temporary differences: (1) a temporary difference related to the right-of-use asset, and (2) a temporary difference related to the lease liability. If an operating lease contains uneven lease payments, an additional temporary difference may be identified by the entity.

Lessee considerations – finance leases

10.1.60 For finance leases, a lessee recognizes the following (see chapter 6):

- right-of-use asset (on the commencement date);
- lease liability (on the commencement date);
- interest expense on the lease liability each period of the lease term; and
- amortization of the right-of-use asset each period of the lease term.

10.1.70 A lessee amortizes the right-of-use asset on a straight-line basis, unless another systematic basis is more representative of the pattern in which the lessee expects to consume the economic benefits of the right-of-use asset. Amortization is recognized over the period from the commencement date to the earlier of the end of the useful life of the right-of-use asset or the end of the lease term. If the lessee is reasonably certain to exercise a purchase option to acquire the underlying asset, the lessee amortizes the right-of-use asset over the period to the end of the underlying asset's useful life.

10.1.80 For tax purposes, finance leases are often treated as either true tax leases or non-tax leases (which is the income tax equivalent of a sales-type lease). Under a true tax lease, the lessor maintains ownership of the asset and the related deductions for depreciation and the lessee is able to deduct rental payments for use of the asset. Compare this with a non-tax lease: Although legal ownership of the asset remains with the lessor in a non-tax lease, the lessor is not considered to have substantial risks and rewards of ownership because the lease is more akin to a financing transaction (e.g. because the lessee has a nominal purchase option at the end of the lease). As a result, the lessee receives the tax benefits of ownership and is able to deduct (1) the related depreciation for the asset, and (2) the portion of the payments that are considered interest, but is not permitted to deduct the total rental payments. The lessor recognizes interest income.

10.1.90 As a result of different classification requirements for book and tax purposes, it is possible for a finance lease to be classified as a true tax lease. In those situations, the lessee will record a right-of-use asset and a lease liability at lease commencement, and subsequently will recognize interest expense and right-of-use asset amortization. For the tax provision, the lessee will have temporary differences related to the right-of-use asset and the lease liability since those do not exist for tax purposes.

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Lessor considerations

10.1.100 A lessor classifies leases as operating, direct-financing, or sales-type leases for book purposes. For tax purposes, those leases are generally treated as true tax leases or as non-tax leases – i.e. similar to a sales transaction. For direct-financing or sales-type leases, the present value of the lease payments during the lease term plus the present value of the expected residual value of the underlying asset at the end of the lease term are recognized as the lessor's net investment in the lease (see section 7.3.2). In some jurisdictions and fact patterns, the lease may be considered a true tax lease, where the lessor will be considered to own the asset for tax purposes and will deduct the depreciation for the asset and recognize taxable income for the rental income. In other jurisdictions and fact patterns, the lease may be treated as a non-tax lease for tax purposes. In this situation, the lessor would recognize a taxable gain or loss on the sale of the asset and will recognize interest income over the lease term for the financing provided to the lessee that is repaid through the payments under the lease.

10.1.110 The deductible amount scheduled in each future year is based on the depreciation to be recognized for tax purposes in those future years. The taxable amount scheduled in each future year generally is based on the present value of amounts to be received in each future year or on the future principal reductions in the lease receivable.

Sale-leaseback considerations

10.1.120 As discussed in chapter 9, an entity entering into a sale-leaseback transaction will apply the specific requirements of Topic 606 (and other sale-leaseback specific considerations, such as whether the leaseback would be classified as a finance/sales-type lease) to determine whether the transfer of the asset is a sale.

10.1.130 If the transfer of the asset is considered a sale, the seller-lessee recognizes the transaction price for the sale (determined in accordance with Topic 606) when the buyer-lessor obtains control of the asset (which may be adjusted for off-market terms), derecognizes the carrying amount of the sold asset, and accounts for the lease in accordance with Topic 842.

10.1.140 The buyer-lessor recognizes the asset at its purchase price (which would be adjusted for off-market terms) and accounts for the lease in accordance with Topic 842. If the transfer of the asset is not deemed a sale (or purchase for the buyer-lessor), the seller-lessee does not derecognize the asset, continues to depreciate the asset, and accounts for any amounts received as a financial liability. The buyer-lessor does not recognize the asset and accounts for any amounts paid as a receivable in accordance with other Topics.

10.1.150 If the form of the transaction is respected for tax purposes, a sale-leaseback transaction generally enables the seller-lessee to deduct the full rental payments that it makes to the buyer-lessor for tax purposes. In addition, the entity typically recognizes a gain or loss related to the sale of the asset. The gain may qualify as capital gains and the loss may be deductible in full as an ordinary loss for tax purposes depending on the specific situation. If the form of the transaction is not respected for tax purposes, a sale-leaseback is generally treated as a secured financing for tax purposes, in which case the seller-lessee is not treated as transferring tax ownership of the underlying asset and continues to take deductions for depreciation, as well as deductions for interest on financing provided by the buyer-lessor.

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Lease origination costs

10.1.160 Generally, for both lessees and lessors, costs incurred to originate a lease are capitalized for tax purposes unless they are de minimis (not exceeding $5,000 in the aggregate per lease for US federal purposes), in which case they may be deductible. The result in that case would be a temporary difference, which is accounted for by recording a deferred tax liability equal to the tax effect of the net carrying amount of the initial direct costs that were capitalized for book purposes.

10.1.170 Under Topic 842, many types of lease origination costs will not meet the definition of initial direct costs (see section 5.5), and therefore will be expensed as incurred for book purposes. Those lease origination costs that meet the definition of initial direct costs are capitalized and recognized as expense over the lease term; an exception is sales-type leases in which the fair value of the underlying asset differs from its carrying amount at lease commencement (see section 7.3.2). For lessees, those initial direct costs are a component of the right-of-use asset (see section 6.3), and as a result impact the measurement of the deferred tax liability associated with the right-of-use asset.

Example 10.1

Deferred tax measurement of operating leases under current US GAAP (lessee)

10.1.180 Lessee LE leases a building from Lessor LR. The lease is classified as an operating lease. LE has a tax rate of 30%. The following facts are also relevant.

- The total rent payments are $166,535, which equals the sum of the lease payments for the term of the lease of $14,527 in Year 1, and escalating 3% per year thereafter for a lease period of 10 years, paid in arrears.
- LE incurs $5,000 in lease origination costs that meet the current GAAP definition of initial direct costs, which are capitalized for book and tax purposes. LE does not deduct the initial direct costs for tax purposes, even though they would be considered de minimus (see 10.1.160).
- The total cost of the lease is $171,535 ($166,535 total lease payments + $5,000 in initial direct costs). Therefore, the annual lease expense recognized for book purposes is $17,154 ($171,535 ÷ 10 years).
- Assume that the lease is a true tax lease for income tax purposes and that rent is deductible for tax purposes as paid.

10.1.190 During the first year of the lease, LE recognizes lease expense as follows (for book purposes).

	Debit	Credit
Lease expense	17,154	
Accrued rent liability		2,127
Capitalized initial direct costs		500
Cash		14,527

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10.1.200 At the end of the first year of the lease, LE has deductible expenses of $15,027 for tax purposes (actual cash rent paid + Year 1 amortization of the initial direct costs ($5,000 ÷ 10 years) and lease expense of $17,154 for book purposes (straight-line lease expense, which includes $500 in Year 1 amortization of the initial direct costs). As a result, LE recognizes a current tax benefit of $4,508 ($15,027 × 30%).

	Debit	Credit
Income taxes payable	4,508	
Current income tax expense (benefit)		4,508

10.1.210 The accrued rent liability of $2,127 would constitute a temporary difference that would need to be tax-effected to calculate the related deferred tax asset. LE would record the following journal entry.

	Debit	Credit
Deferred tax asset[1]	638	
Deferred income tax expense (benefit)		638

Note 1:

$2,127 × 30%.

10.1.220 The total income tax benefit for Year 1 of the lease is therefore $5,146 ($4,508 + $638), which equals 30% of the book lease expense for Year 1 of $17,154.

Example 10.2

Deferred tax measurement of operating leases under Topic 842 (lessee)

10.1.230 Assume the same lease and the same facts as in Example 10.1, except for the following.

- The $5,000 in lease origination costs do not meet the definition of initial direct costs under Topic 842, and therefore are expensed as incurred for book purposes.
- The rate implicit in the lease is not readily determinable, so LE uses its incremental borrowing rate of 10% as the discount rate for the lease.
- LE determines the cost of the lease to be $166,535 (sum of the lease payments for the term of the lease of $14,527 in Year 1 and escalating 3% per year thereafter for a lease period of 10 years). Therefore, the annual lease expense to be recognized for book purposes is $16,654 ($166,535 ÷ 10 years).

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At lease commencement

10.1.240 LE recognizes a right-of-use asset and lease liability as follows.

	Debit	Credit
Right-of-use asset[1]	100,000	
Lease liability		100,000

Note 1:

Present value of the lease payments, discounted at 10%.

10.1.250 For tax purposes, the right-of-use asset and the lease liability are not recognized, resulting in temporary differences, while the lease origination costs are deferred for tax purposes (see Scenario 1). Therefore, LE recognizes a deferred tax asset associated with the lease liability, a deferred tax liability associated with the right-of-use asset, and another deferred tax asset associated with the lease origination costs that are capitalized for tax purposes, but not for book purposes.

	Debit	Credit
Deferred tax asset[1]	30,000	
Deferred income tax expense (benefit)[1]		30,000
Deferred income tax expense (benefit)[2]	30,000	
Deferred tax liability[2]		30,000
Deferred tax asset[3]	1,500	
Deferred income tax expense (benefit)[3]		1,500

Notes:

1. 30% × $100,000 carrying amount of the lease liability.
2. 30% × $100,000 carrying amount of the right-of-use asset.
3. 30% × $5,000 lease origination costs deferred for tax purposes only.

10.1.260 Lastly, LE expenses the lease origination costs for book purposes (when they are incurred).

	Debit	Credit
Operating expense	5,000	
Cash		5,000

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During the first year of the lease

10.1.270 LE recognizes lease expense along with the lease payment as follows (for book purposes).

	Debit	Credit
Lease expense	16,654	
Right-of-use asset amortization		6,654
Lease liability (interest accretion)		10,000
Lease liability	14,527	
Cash (Year 1 lease payment)		14,527

10.1.280 At the end of the first year of the lease:

– the carrying amount of the lease liability is $95,473 – i.e. the present value of the nine future payments, discounted at 10%;

– the carrying amount of the right-of-use asset is $93,346 – i.e. $95,473 carrying amount of the lease liability - $2,127 (representing the difference between Year 1 lease cost of $16,654 and the Year 1 lease payment of $14,527 – i.e. accrued rent); and

– the tax basis of the deferred lease origination costs is $4,500 ($5,000 - [$5,000 initial balance ÷ 10 years]).

10.1.290 Therefore:

– the carrying amount of the deferred tax asset related to the lease liability is $28,642 ($95,473 × 30%);

– the carrying amount of the deferred tax liability related to the right-of-use asset is $28,004 ($93,346 × 30%); and

– the carrying amount of the deferred tax asset related to the tax-deferred lease origination costs is $1,350 ($4,500 × 30%).

10.1.300 LE records the following for book purposes related to income taxes to adjust the deferred tax asset and deferred tax liability for the changes in the carrying amount of the lease liability and the right-of-use asset, respectively; as well as to recognize the tax effect of the current year tax deductible payments.

	Debit	Credit
Deferred income tax expense (benefit)[1]	1,358	
Deferred tax asset[1]		1,358
Deferred tax liability[2]	1,996	
Deferred income tax expense (benefit)[2]		1,996
Deferred income tax expense (benefit)[3]	150	
Deferred tax asset[3]		150
Income taxes payable[4]	4,508	
Current income tax expense (benefit)[4]		4,508

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Notes:

1. $30,000 initial deferred tax asset - $28,642 end of Year 1 deferred tax asset related to the lease liability.
2. $30,000 initial deferred tax liability - $28,004 end of Year 1 deferred tax liability related to the right-of-use asset.
3. $1,500 initial deferred tax asset - $1,350 end of Year 1 deferred tax asset related to the origination costs.
4. Tax deductible lease expense of $15,027 (cash paid for Year 1 lease payment [$14,527] + Year 1 tax amortization of lease origination costs [$500]) × 30%.

10.1.310 The total income tax benefit for Year 1 is, therefore, $6,496 ($4,508 current tax benefit + $1,988 [$1,996 - $1,358 + $1,350] net deferred tax benefit), which equals 30% of the sum of (1) the book lease expense for Year 1 of $16,654 and (2) the expensed lease origination costs of $5,000.

Example 10.3

Direct financing lease for book purposes (Topic 842) treated as non-tax lease (similar to a sale transaction) for tax purposes (lessor)

10.1.320 Lessor LR leases a piece of equipment to Lessee LE. The following facts are relevant at the commencement date.

– Lease term:	3 years
– Lease payments:	Fixed payments of $10,500 per year (paid in arrears); no variable lease payments
– Lease options:	None
– Expected future residual value:	$12,500
– Residual value guarantee:	$9,200 (third party other than LE)
– Initial direct costs:	None
– Rate implicit in the lease:	4.29%
– Fair value:	$40,000
– Tax basis:	$29,000
– Book carrying amount:	$36,000
– Remaining economic life of equipment:	5 years
– LR's tax rate:	30%

10.1.330 For book purposes, the lease is a direct financing lease. For tax purposes, the lease qualifies as a non-tax lease and therefore it is treated as a sale for income tax purposes.

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10.1.340 At lease commencement, LR recognizes the following for book purposes (exclusive of income tax effects).

	Debit	Credit
Lease receivable[1]	37,091	
Unguaranteed residual asset[2]	2,909	
Property, plant, and equipment		36,000
Deferred selling profit[3]		4,000

Notes:

1. Present value of the $10,500 annual contractual lease payments and the $9,200 guaranteed residual value, discounted at 4.29%.
2. Present value of the unguaranteed residual value ($3,300 = $12,500 - $9,200 guarantee), discounted at 4.29%.
3. Deferred selling profit = fair value of the underlying asset ($40,000) less its carrying amount ($36,000). This is the same as the difference between the lease receivable ($37,091) and the carrying amount of the underlying asset, net of the unguaranteed residual value ($33,091).

10.1.350 Because the lease is treated as a sale for income tax purposes, LR records the following entry to recognize the income tax effects of the lease on the commencement date.

	Debit	Credit
Current income tax expense (benefit)[1]	3,300	
Income taxes payable[1]		3,300
Deferred tax asset[2]	1,200	
Deferred income tax expense (benefit)[2]		1,200
Deferred tax liability[3]	2,100	
Deferred income tax expense (benefit)[3]		2,100

Notes:

1. 30% tax effect of tax gain of $11,000 ($40,000 tax sales price less $29,000 tax carrying amount).
2. 30% tax effect of the deferred profit of $4,000 ($40,000 fair value - $36,000 book carrying amount).
3. 30% tax effect of previous book-tax basis difference of $7,000 ($36,000 book carrying amount less $29,000 tax carrying amount) – i.e. reduction of the previous deferred tax liability that existed because of the greater book carrying amount of the equipment compared to the tax basis in the equipment.

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10.1.360 At the end of Year 1, LR recognizes the following journal entry.

	Debit	Credit
Cash (lease payment received)	10,500	
Unguaranteed residual asset[1]	125	
Deferred profit[2]	1,637	
Lease receivable[3]		8,909
Interest income[4]		3,353

Notes:

1. Discount rate of 4.29% × unguaranteed residual asset balance of $2,909.
2. Total lease income of $3,353 (calculated as the initial net investment in the lease of $36,000 x 9.31%) less interest on lease receivable ($1,591 = 4.29% discount rate × carrying amount of $37,091) less accretion of unguaranteed residual asset ($125 = 4.29% discount rate × carrying amount of $2,909). **Note**: 9.31% is the discount rate that would have been required at lease commencement for the lease receivable plus the unguaranteed residual asset to equal the fair value of the underlying asset ($40,000) less the deferred selling profit ($4,000).
3. Total contractual payments of $10,500 less interest on lease receivable of $1,591.
4. Accretion of unguaranteed residual asset ($125) plus interest income on lease receivable ($1,591) + release of deferred profit ($1,637).

10.1.370 At the end of Year 1, LR records the following journal entry to account for the tax effects of the lease.

	Debit	Credit
Current income tax expense (benefit)[1]	515	
Income tax payable[1]		515
Deferred income tax expense (benefit)[2]	491	
Deferred tax asset[2]		491

Notes:

1. 30% tax effect × ($40,000 tax basis in the financing × 4.29% = $1,716). This is also the 30% tax effect of Year 1 interest income on the lease receivable ($1,591) and the unguaranteed residual asset ($125). The interest on the deferred selling profit of $1,637 is not factored in because there is no deferred selling profit for tax purposes.
2. 30% tax effect of the change in the deferred profit of $1,637.

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Example 10.4

Sale-leaseback transaction accounted for as a sale and a leaseback for book purposes and for tax purposes (seller-lessee)

10.1.380 Seller-Lessee SL sells a piece of land to unrelated Buyer-Lessor BL and at the same time reaches an agreement to lease the land back for 10 years. The following facts are relevant at the date of the transaction.

– Contractual sale price:	$3.5 million
– Fair value of the land:	$2.8 million
– Carrying amount of the land:	$2 million
– Tax basis in the land:	$2 million
– Leaseback term:	10 years
– Leaseback payments:	Fixed payments of $200,000 per year (paid in arrears); no variable lease payments
– Leaseback options:	None
– Initial direct costs:	None
– Rate implicit in the lease:	Not readily determinable
– SL's incremental borrowing rate:	6%
– SL's tax rate for ordinary income and capital gains:	30%

10.1.390 In addition:

- The transaction is accounted for as a sale and a leaseback (i.e. the transaction is not a failed sale) for both book and tax purposes.
- The leaseback is a true tax lease for tax purposes.

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10.1.400 At the date that the sale is completed and the leaseback commences, SL recognizes the following journal entry for book purposes (exclusive of income tax effects).

	Debit	Credit
Cash (sales price of asset)	3,500,000	
Gain[1]		800,000
Land		2,000,000
Financing liability[2]		700,000
Right-of-use asset[3]	772,017	
Lease liability[3]		772,017

Notes:

1. $2.8 million fair value - $2 million carrying amount.
2. $3.5 million sales price - $2.8 million fair value.
3. Present value of 10 annual lease payments of $104,892, discounted at 6%; $104,892 = $200,000 contractual leaseback payment - $95,108 allocated to repayment of the $700,000 financing liability.

10.1.410 For tax purposes, SL recognizes the $1.5 million difference between the contractual sales price of $3.5 million and the tax basis in the land of $2 million as a gain on the sale of the land. In addition, because the leaseback is a true tax lease, SL does not have any lease asset or lease liability for tax purposes.

10.1.420 Consequently, at the date the sale is completed and the leaseback commences, SL recognizes the following income tax effects for book purposes.

	Debit	Credit
Current income tax expense (benefit)[1]	450,000	
Current tax payable[1]		450,000
Deferred tax asset[2]	210,000	
Deferred income tax expense (benefit)[2]		210,000
Deferred tax asset[3]	231,605	
Deferred income tax expense (benefit)[3]		231,605
Deferred income tax expense (benefit)[4]	231,605	
Deferred tax liability[4]		231,605

Notes:

1. 30% tax effect on taxable gain of $1.5 million ($3.5 million contractual purchase price less $2 million tax basis carrying amount).
2. 30% × $700,000 carrying amount of the financing liability.
3. 30% × $772,017 carrying amount of the lease liability.
4. 30% × $772,017 carrying amount of the right-of-use asset.

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10.1.430 During the first year of the leaseback, for book purposes, SL recognizes the following journal entry (exclusive of income tax effects).

	Debit	Credit
Interest expense[1]	42,000	
Operating lease cost[2]	104,892	
Lease liability[3]	58,571	
Financing liability[4]	53,108	
Right-of-use asset[5]		58,571
Cash		200,000

Notes:

1. 6% discount rate x $700,000 financial liability.
2. Total lease payments of $1,048,920 ÷ 10-year lease term.
3. $104,892 (portion of $200,000 annual payment allocated to the lease) - $46,321 accretion of the lease liability (6% × $772,017).
4. $95,108 (portion of $200,000 annual payment allocated to the financial liability) - $42,000 interest on the financial liability (6% × $700,000).
5. Total lease cost of $104,892 less accretion on lease liability of $46,321.

10.1.440 During the first year of the leaseback, for tax purposes, SL deducts the $200,000 rental payment from its taxable income and SL recognizes all of the following for book purposes related to income taxes.

	Debit	Credit
Current tax payable[1]	60,000	
Current income tax expense (benefit)[1]		60,000
Deferred tax liability[2]	17,571	
Deferred income tax expense (benefit)[2]		17,571
Deferred income tax expense (benefit)[3]	17,571	
Deferred tax asset[3]		17,571
Deferred income tax expense (benefit)[4]	15,932	
Deferred tax asset[4]		15,932

Notes:

1. 30% tax effect of the $200,000 contractual lease payment, fully deductible in the year paid.
2. 30% tax effect of the Year 1 change in the book carrying amount of the right-of-use asset of $58,571.
3. 30% tax effect of the Year 1 change in the book carrying amount of the lease liability of $58,571.
4. 30% tax effect of the Year 1 change in the book carrying amount of the financing liability of $53,108.

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Example 10.5

Failed equipment sale-leaseback transaction for book purposes; sale and true tax leaseback for tax purposes

10.1.450 On January 1, 20X9, Seller-Lessee SL has a piece of equipment that it has decided to sell to Buyer-Lessor BL and lease back for liquidity purposes. The following facts are relevant at the date of the transaction.

– Contractual sale price:	$1 million
– Fair value of the equipment:	$1 million
– Carrying amount of the equipment:	$900,000
– Tax basis in the equipment:	$750,000
– Leaseback term:	5 years
– Remaining economic life of the equipment:	10 years, which is also the remaining useful life of the equipment
– Expected future residual value:	$450,000
– Leaseback payments:	Fixed payments of $170,000 per year (paid in arrears); no variable lease payments
– Leaseback renewal or termination options:	None
– Initial direct costs:	None
– Rate implicit in the leaseback:	Not readily determinable by SL; 7.5381% for BL
– SL's incremental borrowing rate:	7%
– SL's tax rate for ordinary income and capital gains:	30%

10.1.460 In addition:

- There is a fixed price repurchase option for SL to repurchase the equipment at any time during the fifth year of the leaseback; therefore, the transaction is a failed sale for book purposes.
- The transaction is a sale and leaseback for tax purposes; the leaseback is a true tax lease for tax purposes.

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Scenario 1: Seller-lessee accounting

10.1.470 On January 1, 20X9, SL records the following journal entry to account for the failed sale (exclusive of tax effects).

	Debit	Credit
Cash	1,000,000	
Financing liability		1,000,000

10.1.480 On January 1, 20X9, SL records the following journal entry to account for the sale date tax effects of the transaction.

	Debit	Credit
Current income tax expense (benefit)[1]	75,000	
Income taxes payable[1]		75,000
Deferred tax liability[2]	45,000	
Deferred income tax expense (benefit)[2]		45,000
Deferred income tax expense (benefit)[3]	270,000	
Deferred tax liability[3]		270,000
Deferred tax asset[4]	300,000	
Deferred income tax expense (benefit)[4]		300,000

Notes:

1. 30% tax effect of sales price ($1,000,000) - tax basis carrying amount ($750,000).
2. Reversal of existing deferred tax liability ($900,000 - $750,000) x 30%.
3. 30% tax effect of the basis difference between the carrying amount of the equipment for book purposes ($900,000) and the tax basis (nil).
4. 30% tax effect of the financing liability ($1,000,000), which has no tax basis.

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10.1.490 On December 31, 20X9, SL records the following entry to record the payment made to BL under the terms of the sale-leaseback agreement, and depreciation on the equipment that continues to be recognized by SL due to the failed sale (exclusive of income tax effects).

	Debit	Credit
Interest expense[1]	70,000	
Financing liability[2]	100,000	
Cash		170,000
Depreciation expense[3]	90,000	
Accumulated depreciation[3]		90,000

Notes:

1. $1,000,000 principal balance × 7% (SL's incremental borrowing rate).
2. Payment of $170,000 - interest component of $70,000.
3. $900,000 book carrying amount at beginning of the year ÷ 10 years.

10.1.500 Also on December 31, 20X9, SL records the following journal entry for the income tax effects of the first year of the arrangement.

	Debit	Credit
Income taxes payable[1]	51,000	
Current income tax expense (benefit)[1]		51,000
Deferred tax liability[2]	27,000	
Deferred income tax expense (benefit)[2]		27,000
Deferred income tax expense (benefit)[3]	30,000	
Deferred tax asset[3]		30,000

Notes:

1. Year 1 lease payment for tax purposes of $170,000 × 30%, which is fully deductible in the year paid.
2. 30% of the change in the book carrying amount of the equipment, which decreased from $900,000 to $810,000 as a result of depreciation ($90,000) during the year.
3. 30% of the change in the book carrying amount of the financing liability, which decreased from $1,000,000 to $900,000 during the year.

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Scenario 2: Buyer-lessor accounting

10.1.510 On January 1, 20X9, BL records the following journal entry to account for the failed sale (exclusive of income tax effects).

	Debit	Credit
Financing receivable	1,000,000	
Cash		1,000,000

10.1.520 On January 1, 20X9, BL records the following journal entry to account for the sale date income tax effects of the transaction.

	Debit	Credit
Deferred tax asset[1]	300,000	
Deferred income tax expense (benefit)[1]		300,000
Deferred income tax expense (benefit)[2]	300,000	
Deferred tax liability[2]		300,000

Notes:

1. 30% tax effect of $1,000,000 of equipment recognized as an asset for tax purposes, but not recognized for book purposes (failed purchase).
2. 30% tax effect of the financing receivable recognized for book purposes, but not for tax purposes.

10.1.530 On December 31, 20X9, BL records the following journal entry to record the payment from SL under the terms of the sale-leaseback agreement (exclusive of income tax effects).

	Debit	Credit
Cash	170,000	
Interest income[1]		60,000
Financing receivable[2]		110,000

Notes:

1. $1,000,000 principal balance × 6%. Consistent with Example 2 in Subtopic 842-40, BL determined this rate of interest based on the guidance in Subtopic 835-30.
2. Payment of $170,000 - interest component of $60,000.

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10.1.540 On December 31, 20X9, BL records the following journal entry to account for the first year income tax effects of the arrangement.

	Debit	Credit
Deferred income tax expense (benefit)[1]	60,000	
Deferred tax asset[1]		60,000
Deferred tax liability[2]	33,000	
Deferred income tax expense (benefit)[2]		33,000
Income tax payable[3]	9,000	
Current income tax expense (benefit)[3]		9,000

Notes:

1. 30% tax effect of decrease in the tax basis of the equipment resulting from MACRS depreciation. MACRS depreciation for the year ended December 31, 20X9 is $200,000.
2. 30% tax effect of the change in the book carrying amount of the financing receivable (30% × $110,000).
3. 30% tax effect of the true tax lease income of $170,000 earned in the first year of the leaseback - 30% tax effect of MACRS tax depreciation of equipment of $200,000.

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Changes to the accounting for deferred taxes

10.1.550 The following changes to the accounting for leases, resulting from the issuance of Topic 842, will have the most impact on an entity's accounting for deferred taxes (and are the scenarios illustrated in the examples in this chapter).

Lessees

10.1.560 For lessees, the recognition of right-of-use assets and lease liabilities for operating leases. This will require entities to recognize new deferred tax assets and deferred tax liabilities that were not previously recognized.

10.1.570 For seller-lessees in sale-leaseback transactions, changes to the sale-leaseback guidance mean that many equipment sale-leaseback transactions accounted for as a sale and a leaseback under current US GAAP may be failed sales under Topic 842. This could create new deferred tax issues if the sale-leaseback transaction is accounted for as a sale and a leaseback for tax purposes. For example, while the seller-lessee may be considered to have sold the asset for tax purposes, it may still have the asset, as well as a financing liability, in its accounts for book purposes.

10.1.580 The following table highlights the effect of the changes in Topic 842 on various combinations of book and tax lease classification for lessees.

Book classification	Tax classification	Primary impact of Topic 842
Operating	True tax lease (tax operating lease)	New deferred tax balances because assets and liabilities are created with no tax basis (see Example 10.2).
Operating	Non-tax lease (tax sales type lease)	Smaller deferred tax balances because there will be book *and* tax basis assets and liabilities going forward, rather than only tax basis assets and liabilities.
Finance	True tax lease	No significant change, amounts may vary.
Finance	Non-tax lease	No significant change, amounts may vary.

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$ Lessors

10.1.590 For lessors, the deferral of selling profit for some direct financing leases could create new (or larger) deferred tax assets in that those leases will frequently be non-tax leases for tax purposes and the entire tax profit on the lease (sale price - tax basis of the asset) will be recognized for tax purposes at the time of sale.

10.1.600 For buyer-lessors in sale-leaseback transactions, the new requirements that can result in a buyer-lessor having a failed purchase of the transferred asset could result in new deferred tax issues if the sale-leaseback transaction is accounted for as a sale and a leaseback for tax purposes. This is because the buyer-lessor might own the asset and be earning taxable lease income from the seller-lessee from the leaseback for tax purposes, but have a financing receivable and be earning interest income for book purposes.

10.1.610 The following table highlights the effect of the changes in Topic 842 on various combinations of book and tax lease classification for lessors.

Book classification	Tax classification	Primary impact of Topic 842
Operating	True tax lease	No significant change; amounts may vary
Operating	Non-tax lease	No significant change; amounts may vary
Sales-type	True tax lease	No significant change; amounts may vary
Sales-type	Non-tax lease	No significant change; amounts may vary
Direct financing	True tax lease	No significant change; amounts may vary
Direct financing	Non-tax lease	No significant change; amounts may vary[1]

Note 1:

More significant changes from current US GAAP may result if, under Topic 842, a direct financing lease results in selling profit that is required to be deferred and recognized over the lease term (see Example 10.3).

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KPMG observation – Leases denominated in a foreign currency

10.1.620 For leases denominated in a foreign currency, the right-of-use asset is a non-monetary asset while the lease liability is a monetary liability. Therefore, when accounting for a lease that is denominated in a foreign currency, the lease liability is remeasured using the current exchange rate, while the right-of-use asset is remeasured using the exchange rate as of the lease commencement date (see section 6.4). As a result, the exception on recognizing a deferred tax asset or liability for differences related to assets and liabilities that are remeasured from the local currency into the functional currency using historical exchange rates and that result from changes in exchange rates will apply to the right-of-use asset but will not apply to the lease liability under Topic 842. [842-20-55-10, 740-10-25-3(f)]

KPMG observation – Tax effects of initial direct costs

10.1.630 It is expected that some lease origination costs that will be deferred for tax purposes, and generally amortized on a straight-line basis over the lease term, will not meet the narrow definition of initial direct costs under Topic 842 (see section 5.5). Therefore, new deferred tax assets may arise, reflecting those origination costs that are deferrable for tax purposes, but must be expensed as incurred for book purposes. [Master Glossary, 740-10-25-2(b)]

KPMG observation – Related party leases

10.1.640 Under current US GAAP, a related party lease is not recognized based on the written terms and conditions if they differ from the substance of the arrangement. However, under Topic 842 only the legally enforceable terms and conditions are considered. This change in the book accounting for related party leases could result in additional temporary differences for entities that engage in leasing activities with related parties at other than arm's length terms. [842-20-55-12, 740-10-25-2(b)]

KPMG observation – Leveraged leases

10.1.650 Topic 740 includes an exception to its basic requirements related to leveraged leases. Topic 842 eliminates leveraged lease accounting prospectively – i.e. for all leases that commence on or after the effective date of Topic 842. Therefore, once Topic 842 becomes effective, and as the grandfathered leveraged leases gradually expire, this exception in Topic 740 will no longer be relevant. The Board retained this exception in ASU 2016-02 because of its decision to grandfather existing leveraged leases. [740-10-25-3(c)]

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10.2 State and local income tax implications

10.2.10 Although domestic tax laws may remain unchanged on the adoption of Topic 842, and most states that use a property factor already include the value of leased assets in the apportionment formula, the requirement to bring all leases (other than those qualifying for the short-term exemption – see section 6.3.1) on the balance sheet may impact the apportionment of taxable income in some states. Entities should consider the need to review both state and local income tax laws to determine the impact of Topic 842, if any.

10.2.20 An entity will need to consider the impact of any changes, if applicable, on its state apportionment factors in its assessment of any necessary valuation allowance. Most states that use a property factor already require leased assets to be included in the factor and provide a valuation method for including such assets. In general, the Uniform Division of Income for Tax Purposes Act, which has been widely adopted by the states, provides that property rented by the taxpayer is valued at eight times the net annual rental rate. Nevertheless, the effect of including leases on the balance sheet may change the apportionment of taxable income in some states.

10.2.30 For measuring state deferred tax assets and liabilities, an entity should assume that temporary differences will reverse in the tax jurisdictions in which the related assets or liabilities are expected to be realized or settled, and therefore would apply the enacted tax rate for that particular state for measuring deferred taxes. Entities generally should not assume that taxable or deductible amounts related to temporary differences in a tax jurisdiction will be shifted to a different tax jurisdiction through future intercompany transactions.

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10.3 Change in US federal tax accounting method

10.3.10 Generally, a change in book accounting method (e.g. in accounting for leases) will not be deemed to constitute a change in underlying facts for US federal tax procedural purposes. If a new tax accounting method is required or desirable because the book accounting method changes, an entity must obtain permission from the IRS in advance of the change. The filing procedures and timing vary based on whether the change is automatic or requires advance consent from the IRS.

10.3.20 An entity that changes to a tax accounting method identified in published IRS guidance (i.e. currently Rev. Proc. 2015-14) is deemed to be automatically approved by the IRS when the copy of Form 3115, Application for Change in Accounting Method, is filed and, at the same time, generally receives audit protection for prior years. For book purposes, the timing of recognizing the effects of a change in tax accounting methods will depend on when the entity determines to make the change, when Form 3115 is filed, and whether the entity is changing from an impermissible method to a permissible method.

10.3.30 When a tax accounting method change is outside the automatic procedures, IRS approval of the change is not automatic. The entity will need to consider the US GAAP requirements on accounting for tax uncertainties to determine whether it is appropriate to account for the change before it receives approval (i.e. the consent letter).

10.3.40 The adoption of Topic 842 may result in a change in the pattern of recognizing income and expenses for financial reporting purposes for an entity. An entity should consider whether a tax accounting method change is appropriate and the related tax adjustment. An unfavorable adjustment (i.e. the income inclusion catch-up adjustment that is the difference between the tax accounting on the old method and new method as of the beginning of the year of change) would generally be spread over four years for US federal tax purposes. This would also create an additional temporary difference for the portion of the effect of the tax accounting method change that has not yet been recognized for tax purposes.

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10.4 Transfer pricing

10.4.10 The classification of leases may impact both the lessee and lessor from a transfer pricing perspective. Changes to the amount and timing of lease revenue and lease expense as a result of adopting Topic 842 could have an effect on transfer pricing, specifically as it relates to using revenue or profit-based methods for establishing the transfer pricing.

10.4.20 Entities use transfer pricing to determine the appropriate amount to charge for intercompany transactions. Intercompany transactions are eliminated from the consolidated results for book purposes, but are not eliminated in each taxing jurisdiction for tax purposes. As a result, an entity utilizes transfer pricing to help determine each member of the group's taxable income.

10.4.30 While each taxing authority has different rules and thresholds, the transactions must usually be priced at arm's length. Under the arm's length standard, governments evaluate whether intercompany transactions are priced similar to arm's length transactions. Arm's length transactions help ensure that an entity is not inappropriately allocating income to any particular tax jurisdiction.

10.4.40 Entities may lease assets to one another for various reasons. If a finance lease is obtained from a related party, the interest rate and related terms generally should be the same (or within a reasonable range) compared to what it would receive from an unrelated party in an arm's length transaction. For a true tax lease, an entity will need to determine that the rental rates are appropriate and are considered to be at arm's length. Entities should carefully consider the classification of the leases from both a lessor and lessee perspective.

10.4.50 An entity may need to consider whether its transfer pricing studies and supporting documentation should be revised or updated once the standard has been adopted.

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11 Leases acquired in a business combination

How the standard works

In summary, the following is recognized as part of the acquisition accounting:

Acquiree is lessee	Acquiree is lessor	
Operating or finance lease	**Operating lease**	**Sales-type or direct financing lease**
– Right-of-use asset – Lease liability	– Property, plant, and equipment – Asset or liability (off-market lease terms)	– Lease receivable – Unguaranteed residual asset
In all cases, any related intangible assets (e.g. a customer relationship)		

In all cases, the lease assets and lease liabilities are measured as if the lease were a new lease of the acquirer at the acquisition date.

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11.1.10 Topic 842 includes only limited guidance on accounting for leases acquired in a business combination. Most of the guidance on this topic, including more detailed guidance on the initial and subsequent measurement of assets and liabilities related to lease contracts acquired in a business combination, is included in Topic 805 (business combinations), which was amended by ASU 2016-02.

11.1.20 The following chart summarizes the acquirer's initial accounting at the acquisition date. As the chart highlights: [805-20-25-10A, 25-12, 25-28A, 30-24 – 30-25]

- If the acquiree is a lessee, the same assets and liabilities are recognized regardless of whether the lease is an operating or finance lease.
- If the acquiree is a lessor, the assets and liabilities recognized depend on the classification of the lease.
- In all cases, there may be one or more intangible assets related to the lease, such as a customer relationship.

Lease acquired in a business combination[1]			
Acquiree is lessee		**Acquiree is lessor**	
Operating and finance leases		**Operating leases**	**Sales-type and direct financing leases**
Lease liability[2] Present value of the remaining lease payments[3]	**Right-of-use asset** Equal to the liability, adjusted for any favorable/ unfavorable terms	**Property, plant, and equipment** Underlying asset at fair value	**Lease receivable[2]** Present value of the remaining lease payments and guaranteed residual value[5]
Intangible assets Associated with the lease[4]		**Asset or liability** Favorable/ unfavorable terms	**Unguaranteed residual asset** Difference between fair value of underlying asset[6], and lease receivable
		Intangible assets Associated with the lease[4]	

Notes:

1. The acquirer retains the acquiree's lease classification unless the lease is modified as part of the business combination, and that modification is not accounted for as a separate contract. [805-20-25-8, 842-10-55-11, 842-50-25-2]
2. The lease liability (lessee) or lease receivable (lessor in a sales-type or direct financing lease) is measured as if the lease were a new lease at that date – i.e. as if the acquisition date were the lease commencement date. [805-20-30-24, 30-25(a)]
3. Discounted at the rate implicit in the lease if readily determinable, or otherwise using the *acquirer's* incremental borrowing rate. [805-20-30-24]

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4. Even if a lease is at market terms, there may be other identifiable intangible assets associated with the lease; for example, a lease of gates at an airport or of retail space in a prime shopping area might provide entry into a market, or other future economic benefits that qualify as an identifiable intangible asset, such as an in-place lease asset or a customer relationship. Such identifiable intangible assets are recognized at fair value in the acquisition accounting. [805-20-25-10A]
5. Discounted at the rate implicit in the lease. [805-20-30-25]
6. The terms and conditions of the lease are taken into account in determining the fair value of the underlying asset in a sales-type or direct financing lease. See KPMG observation at 11.1.320–330. [805-20-30-25]

Prepaid or accrued rent

11.1.30 Prepaid or accrued rent (of lessees or lessors) is not recognized in the acquisition accounting because those amounts do not meet the definition of an asset or a liability. Instead, the remaining lease payments affect whether the lease, as of the acquisition date, is at market terms. This means that if the lease payments are significantly front- or back-loaded, at the acquisition date this may result in a conclusion that the terms and conditions of the lease from the acquisition date are off-market. [ASU 2016-02.BC415]

Practical expedient for lessees only

Short-term leases

11.1.40 An acquirer may elect, as an accounting policy election (by class of underlying asset), not to recognize right-of-use assets or lease liabilities for leases that, at the acquisition date, have a remaining lease term of 12 months or less. In that case, the acquirer does not recognize any asset or liability for favorable or unfavorable terms relative to market. [805-20-25-28B]

11.1.50 This election applies to all of an acquirer's acquisitions – i.e. it cannot be applied to select leases that meet the criterion, or to select acquisitions. [805-20-25-28B]

Acquired lease is a grandfathered leveraged lease

11.1.60 If an entity acquires a grandfathered leveraged lease on or after the effective date of Topic 842, the lease is subject to the leveraged lease guidance in Subtopic 842-50 unless the lease is modified. If the lease is modified, the acquirer accounts for the lease in accordance with Topic 842 as if it were a new lease from the acquisition date. [842-10-65-1(z)(1)]

Post-acquisition accounting

11.1.70 Subsequent to the acquisition date, the acquirer applies the subsequent measurement guidance in Topic 842 to leases acquired in a business combination. The acquirer accounts for any intangible assets associated with the lease in accordance with Topic 350 (intangibles – goodwill and other).

11.1.80 Leasehold improvements acquired in a business combination are amortized from the acquisition date over the shorter of the useful life of the leasehold improvements and the remaining lease term at the date of acquisition. However, if the lease transfers ownership of the underlying asset to the lessee, or the lessee is reasonably certain to exercise an option to purchase the underlying asset, the lessee amortizes the leasehold improvements to the end of their useful life. [805-20-35-6]

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Example 11.1
Accounting for an acquired lease (operating lease)

Scenario 1: Lease is at market terms at the acquisition date (acquiree is the lessee)

11.1.90 Company AR acquires Lessee LE, which leases its main transportation hub from Lessor LR. The hub comprises a large building and surrounding land near a major airport that serves as a storage and processing facility.

11.1.100 The following facts about the underlying lease (an operating lease, properly classified) are relevant.

– Lease term:	25 years
– Lease payments:	Fixed payments of $1 million per year in arrears, with a 3% increase each year after Year 1
– Residual value guarantee:	None
– Options:	None
– At lease commencement:	
» Fair value of building and surrounding land:	$30 million
» Remaining economic life of building:	45 years
» LE's incremental borrowing rate:	7%

11.1.110 The following facts at the *acquisition date* are relevant.

– Lease term remaining:	19 years
– Lease terms:	At market
– Accrued rent liability:	$2,281,816[1]
– AR's incremental borrowing rate:	8%[2]

11.1.120 AR recognizes a lease liability and a right-of-use asset. There are no other identifiable intangible assets associated with the lease (see 11.1.20).

– Lease liability:	$14,177,968[3]
– Right-of use asset:	$14,177,968[4]
– Intangible assets (associated with the lease):	None

11.1.130 AR retains LE's classification of the lease and accounts for the remainder of the lease as if it is a new operating lease for the same facility.

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Notes:

1. The difference between the lease payments made through the end of Year 6 of $6,468,410 and the straight-line lease cost recognized of $8,750,220 (($36,459,250 total lease payments ÷ 25) x 6).
2. AR cannot readily determine LR's implicit rate for the lease.
3. The present value of the remaining lease payments due under the lease.
4. Equal to the lease liability. No adjustment is required to the right-of-use asset because the terms of the lease are at market at the acquisition date. The right-of-use asset is also not adjusted for LE's pre-acquisition accrued rent liability, which is not carried forward in the acquisition accounting.

Scenario 2: Lease is at market terms at the acquisition date (acquiree is the lessor)

11.1.140 Assume the same facts as in Scenario 1 except for the following.

- Company AR is acquiring Lessor LR, rather than Lessee LE.
- The building and the land (i.e. the assets subject to the lease with LE) have fair values of $16 million and $12 million, respectively.

11.1.150 Because the acquiree is the lessor in the operating lease, AR recognizes the land and building, but no other assets:

– Land:	$12 million[1]
– Building:	$16 million[2]
– Asset or liability (off-market lease terms):	N/A
– Intangible assets (associated with the lease):	None (in this scenario)

Notes:

1. AR recognizes the land at its fair value. AR will not depreciate the land subsequently.
2. AR recognizes the building at its fair value. AR will depreciate the building over its remaining useful life, which is not necessarily the same as its remaining economic life (see section 5.7).

11.1.160 Consistent with Scenario 1, AR does not recognize an accrued rent asset for the difference between the income recognized by LR on a straight-line basis prior to the acquisition date and the lease payments made through the acquisition date by LE – i.e. the $2,281,816 calculated in Scenario 1.

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Scenario 3: Lease is at below-market rates at the acquisition date (acquiree is the lessee)

11.1.170 Assume the same facts as in Scenario 1 except that, at the acquisition date, the terms of the lease to Lessee LE are considered favorable as compared to market terms. Although the Year 7 lease payment is reasonable compared to market rental terms, lease payments in this market should be increasing by 4% per year thereafter.

Contractual payments in Years 7 to 25 (undiscounted):	$29,990,840	$1,194,052 in Year 7, increasing by 3% each of the 18 years thereafter
Market-based payments in Years 7 to 25 (undiscounted):	$33,040,903	$1,194,052 in Year 7, increasing by 4% each of the 18 years thereafter

11.1.180 Company AR recognizes a lease liability and a right-of-use asset. Consistent with Scenario 1, there are no other identifiable intangible assets associated with the lease (see 11.1.20).

– Lease liability:	$14,177,968
– Right-of use asset:	$15,278,427[1]
– Intangible assets (associated with the lease):	None

Note 1:

While the lease liability at the acquisition date is the same as in Scenario 1 (based on contractual lease payments), the right-of-use asset is $15,278,427. This is because the asset is based on the present value of the *market-based* rental payments.

The difference between the right-of-use asset and the lease liability of $1,100,459 reduces the goodwill recognized in AR's acquisition accounting, and will be recognized as additional operating lease cost over the 19-year remaining lease term.

Scenario 4: Lease is at below-market rates at the acquisition date (acquiree is the lessor)

11.1.190 Assume the same facts as in Scenario 3 except that Company AR is acquiring Lessor LR, rather than Lessee LE. In addition, AR's rate implicit in the lease at the acquisition date is 7.85%.

11.1.200 Because the acquiree is the lessor in the operating lease, AR considers recognition of the following.

Land:	$12 million
Building:	$16 million
Asset or liability (off-market lease terms):	$1,119,754 (liability)[1]
Intangible assets (associated with the lease):	None

Note 1:

The difference between the present value of the remaining lease payments ($14,348,787) and the present value of the remaining market-based rental payments ($15,468,541) is recognized as an *unfavorable lease liability* in AR's acquisition accounting.

This liability increases the goodwill recognized by AR in the acquisition accounting, and will be recognized as additional lease income over the 19-year remaining lease term.

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Example 11.2

Accounting for an acquired lease (finance/sales-type lease)

Scenario 1: Acquiree is the lessor

11.1.210 Company AR acquires Lessor LR, which leases manufacturing equipment to its customers. The following facts about one of those leases (a sales-type lease, properly classified) to Lessee LE are relevant.

– Lease term:	5 years
– Lease payments:	Fixed payments of $165,000 per year in arrears, with a 4% increase each year after Year 1
– End of lease:	Ownership transfers to LE for no additional consideration
– At lease commencement:	
» Fair value of the equipment:	$700,000
» Rate implicit in the lease:	8.49%

11.1.220 The following facts at the *acquisition date* are relevant.

– Lease term remaining:	4 years
– Lease terms:	At market
– Fair value of the equipment:	$600,000
– Rate implicit in the lease:	8.08%

11.1.230 The underlying asset is not recognized in AR's acquisition accounting. In its acquisition accounting, AR recognizes a lease receivable of $600,000, which equals the remaining lease payments of $728,694 discounted at the acquisition date implicit rate of 8.08%. There is no unguaranteed residual asset to recognize because LE obtains ownership of the equipment at the end of the lease term. Subsequent to the acquisition date until the end of the lease term, AR accounts for the acquired lease in the same manner as it would any other sales-type lease.

Scenario 2: Acquiree is the lessee

11.1.240 Assume the same facts as in Scenario 1, except that Company AR is acquiring Lessee LE, rather than Lessor LR. The rate implicit in the lease is not readily determinable and AR's incremental borrowing rate is 7% at the acquisition date.

11.1.250 As part of its acquisition accounting, AR recognizes a lease liability of $615,018 (the remaining lease payments of $728,694 discounted at AR's incremental borrowing rate of 7%) and a right-of-use asset for the same amount. Because the lease is at market terms, there is no adjustment to the right-of-use asset from the amount of the lease liability. Subsequent to the acquisition date, AR accounts for the lease in the same manner as it would any other finance lease.

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KPMG observation – Measurement of lease assets and lease liabilities is not at fair value

11.1.260 The business combinations guidance generally requires all assets acquired and liabilities assumed to be measured at fair value as of the acquisition date. However, the Board concluded that requiring acquirers to measure lease assets and lease liabilities at fair value was not justifiable from a cost-benefit perspective. This is because of the likely difficulties and cost of obtaining reliable fair value measurements for those items, particularly right-of-use assets. [ASU 2016-02.BC416–BC417]

11.1.270 However, the Board believes that the measurement requirements for acquired lease assets and lease liabilities will, at least in many cases, reasonably approximate fair value. For example, the Board observed that, for lessors, the acquisition-date net investment in the lease measured under Topic 805 (as amended) will generally equal the acquisition-date fair value of the underlying asset; for lessees, the net carrying amount of the right-of-use asset and the lease liability recognized by the acquirer will generally approximate the fair value of the lease. [ASU 2016-02.BC416–BC417]

KPMG observation – In-place leases may trigger recognition of additional assets

11.1.280 An acquirer may identify value associated with leases in place at the acquisition date. Value related to in-place leases may reflect, for example, the value associated with avoiding the costs of originating the acquired in-place leases, as well as the value associated with the avoidance of holding costs that would be incurred if an asset intended to be leased was acquired without a lessee. Origination costs comprise the costs to execute similar leases, including marketing costs, leasing commissions, legal, and other related costs.

11.1.290 Neither Topic 842 nor Topic 805 (current or as amended by ASU 2016-02), explicitly address the recognition of in-place lease intangible assets. However, consistent with our view under current US GAAP (which also does not explicitly address in-place lease intangible assets), we believe that an acquirer should separately measure an intangible asset for in-place leases on a lease-by-lease basis.

11.1.300 Generally, we would expect that the intangible asset recognized in accordance with Topic 805 (as amended) for in-place leases would be recognized and reported separately in the financial statements. It would not be combined with the acquired lease assets (i.e. lessee right-of-use assets, or lessor lease receivables and unguaranteed residual assets), or with other lease-related intangibles (e.g. favorable lease assets or unfavorable lease liabilities of operating lessors).

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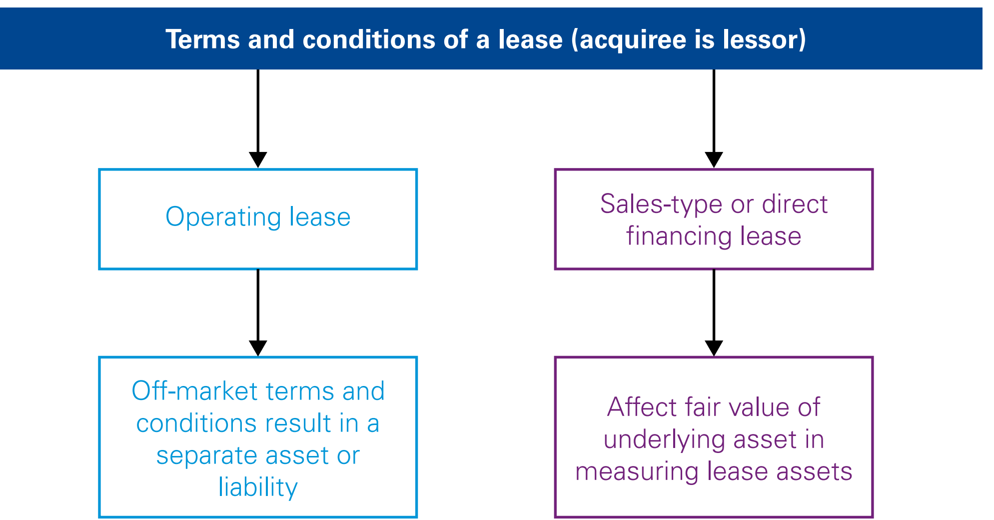
KPMG observation – Accounting for lease assets and lease liabilities acquired in an asset acquisition is unclear

11.1.310 Topic 805 (current or as amended by ASU 2016-02) does not contain guidance on the accounting for leases acquired in an asset acquisition – i.e. from the acquisition of assets that have a lease attached that do not constitute a business. In our experience, practice under current US GAAP is mixed. In some cases, the acquired leases are accounted for in the same manner as they would be if they were acquired in a business combination; in other cases, lease-related intangibles are not recognized separately from the acquired underlying assets.

KPMG observation – Type of lease impacts measurement of underlying asset's fair value when acquiree is the lessor

11.1.320 When the acquiree is the lessor, the terms and conditions of a lease are factored into the acquisition accounting differently depending on the type of lease.



11.1.330 This difference means that acquirers of lessors will use different assumptions in measuring the fair value of the underlying asset depending on the classification of the lease to which the underlying asset relates. The Board's decisions in this regard appear to principally stem from its desire to retain current lessor accounting in most respects. Under current US GAAP, acquirers generally already consider lease terms and conditions in valuing lessor lease assets for acquired sales-type or direct financing leases and recognize favorable (unfavorable) assets (liabilities) for acquired operating leases.

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KPMG observation – Acquiree failed sale or failed purchase in a sale-leaseback transaction

11.1.340 Consistent with current practice when the acquiree is a seller-lessee in failed sale-leaseback transaction, under Topic 842 and Topic 805 (as amended) we believe that the business combination does not eliminate the failed sale (if acquiree is the seller-lessee) or the failed purchase (if the acquiree is the buyer-lessor). The acquirer would continue with the failed sale/purchase accounting until the transaction meets the requirements in Subtopic 842-40 for a sale/purchase. The assets and liabilities of the acquiree related to the failed sale-leaseback transaction (e.g. the underlying asset and financial liability if the seller-lessee or the financial receivable if the buyer-lessor) are still subject to any appropriate adjustments to those assets and liabilities as required by Topic 805.

US GAAP different from IFRS – Lease terms and conditions in measuring the fair value of acquired underlying assets

11.1.350 In measuring the acquisition-date fair value of an underlying asset that is subject to an operating lease in which the acquiree is the lessor, IFRS 3 (business combinations, as amended by IFRS 16) requires that the acquisition-date fair value of an underlying asset take into account the terms and conditions of the lease. Acquirers applying IFRS will not recognize favorable lease assets or unfavorable lease liabilities for leases in which the acquiree is a lessor. [IFRS 16.B42]

11.1.360 Unlike IFRS, an acquirer applying the guidance in Topic 805 (as amended) will *not* take into account the terms and conditions of the lease when determining the acquisition-date fair value of an underlying asset subject to an *operating* lease in which the acquiree is the lessor. Instead, consistent with current US GAAP and current IFRS, the acquirer recognizes a separate intangible asset or liability to the extent the terms and conditions of the lease are not at market.

11.1.370 Therefore, in some cases, an acquirer will measure an acquired underlying asset subject to an operating lease differently under US GAAP than under IFRS and US GAAP acquirers may recognize intangible assets or liabilities not recognized by their IFRS counterparts.

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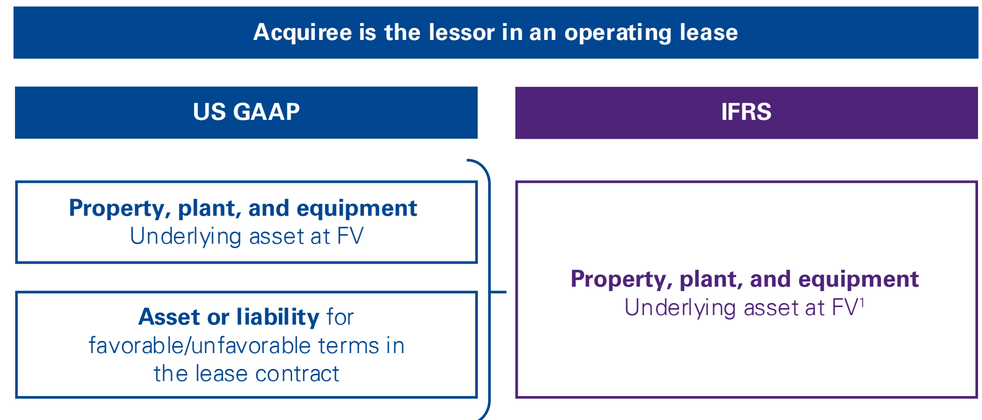

Note 1:

The terms and conditions of the lease are taken into account when measuring the fair value of the underlying asset subject to an operating lease (IFRS only).

Comparison with current US GAAP – Acquisition accounting

Acquired operating leases where the acquiree is a lessee

11.1.380 Under current US GAAP, an asset or a liability is recognized in a business combination only to the extent that the operating lease is favorable or unfavorable to market terms. In contrast, under Topic 805 (as amended), the acquirer will recognize a lease liability and a right-of-use asset for acquired operating leases. The right-of-use asset is adjusted for favorable or unfavorable terms at the acquisition date. [805-20-25-12]

11.1.390 The acquirer's measurement of any favorable/unfavorable adjustment to the right-of-use asset under Topic 805 (as amended) will likely be similar to an acquirer's measurement of any favorable lease asset or unfavorable lease liability under current US GAAP. Consequently, the *net* effect of this change to US GAAP on the amount of goodwill (or bargain purchase gain) resulting from an acquisition may not be significant.

Acquired finance (capital) lease assets and lease liabilities no longer measured at fair value

11.1.400 Current US GAAP generally requires the recognition of lease assets and lease liabilities related to capital (sales-type/direct financing) leases at fair value, regardless of whether the acquiree is a lessee or a lessor. In contrast, as outlined in the KPMG observation at 11.1.260, Topic 805 (as amended) prescribes the measurement of lease assets and lease liabilities on a basis other than fair value. [805-20-30-1]

11.1.410 It is unclear how significant the financial statement effect of this difference in measurement will be; the basis for conclusions notes that the prescribed measurement will approximate fair value. However, eliminating the requirement to account for finance (sales-type/direct financing) lease assets and lease liabilities at fair value may simplify the acquisition accounting for such leases as compared to current US GAAP. [ASU 2016-02.BC416–BC417]

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Consideration of lease terms and conditions in determining the fair value of lease assets in an acquired sales-type/direct financing lease

11.1.420 Current US GAAP, unlike Topic 805 (as amended), does not explicitly require consideration of the terms and conditions of the lease when measuring the lessor's lease receivable or unguaranteed residual asset. However, current *practice* has frequently concluded that measurement of the lease receivable and the unguaranteed residual asset at fair value under current US GAAP would take into consideration the terms and conditions of the lease.

Acquired operating leases where the acquiree is a lessor

11.1.430 An acquirer's accounting for an acquired operating lease as a lessor in acquisition accounting under Topic 805 (as amended) is substantially unchanged from current US GAAP.

Acquired leasehold improvements

11.1.440 An acquirer's accounting for acquired leasehold improvements under Topic 805 (as amended) is substantially unchanged from current US GAAP.

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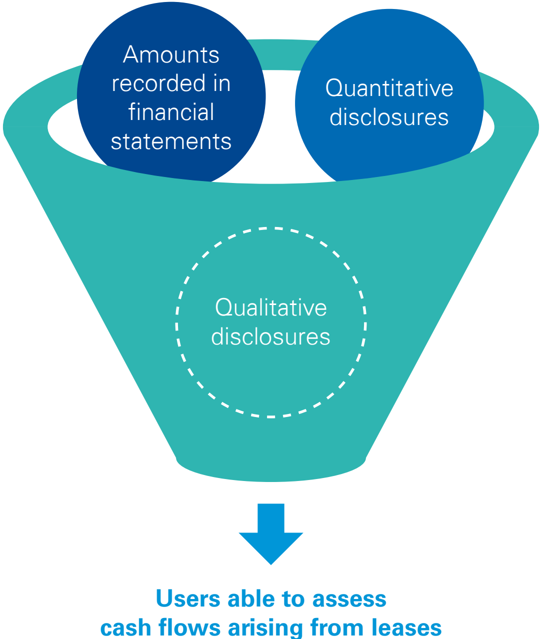
12 Disclosures

How the standard works

The disclosure objective in Topic 842 is to provide financial statement users sufficient information to assess the amount, timing, and uncertainty of cash flows arising from leases. To achieve that objective, lessees and lessors will disclose qualitative and quantitative information about lease transactions.



Users able to assess cash flows arising from leases

This generally will result in increased information being disclosed compared to current US GAAP. Accordingly, entities will need to evaluate whether they have appropriate systems, processes, and internal controls to capture the complete and accurate lease data necessary to prepare the financial statement notes.

For a discussion of the transition disclosures, see chapter 13.

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12.1 General disclosure requirements

12.1.10 The objective of the disclosure requirements for lessees and lessors is to enable financial statement users to assess the amount, timing, and uncertainty of cash flows arising from the entity's leases. To that effect, an entity discloses qualitative and quantitative information about:

- its leases;
- the significant judgments made in applying Topic 842; and
- the lease-related amounts recognized in the financial statements. [842-20-50-1, 842-30-50-1]

12.1.20 In preparing its notes to the financial statements, an entity considers the level of detail needed, how much emphasis to place on each disclosure requirement, and the appropriate level of aggregation. Useful information should not be obscured, for example by including a large amount of insignificant detail or by aggregating items with different characteristics. [842-20-50-2, 842-30-50-2]

12.1.30 In a sale-leaseback transaction for which the asset transfer qualifies as a sale (see chapter 9):

- the seller-lessee provides all applicable disclosures required by a lessee; and
- the buyer-lessor provides all applicable disclosures required by a lessor. [842-40-50-1]

KPMG observation – One size does not fit all

12.1.40 The Board included a disclosure objective in the standard so that entities understand the purpose of the disclosure requirements, and to assist entities in determining the extent of information to disclose about leases. Lessees and lessors will need to use judgment in determining how much to disclose, and what level of aggregation to use. While Topic 842 is silent on whether each disclosure requirement should be provided in *all* circumstances, the basis for conclusions highlights that it is implicit to the overall disclosure objective that the level of detail used in the notes should reflect the significance of the entity's leasing activity. As an entity's leasing activities become more significant, the disclosures will be more comprehensive. [ASU 2016-02.BC272–BC276]

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KPMG observation – No specific guidance on disaggregation

12.1.50 While Topic 842 requires entities to consider the appropriate level of detail and aggregation for its lease disclosures, the Board decided not to provide specific disaggregation requirements such as those required of entities about their contracts with customers under Topic 606. [ASU 2016-02.BC274]

12.1.60 Topic 606 explicitly requires entities to disaggregate revenue recognized from contracts with customers into categories that depict how the nature, amount, timing, and uncertainty of revenue and cash flows are affected by economic factors and provides implementation guidance to assist in selecting the categories for disaggregation. [606-10-50-5, 55-2 – 55-91]

US GAAP different from IFRS – Required qualitative disclosures for lessees and lessors

12.1.70 The objective of the disclosures in IFRS 16 is for entities to disclose information in the notes that, together with the information provided on the face of the financial statements, enables financial statement users to assess the effect that leases have on the entity's financial position, financial performance, and cash flows. [IFRS 16.51–60, 89–97]

12.1.80 While there are substantial similarities between IFRS 16 and Topic 842 for quantitative disclosures, IFRS 16 does not include a list of qualitative disclosure requirements. Instead, lessees and lessors reporting under IFRS 16 will disclose other information, in addition to the quantitative disclosures, in sufficient detail to satisfy the disclosure objective.

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12.2 Lessee disclosures

12.2.10 Qualitative information

☑ Nature of leases (and subleases), including:

- General description of those leases.
- Basis, and terms and conditions, of variable lease payments.
- Existence, and terms and conditions, of options to extend or terminate leases; this includes narrative disclosure of options recognized (and not recognized) as part of the right-of-use assets and lease liabilities.
- Existence, and terms and conditions, of lessee residual value guarantees.
- Restrictions or covenants imposed by leases (e.g. those relating to dividends or incurring additional financial obligations). [842-20-50-3]

☑ Leases that have not yet commenced, but that create significant rights and obligations for the lessee, including the nature of any involvement with the construction or design of an underlying asset. [842-20-50-3]

☑ Significant lease accounting judgments and assumptions, which might include determining:

- whether a contract contains a lease;
- the allocation of consideration between lease and non-lease components; and
- the discount rate for the entity's leases. [842-20-50-3]

☑ Main terms and conditions of any sale-leaseback transactions. [842-40-50-2]

☑ Lease transactions between related parties in accordance with Topic 850. [842-20-50-7, 850-10-50-1 – 50-6]

Short-term lease exemption

☑ The fact that the short-term lease exemption has been applied (see section 6.3.1). We believe that this would include disclosing to which class(es) of underlying assets the exemption is being applied. [842-20-50-8]

☑ To the extent that the periodic short-term lease cost does not reasonably reflect the lessee's short-term lease commitments as of the reporting date, that fact and the amount of its short-term lease commitments (see Example 12.4). [842-20-50-8]

Practical expedient: Combining lease and non-lease components

☑ The fact that the practical expedient has been applied (see 4.4.30–40). [842-20-50-9]

☑ The class(es) of underlying assets for which the practical expedient was elected. [842-20-50-9]

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12.2.20 Quantitative information

- ☑ For finance leases, amortization of right-of-use assets and interest on lease liabilities (including capitalized costs). [842-20-50-4(a)]
- ☑ Operating lease cost (including capitalized costs). [842-20-50-4(b)]
- ☑ Short-term lease cost (when the lease term is greater than one month). [842-20-50-4(c)]
- ☑ Variable lease cost. [842-20-50-4(d)]
- ☑ Sublease income. [842-20-50-4(e)]
- ☑ Net gains (losses) on sale-leaseback transactions. [842-20-50-4(f)]
- ☑ Cash paid for amounts included in the measurement of lease liabilities, segregated between finance and operating leases, and between operating and financing cash flows. [842-20-50-4(g)]
- ☑ Supplemental noncash information on lease liabilities arising from obtaining right-of-use assets, separately for finance and operating leases. [842-20-50-4(g)]
- ☑ Weighted-average remaining lease term (see Example 12.2), presented separately for finance and operating leases. [842-20-50-4(g), 50-5]
- ☑ Weighted-average discount rate (see Example 12.3), presented separately for finance and operating leases. [842-20-50-4(g), 50-5]
- ☑ Maturity analysis of lease liabilities, presented separately for finance and operating leases, for each of the first five years after the balance sheet date and in total thereafter, including a reconciliation of the undiscounted cash flows to the lease liabilities recognized in the balance sheet.[1] [842-20-50-6]

Note 1:

Finance and operating lease liabilities are either presented separately in the balance sheet or disclosed separately in the notes to the financial statements. [842-20-45-1]

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Example 12.1

Selected lessee quantitative disclosures in a tabular format

12.2.30 While the Board did not specify a format that must be used to make the required quantitative disclosures, Topic 842 includes an illustration presenting the lessee quantitative disclosures in a tabular format. The following example is based on the example in the standard, and illustrates a lessee's quantitative disclosures. [842-20-55-53]

For the years ended December 31, 20X9 and 20X8 (in thousands)	20X9	20X8
Lease cost		
Finance lease cost (cost resulting from lease payments):		
Amortization of right-of-use assets	$ 600	$ 525
Interest on lease liabilities	150	110
Operating lease cost (cost resulting from lease payments)	1,000	900
Short-term lease cost	50	40
Variable lease cost (cost from amounts excluded from lease payments)	75	60
Sublease income	(10)	(8)
Total lease cost	**$1,865**	**$1,627**

Other information		
(Gains) losses on sale-leaseback transactions, net	$ (8)	$ 5
Cash paid for amounts included in the measurement of lease liabilities for finance leases:		
Operating cash flows	1,400	1,300
Financing cash flows	200	170
Cash paid for amounts included in the measurement of lease liabilities for operating leases:		
Operating cash flows	800	635
Right-of-use assets obtained in exchange for new finance lease liabilities	475	515
Right-of-use assets obtained in exchange for new operating lease liabilities	150	175
Weighted-average remaining lease term (in years):		
Finance leases	9.7	2.9
Operating leases	5.2	5.4
Weighted-average discount rate:		
Finance leases	5.8%	6.0%
Operating leases	6.1%	6.3%

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Example 12.2
Weighted-average remaining lease term disclosure

12.2.40 A lessee calculates the weighted-average remaining lease term based on the remaining lease term and the lease liability balance for each lease at the reporting date. [842-20-55-11]

12.2.50 For the year ended December 31, 20X9, Lessee LE discloses a weighted-average remaining lease term of 4.96 years for its finance leases, and 2.73 years for its operating leases. LE calculated the weighted-average remaining lease terms as follows.

Lease ID	Lease liab. 12/31/20X9 (A)	Remain. lease term at 12/31/20X9 (B)	(A x B)	Weight. avg. lease term at 12/31/20X9
Finance leases				
FL1	$ 52,936	4.00	$211,744	
FL2	94,499	5.50	519,745	**D/C**
	C = $147,435		**D =** $731,489	**4.96**
Operating leases				
OL1	$ 14,104	2.00	$ 28,208	
OL2	21,654	2.25	48,722	
OL3	33,570	2.54	85,268	
OL4	24,365	4.00	97,460	
OL5	12,847	2.42	31,090	**F/E**
	E = $106,540		**F =** $290,748	**2.73**

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Example 12.3
Weighted-average discount rate disclosure

12.2.60 A lessee calculates the weighted-average discount rate based on:

- the discount rate for the lease – i.e. used to calculate the lease liability balance for each lease at the reporting date; and
- the remaining balance of the lease payments for each lease at the reporting date. [842-20-55-12]

12.2.70 For the year ended December 31, 20X9, Lessee LE discloses a weighted-average discount rate of 5.72% for its finance leases, and 4.29% for its operating leases. The leases described are the same as in Example 12.2. LE calculated the weighted-average discount rates as follows.

Lease ID	Remain. pmts. 12/31/20X9 (A)	Rate to calc. liabs. (B)	(A x B)	Weighted avg. discount rate 12/31/20X9
Finance leases				
FL1	$ 60,000	5.20%	$3,120	
FL2	112,500	6.00%	6,750	**D/C**
	C = $172,500		**D =** $9,870	**5.72%**
Operating leases				
OL1	$ 15,000	4.20%	$ 630	
OL2	22,800	4.20%	958	
OL3	36,000	4.70%	1,692	
OL4	27,000	4.20%	1,134	
OL5	13,500	3.60%	486	**F/E**
	E = $114,300		**F =** $4,900	**4.29%**

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Example 12.4

Periodic short-term lease cost does not reasonably reflect lessee's short-term lease commitments

12.2.80 Lessee LE has elected to apply the short-term lease exemption to one of its classes of underlying assets: office equipment (e.g. copiers and printers). During 20X8, LE only has a small number of leases within this class of underlying asset that qualify for the exemption. The short-term lease cost recognized and disclosed for those leases during 20X8 is $200,000. The remaining lease payments due in 20X9 are $40,000.

12.2.90 On December 31, 20X8, LE enters into a master lease agreement for a number of new items of office equipment. The leases subject to that master lease agreement qualify as short-term leases because the non-cancellable period of the leases is one year, and LE is not reasonably certain to exercise its right to renew those leases at the end of the non-cancellable period – i.e. the lease term is one year or less.

12.2.100 Because LE has elected the short-term lease exemption for its leases of office equipment, the short-term lease exemption applies to these new office equipment leases. The total lease payments that will be paid during 20X9 for the additional items of office equipment is $2,400,000.

12.2.110 In accordance with the lessee disclosure requirements in Topic 842, LE discloses the following in its financial statements:

- the fact that it elected to apply the short-term lease exemption for its leases of office equipment;
- short-term lease cost for 20X8 of $200,000; and
- because the periodic short-term lease cost of $200,000 disclosed does not reasonably reflect the lessee's short-term lease commitments as of December 31, 20X8, it discloses that fact and the amount of its short-term lease commitments of $2,440,000 ($2,400,000 + $40,000).

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KPMG observation – Disclosure requirements not meant to be exhaustive

12.2.120 Although the Board provided a list of qualitative and quantitative disclosures, a lessee may need to provide additional information about its leases to achieve the disclosure objective at 12.1. For example, a lessee will need to consider whether to disclose information about reassessments or modifications that occurred during the reporting period, such as the following.

Disclosure	Required for:	
	Reassessments	Modifications
Lessee action(s) that triggered a reassessment of the lease term or exercise of purchase option(s)	✔	
The existence, and terms and conditions, of contract modifications		✔
Whether a contract modification was accounted for as a separate contract and any significant judgments made in that determination		✔
Reallocation of the remaining contract consideration to the lease components and non-lease components	✔	✔[1]
If the lease classification changes, that fact and how it impacts the comparative periods presented (e.g. amounts recognized in profit or loss, and in the statement of cash flows)	✔	✔[1]
The effect on the measurement of the lease liability, right-of-use asset, and any amounts recognized in profit or loss	✔	✔[1]

Note 1:

When the lease modification is not accounted for as a separate contract.

KPMG observation – No reconciliation of lease liabilities

12.2.130 The Board decided not to require a reconciliation of the opening and closing balances of lease liabilities due to preparers' concerns about the costs and complexity of implementation. Some preparers cited the need for more robust IT systems and/or process capabilities to track and accumulate reconciling items that are not identified for disclosure today. Instead, the Board decided to require lessees to disclose key components of the reconciliation, including total lease cost and cash paid for amounts included in the measurement of lease liabilities. This decision is consistent with current US GAAP for other financial liabilities, which does not require a reconciliation. [ASU 2016-02.BC284–BC286]

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US GAAP different from IFRS – Lessee disclosures

Required tabular presentation of lessee quantitative disclosures

12.2.140 IFRS 16 requires provision of the lessee quantitative disclosures in a tabular format, unless the lessee can substantiate that another format is more appropriate. In contrast, Topic 842 only provides a tabular format for the quantitative disclosures as an example of one way a lessee could meet the disclosure requirements. [IFRS 16.54]

Some differences in lessee quantitative disclosure requirements

12.2.150 The following are differences between the lessee quantitative disclosure requirements in IFRS 16 and those in Topic 842.

- *Maturity analysis of lease liabilities* – IFRS 16 requires that lessees disclose a maturity analysis of its lease liabilities in accordance with the IFRS 7 (financial instruments disclosures) disclosure requirements for other financial liabilities. The maturity analysis requirements of IFRS 7 are less prescriptive than the requirements under Topic 842. [IFRS 16.58]
- *Total cash outflow for leases* – IFRS 16 requires disclosure of total cash paid for leases during the reporting period. Topic 842 only requires cash paid in satisfaction of amounts that comprise the lessee's lease liabilities. [IFRS 16.53(g)]
- *Total expense for leases of low-value assets* – IFRS 16 requires disclosure of the lease expense for the period related to leases of low-value assets. There is no equivalent exemption (and consequential disclosure) under Topic 842. [IFRS 16.53(d)]
- *Additions to right-of-use assets* – IFRS 16 requires disclosure of all additions of right-of-use assets by the lessee during the period. Topic 842 only requires the amount of right-of-use assets obtained in exchange for lease liabilities. Therefore, IFRS 16 requires disclosure of right-of-use assets in exchange for cash (i.e. prepaid leases), while Topic 842 only requires disclosure of amounts that equal the lease liability at lease commencement. [IFRS 16.53(h)]
- *Carrying amount of right-of-use assets by class of underlying asset* – IFRS 16 requires a lessee to disclose its right-of-use assets by underlying asset class (e.g. office space, computer equipment, vehicles). Topic 842 does not require a similar disclosure. [IFRS 16.53(j)]
- *Weighted-average remaining lease term* – IFRS 16 does not include a requirement like that in Topic 842 to disclose the weighted-average remaining lease term for a lessee's leases.
- *Weighted-average discount rate* – IFRS 16 does not include a requirement like that in Topic 842 to disclose the weighted-average discount rate used in accounting for the lessee's leases.

12.2.160 In addition, most of the required lessee quantitative disclosures in Topic 842 require separate disclosure for finance and operating leases. Under IFRS 16, there is only one type of lease for lessees; therefore, this is also a difference in how the disclosures will be prepared and presented between IFRS 16 and Topic 842.

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Comparison with current US GAAP – Increased qualitative and quantitative disclosures

12.2.170 Lessee disclosures under Topic 842 are more extensive than current US GAAP. [840-10-50, 840-20-50, 840-30-50, 840-40-50]

- Examples of new qualitative disclosures include (1) information about leases that have not yet commenced at the balance sheet date that create significant rights and obligations to the lessee, and (2) significant judgments made such as determining whether a contract contains a lease, determining the discount rate for the lease, and allocating the consideration in the contract to lease and non-lease components.
- Examples of new quantitative disclosures include cash paid for amounts included in the measurement of lease liabilities, supplemental non-cash information on lease liabilities arising from obtaining right-of-use assets for operating leases, weighted-average remaining lease terms, and weighted-average discount rate information.

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12.3 Lessor disclosures

12.3.10 Qualitative information

☑ Information about the nature of its leases, including:

- General description of those leases.
- Basis, and terms and conditions, on which variable lease payments are determined.
- Existence, and terms and conditions, of lease extension and termination options.
- Existence, and terms and conditions, of lessee purchase options. [842-30-50-3(a)]

☑ Information about the significant assumptions and judgments, which *may* include:

- Determining whether a contract contains a lease.
- Determining the allocation of consideration to the lease and non-lease components in a contract.
- Initially measuring the residual asset. [842-30-50-3(b)]

☑ Lease transactions between related parties in accordance with the related party guidance. [842-30-50-4]

☑ Explanation of significant changes in the carrying amount of the lessor's unguaranteed residual assets and deferred selling profit for net investments in sales-type and direct financing leases. [842-30-50-9]

☑ Information about how a lessor manages residual value risk of its leased assets, including:

- Carrying amount of residual assets covered by residual value guarantees (excluding guarantees considered to be lease payments for the lessor). [842-30-50-7(b)]
- Risk management strategy for residual assets. [842-30-50-7(a)]
- Any other means used by the lessor to reduce its residual asset risk (e.g. buyback agreements or variable lease payments for use in excess of specified limits). [842-30-50-7(c)]

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12.3.20 Quantitative information

☑ Table of lease income received during each annual and interim reporting period, including:

- For sales-type leases and direct finance leases:
  - » Profit or loss recognized at commencement date; presented gross or net depending on lessor's business model – i.e. as a manufacturer/dealer or a financial lessor.
  - » Interest income either in aggregate or separated by the components of the net investment in the lease.
- For operating leases, lease income relating to lease payments.
- Lease income relating to variable lease payments not included in the lease receivable. [842-30-50-5]

☑ The carrying amounts of the components of the aggregate net investment in sales-type and direct financing leases:

- Lease receivables.
- Unguaranteed residual assets.
- Any deferred selling profit on direct financing leases. [842-30-50-6]

☑ For finance leases, a maturity analysis of the undiscounted cash flows comprising the lessor's lease receivables for each of the first five years and a total of the amounts thereafter, reconciled to the balance of lease receivables. [842-30-50-10]

☑ For operating leases, a maturity analysis of the undiscounted future lease payments for each of the first five years and a total of the amounts thereafter. A lessor presents the operating lease maturity analysis separately from the maturity analysis required for sales-type and direct financing leases. [842-30-50-12]

☑ The general property, plant, and equipment disclosures for assets subject to operating leases, provided by significant class of underlying asset, separately from those disclosures for the lessor's other owned assets. [842-30-50-13, 360-10-50]

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Example 12.5
Table of lease income for the reporting period

12.3.30 The following table is an example of the lease income disclosure by a Lessor LR, which is required to be in tabular format.

For the years ended December 31, 20X9 and 20X8 (in thousands)		
	20X9	**20X8**
Lease income – sales-type and direct financing leases		
Profit at lease commencement[1]	$ 17	$ 5
Interest income on lease receivables[2]	345	320
Interest income from accretion of unguaranteed residual assets[2]	105	97
Subtotal	**467**	**422**
Lease income – operating leases	510	495
Variable lease income	25	22
Total lease income	**$1,002**	**$939**

Notes:

1. Presentation is based on LR's business model in accordance with paragraph 842-30-45-4. In this example, LR uses leases for the purpose of providing finance and therefore profit is presented net.
2. Interest income on LR's net investment in leases may be disclosed either in aggregate or separately (as shown) for each component of the net investment in the lease.

KPMG observation – Assets subject to operating leases are a separate major class of depreciable assets

12.3.40 In the Board's view, leased assets are often subject to risks different from owned assets that are held and used by the entity, and providing separate disclosures benefits users. Accordingly, a lessor should treat assets subject to operating leases as a separate major class of depreciable assets, which should be further disaggregated by significant class of underlying assets (e.g. airplanes versus buildings). In addition, the risks related to one class of leased asset may be very different from another. [ASU 2016-02.BC341]

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Comparison with current US GAAP – More information on risks to which a lessor is exposed and lease income

12.3.50 Although the Board decided not to substantially change lessor accounting and to retain most of the existing disclosure requirements, its decision to expand the lessor disclosure requirements is intended to provide financial statement users (e.g. investors and analysts) with:

– more information about the risks to which a lessor is exposed; for example, collectibility of lease receivables (i.e. credit risk), and risks related to the lessor's residual interest in its leased assets; and

– additional information about the lessor's lease income (as illustrated in Example 12.5). [840-10-50, 840-20-50, 840-30-50, 840-40-50]

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13 Effective dates and transition

How the standard works

Effective date:	**Public business entities**:[1] Annual and interim periods in fiscal years beginning after December 15, 2018.	**Other entities:** – Annual periods beginning after December 15, 2019. – Interim periods in fiscal years beginning after December 15, 2020.
Early adoption:	All entities can adopt Topic 842 immediately.	
Transition method:	Modified retrospective, which requires application of the new guidance for all periods presented.	
Transition date:	As referred to in this chapter, the date on which an entity applies the transition requirements to a lease, which is the later of: (1) the beginning of the earliest period presented in the financial statements, or (2) the 'commencement date' for the lease (see section 5.1).	
Package of practical expedients (all or nothing):	An entity may elect not to reassess: – whether expired or existing contracts contain leases under the new definition of a lease; – lease classification for expired or existing leases; and – whether previously capitalized initial direct costs would qualify for capitalization under Topic 842.	
Use of hindsight:	– Hindsight allowed when considering the likelihood that lessee options to extend or terminate a lease or purchase the underlying asset will be exercised, and in assessing the impairment of right-of-use assets. – Elect on its own or with the package of practical expedients.	

Note 1:

This includes (1) not-for-profit entities that have issued or are conduit bond obligors for securities that are traded, listed, or quoted on an exchange or an over-the-counter market, and (2) employee benefit plans that file or furnish financial statements with or to the SEC.

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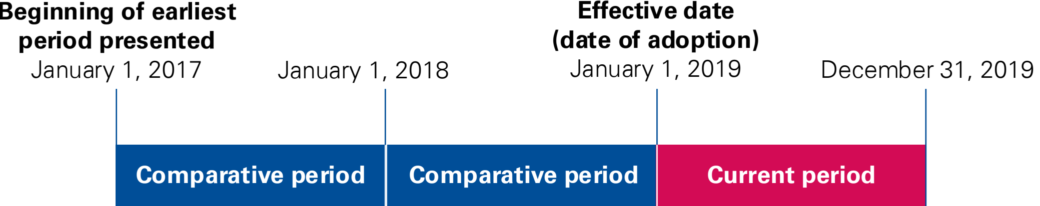
13.1 Effective dates

13.1.10 Public business entities apply Topic 842 for interim and annual periods in fiscal years beginning after December 15, 2018. All other entities apply Topic 842 for fiscal years beginning after December 15, 2019, and interim periods in fiscal years beginning one year later. [842-10-65-1(a) – 65-1(b)]

13.1.20 If a calendar year-end public business entity adopts Topic 842 in accordance with the mandatory effective date, then the following are the relevant dates.

13.1.30 An entity can early adopt Topic 842 at any time after issuance. [842-10-65-1(a) – 65-1(b)]



KPMG observation – Early adoption considerations

Lessors may want to align implementation with Topic 606

13.1.40 Most of the changes applicable to lessors transitioning from current US GAAP to Topic 842 were designed to substantially align key aspects of the lessor accounting model with the new revenue recognition guidance in Topic 606. For example, the separation and allocation guidance for lease and non-lease components, the lease modifications guidance, the guidance on initial direct costs, and the contract combinations guidance. [ASU 2016-02.BC8(d)]

13.1.50 Those aspects of Topic 606 and Topic 842 that are substantially aligned are designed to work together. The Board's decision to align these aspects of the two standards explicitly considered that many lessors have contracts that contain lease *and* non-lease (e.g. services or supplies) components and that those lessors in particular would benefit from the alignment. Consequently, many lessors may find it preferable to early adopt Topic 842 at the same time as they adopt Topic 606.

Minimize disruption

13.1.60 Most entities will likely be affected by the implementation of both Topic 606 and Topic 842. Some entities might view it as advantageous to adopt both standards concurrently, in a big bang approach, to minimize the extent of ongoing systems and process changes, get past the disruption, and revert to a steady state accounting environment more quickly.

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Seller-lessees in real estate sale-leaseback transactions

13.1.70 As discussed in section 9.1, it will generally be easier to achieve sale accounting for real estate sale-leaseback transactions than under current US GAAP. A seller-lessee that has, or is contemplating, a significant real estate sale-leaseback transaction that is, or is expected to be, a failed sale under current US GAAP might want to early adopt Topic 842 if the transaction would be accounted for as a sale and a leaseback. For further discussion, see section 13.7.

Lessees with existing build-to-suit lease arrangements

13.1.80 Because of the existing build-to-suit lease accounting guidance in current US GAAP, there are many lessees that have assets and liabilities recognized for assets that they do not legally own, but were deemed to own for accounting purposes during the construction period. In some of those cases, the construction period ended many years ago but, because of the restrictive sale-leaseback requirements applicable to real estate under current US GAAP, the entity has been unable to derecognize those assets and liabilities. Because the transition provisions in Topic 842 applicable to build-to-suit leases and sale-leaseback transactions may permit the entity to derecognize those assets and liabilities (see section 13.8), some entities in this situation may choose to early adopt Topic 842.

KPMG observation – Reporting requirements for SEC registrants

SEC requirements on adoption of a new standard

SEC regulations require registrants to present selected financial data for the five most recent fiscal years. SEC registrants adopting a standard on a retrospective basis (including the use of one or more practical expedients) are required to update the other areas of their filings, including the MD&A, to reflect the retrospective application of the new standard. Additionally, the SEC Staff Financial Reporting Manual states that, if a registrant adopts a new accounting standard retrospectively, the staff will expect all five years to be presented on the same basis. [SEC Reg S-K Item 301, SEC FRM 1610]

13.1.90 We believe that SEC registrants would not restate previously reported information in their Selected Financial Data table that precedes the beginning of the earliest comparative period presented in the registrant's financial statements. For example, if a calendar year-end SEC registrant adopts Topic 842 in accordance with the mandatory effective date (i.e. for calendar 2019), we believe that the registrant would not restate the selected financial data in its 2019 annual report on Form 10-K for 2015 and 2016; it would, however, restate 2017 and 2018 information in the selected financial data table.

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13.1.100 Topic 842 mandates only a *modified* retrospective transition approach (which is not the same as a retrospective transition approach), that does not provide guidance on applying its requirements to periods before the beginning of the earliest period presented. Therefore, it is unclear on what basis, for example, a lessee would measure its operating lease right-of-use assets and lease liabilities. In addition, such measurement (e.g. that uses a discount rate for the lease determined as of a date before the beginning of the earliest period presented) would affect subsequent periods so that those periods would not be in accordance with Topic 842's transition requirements.

US GAAP different from IFRS – Early adoption

13.1.110 IFRS 16 is effective for annual periods beginning on or after January 1, 2019. Early adoption is permitted, but *only* if the entity is concurrently adopting or has already adopted the new revenue recognition standard (IFRS 15). [IFRS 16.C1]

13.1.120 Because current IFRS does not have the same restrictive real estate sale-leaseback guidance as current US GAAP, and does not have specific requirements for build-to-suit lease arrangements, there are likely to be less incentives for IFRS preparers to early adopt IFRS 16 than there will be for US GAAP preparers to early adopt Topic 842.

13.2 Transition principles – Lessees and lessors

Transition approach – general

13.2.10 In the financial statements in which an entity first applies Topic 842, the entity recognizes and measures all leases that exist at the beginning of the earliest comparative period presented using a modified retrospective transition approach. As an exception, a lessee electing the exemption for short-term leases (see section 6.3.1) does not apply the transition requirements to those leases. [842-10-65-1(c) – 65-1(e)]

13.2.20 Topic 842 does not specify what to do instead for those leases in transition. However, we believe that:

- the lessee will recognize the minimum rental payments (as defined in current US GAAP) as lease cost, generally on a straight-line basis over the lease term consistent with the lessee's accounting for those leases under current US GAAP; and
- consistent with all other lessee leases that exist at the effective date, will apply the new requirements in Topic 842 to that lease if, on or after the effective date, it is modified (and that modification is not accounted for as a separate contract) – see section 6.7 – or there is an event that would require remeasurement of the lease liability (e.g. a change in the lease term or change in the assessment of a lessee purchase option) – see section 6.6.

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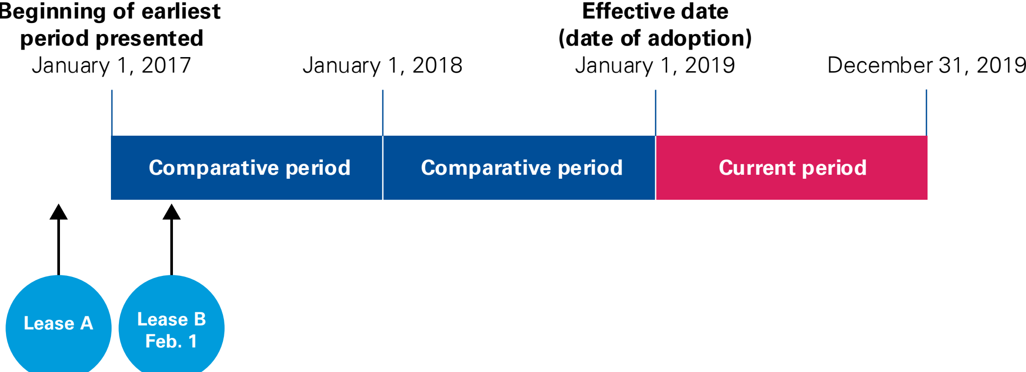
13.2.30 An entity adjusts equity at the beginning of the earliest comparative period presented, and the other comparative amounts disclosed for each prior period presented, as if Topic 842 had always been applied, subject to the transition requirements described in this chapter. [842-10-65-1(d)]

13.2.40 An entity applies the transition requirements at the later of: (1) the beginning of the earliest period presented in the financial statements, or (2) the commencement date (see section 5.1). For ease of reference, this date is referred to as the 'transition date' in this chapter. [842-10-65-1(k), 65-1(r)(1), 65-1(s)(1), 65-1(v)(1), 65-1(w)(1), 65-1(x)(1)]

13.2.50 The following diagram is based on a calendar year-end public business entity that adopts Topic 842 on the mandatory effective date. The transition requirements apply to:

- Lease A at the beginning of the earliest period presented – i.e. January 1, 2017 is the transition date; and
- Lease B at the commencement date of – i.e. February 1, 2017 is the transition date.



Transition approach – modifications

13.2.60 The following transition requirements apply to modifications that are not accounted for as a separate contract, for both lessees and lessors. [842-10-65-1(q), 65-1(t), 65-1(x)(4)]

Modification occurs…	
Before effective date:	**On or after effective date:**
– Apply current GAAP, Topic 840.	– Apply the requirements of Topic 842 in accounting for the modification and in accounting for the lease on and after the effective date of the modification. See section 6.7 (lessees) and section 7.7 (lessors).

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13.2.70 The same requirements apply to lessees in respect of remeasurements that occur on or after the effective date[1] – i.e. Topic 842 applies in:

- determining whether there is a remeasurement (see section 6.6.1);
- accounting for the remeasurement (see section 6.6.2); and
- accounting for the lease after the remeasurement (see section 6.6.2). [842-10-65-1(q), 65-1(t)]

Note 1:

Current US GAAP does not include a lessee remeasurement requirement; therefore, remeasurements will not occur before the effective date.

13.2.80 In the diagram in 13.2.50, if Lease B is modified on March 15, 2019, the modification will be accounted for under Topic 842.

Practical expedients

13.2.90 The following table summarizes the two types of practical expedients in Topic 842. [842-10-65-1(f) – 65-1(g)]

Package of practical expedients	Use of hindsight
On transition, an entity may elect *not* to reassess: – whether expired or existing contracts contain leases under the new definition of a lease (see chapter 3); – lease classification for expired or existing leases – see sections 6.2 (lessees) and 7.2 (lessors); and – whether previously capitalized initial direct costs would qualify for capitalization under Topic 842 (see section 5.5).	An entity may use hindsight: – in determining the lease term, assessing the likelihood that a lessee purchase option will be exercised (see section 5.3); and – for lessees, in assessing the impairment of right-of-use assets (see section 6.5).
Must be elected as a package, but can be elected separately from the use of the hindsight expedient.	May be elected separately or together with the package of practical expedients.
Practical expedients are applied consistently to all leases – i.e. all leases for which the entity is a lessee or a lessor – for leases that commence *before* the effective date.	

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13.2.100 In effect, the transition relief provides four possible transition combinations for entities to choose from for leases entered into before the effective date.

Combination	Package of practical expedients	Use of hindsight
1	✘	✘
2	✔	✔
3	✔	✘
4	✘	✔

13.2.110 Lease modifications that occur before the effective date do not affect the availability of the practical expedients. If the entity modifies its contracts that are leases under current US GAAP but would not be leases under Topic 842 during the transition period – between January 1, 2017 and December 31, 2018 in the diagram in 13.1.20 – and has elected the package of practical expedients, the entity would apply the current US GAAP definition of a lease to the modified contracts. In addition, unless there are additional modifications on or after January 1, 2019 (the effective date in the diagram in 13.1.20), the entity will not evaluate whether those contracts are leases under Topic 842. [842-10-65-1(f), ASU 2016-02.BC390, BC393]

13.2.120 The overall effect of the transition requirements is that an entity that elects to apply all of the practical expedients will, in effect, continue to account for existing leases – i.e. leases for which the commencement date is before the effective date – in accordance with current US GAAP throughout the entire lease term, including periods after the effective date, with the following exceptions. [ASU 2016-02.BC390]

Lessees only	Lessees and lessors
– Recognize a right-of-use asset and a lease liability for all operating leases at each reporting date (see section 13.3). – Apply the reassessment requirements beginning on the effective date and, if the lease liability is remeasured on or after the effective date, account for the lease under Topic 842 beginning on the remeasurement date (see 13.2.70).	– If the lease is modified (and not accounted for as a separate contract) on or after the effective date, account for the lease under Topic 842 beginning on the effective date of the modification (see 13.2.60).

Disclosures

13.2.130 An entity generally provides the transition disclosures required on accounting changes and error corrections. As an exception, an entity is not required to disclose the effect of the change on income from continuing operations, net income, and per-share amounts for the current period and any prior periods retrospectively adjusted. [842-10-65-1(i), 250-10-50-1(b)(2)]

13.2.140 If an entity elects the package of practical expedients and/or the practical expedient to use hindsight, it discloses that fact. [842-10-65-1(j)]

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KPMG observation – Impact on initial direct costs for entities not electing the package of practical expedients

13.2.150 An entity's decision not to elect the package of practical expedients for lease definition, lease classification, and initial direct costs may not have a significant effect on the entity unless it has previously incurred a significant amount of initial direct costs. This is because the new definition of a lease and the new lease classification guidance will likely yield similar outcomes to the related guidance in current US GAAP in most cases. However, because substantially fewer costs qualify as initial direct costs under Topic 842 (see section 5.5), the effect of electing (or not electing) the package of practical expedients may be significant for entities that incur significant lease origination costs. [ASU 2016-02.BC393]

KPMG observation – Errors not grandfathered

13.2.160 The practical expedient not to reassess whether expired or existing contracts contain a lease grandfathers the guidance on identifying a lease under current US GAAP. However, it does not grandfather an incorrect assessment determined under current US GAAP. For example, an entity may have incorrectly determined that a contract does not contain a lease under current US GAAP; the practical expedient does not grandfather this incorrect assessment. [ASU 2016-02.BC393(a)]

KPMG observation – Arrangements committed or agreed to before reporting periods beginning after May 28, 2003

13.2.170 Under current US GAAP, arrangements not accounted for as leases that were committed or agreed to before reporting periods beginning after May 28, 2003 (and not subsequently modified or acquired in a business combination), were grandfathered from determining whether the arrangement is or contains a lease. While Topic 842 does not carry forward that grandfathering provision, the package of practical expedients grandfathers the current US GAAP lease identification guidance for all leases that have commenced prior to the effective date of Topic 842.

13.2.180 We believe that this includes the grandfathering provision. Therefore, if an entity elects the package of practical expedients, leases previously subject to this grandfathering provision would remain eligible for that provision.

13.2.190 However, entities will need to have a process in place to monitor contracts in place before the effective date for modifications that occur on or after the effective date. If a contract previously subject to this grandfathering provision is modified on or after the effective date, the entity will have to consider whether the contract is or contains a lease under Topic 842.

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KPMG observation – Modified retrospective transition approach a middle-ground for preparers and users

13.2.200 The modified retrospective transition approach represents a compromise between providing all of the information that would likely be useful to financial statement users and limiting unnecessary costs to financial statement preparers to implement Topic 842. [ASU 2016-02.BC389]

Financial statement users

13.2.210 The decision to require a modified retrospective approach, rather than a prospective or cumulative effect approach, was made to ensure that, in particular, the principal financial statement changes resulting from Topic 842 – i.e. the recognition of operating leases on the balance sheet by lessees, and enhanced disclosures for lessees *and* lessors – were presented on a comparative basis for all periods presented in entities' first set of financial statements applying Topic 842. [ASU 2016-02.BC389]

13.2.220 The Board also expects financial statement users to benefit from the relatively limited number of transition options (see table in 13.2.90). It was this desire to limit the transition options that drove the Board's decision to require entities to adopt the package of practical expedients on an all-or-nothing basis. Given the options available, we believe that most entities will choose to use hindsight when considering lessee options to extend or terminate a lease or purchase the underlying asset, and in considering the possible impairment of right-of-use assets.

13.2.230 In contrast, financial statement users will not receive completely comparable information because of those aspects of the modified retrospective transition approach that are intended to reduce the burden on preparers. For example, the difference in what comprises *minimum lease payments* and *minimum rental payments* under current US GAAP compared to *lease payments* under Topic 842, which entities do not generally have to revisit for leases that commence prior to the effective date of Topic 842, will reduce comparability between those leases and leases that commence on or after the effective date.

13.2.240 Comparability will be more significantly affected in some cases for entities that elect the package of practical expedients. This might be most pronounced for entities that incur significant lease origination costs that qualify as initial direct costs under current US GAAP but will not qualify as initial direct costs under Topic 842 (see KPMG observation at 13.2.150).

13.2.250 For example, a lessor has two identical operating leases: Lease #1 that commenced just prior to the effective date, and Lease #2 that commenced just after the effective date. The lessor incurred significant lease origination costs on both leases that meet the definition of initial direct costs under current US GAAP (which are then deferred and recognized over the lease term in proportion to the recognition of lease income), but do not meet the new definition of initial direct costs (and therefore are expensed as incurred). Lease #1 may have a substantively lower margin throughout the lease term compared with Lease #2, while the lessor will have some earnings volatility resulting from Lease #2 because it must recognize those one-time origination costs for that lease as incurred.

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Financial statement preparers

13.2.260 Financial statement preparers will generally benefit from not being required to apply Topic 842 on a full retrospective basis, and even more so if they elect the practical expedients that are available to them. Even without the practical expedients, entities will benefit from applying the transition requirements at the transition date and not having to look back to lease commencement for measurement purposes.

13.2.270 In addition, if an entity elects the practical expedients, there will likely be significant cost/effort savings from not having to go back and reassess previous accounting conclusions, identify which initial direct costs previously deferred would have been ineligible for deferral under Topic 842, or consider the impairment of right-of-use assets not previously recognized (lessees only).

13.2.280 The modified retrospective approach, particularly if the practical expedients are elected, may provide more significant benefits to entities that have older leases.

13.2.290 However, the modified retrospective transition approach also represents a compromise from a preparer's perspective because it is not the simplest approach that the Board could have selected. It will require more effort than, for example, a purely prospective transition approach.

US GAAP different from IFRS – IFRS 16 transition significantly different

13.2.300 The transition approaches and options under IFRS 16 are significantly different from Topic 842. In addition, the considerations for preparers when selecting a transition approach will often be different under IFRS and US GAAP. This guidance and the preparer considerations differ significantly because the Topic 842 and IFRS 16 lessee accounting models differ so significantly (see chapter 6).

13.2.310 The IASB has sought to reduce transition costs by introducing a series of practical expedients. Some expedients are accounting policy choices, some apply by class of underlying asset, and some can be elected on a lease-by-lease basis. Therefore, unlike the limited number of transition choices that are available in Topic 842 (see 13.2.100), many entities applying IFRS will have a myriad of transition choices that can result in a dizzying number of combinations and permutations.

13.2.320 **IFRS transition**

Lessees

- Full retrospective approach or cumulative effect approach:
  - Under the cumulative effect approach, a lessee does not restate comparative information.
  - At the date of initial application (i.e. the beginning of the annual reporting period in which an entity first applies IFRS 16), recognize the cumulative effect of application as an adjustment to the opening balance of retained earnings (or other equity component as appropriate). [IFRS 16.C5–C13]

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$ Lessors

- Lessors continue to apply existing accounting for any leases that are existing at the date of initial application, except for intermediate lessors in a sublease. [IFRS 16.C14]
- Intermediate lessors in subleases reassess each existing operating sublease at the date of initial application to determine whether it is classified as an operating lease or a finance lease under IFRS 16, based on the remaining contractual terms of the head lease and the sublease. [IFRS 16.C15(a)]
- For subleases that were classified as operating leases under current IFRS guidance on leases, but finance leases under IFRS 16, account for the sublease as a new finance lease entered into at the date of initial application. [IFRS 16.C15(b)]

13.2.330 IFRS practical expedients

- Entities may elect not to reassess whether a contract is or contains a lease at the date of initial application; the election must be applied to all of the entity's contracts. [IFRS 16.C3]
- Lessees may use one or more of the following practical expedients when applying the modified retrospective approach to leases previously classified as operating leases under current IFRS, which can be elected on a lease-by-lease basis.
  - Use hindsight, such as in determining the lease term.
  - Rely on their assessment of whether leases are onerous under IAS 37 (provisions and contingencies) immediately before the date of initial application instead of performing an impairment review.
  - Apply a single discount rate to a portfolio of leases with reasonably similar characteristics.
  - Elect not to apply the transition requirements to leases for which the lease term ends within 12 months of date of initial application.
  - Exclude initial direct costs from the measurement of the right-of-use asset at the date of initial application. [IFRS 16.C10]

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13.3 Transition for lessees

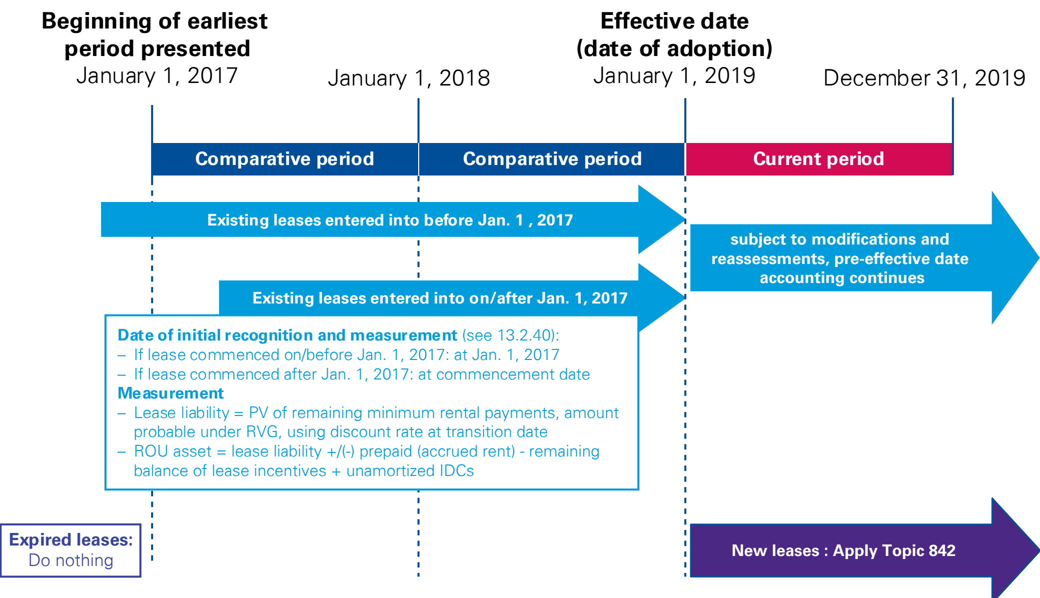
13.3.1 Lessee elects package of practical expedients

13.3.10 The following are the transition requirements applicable to a lessee that elects both of the transition practical expedients (i.e. the package and use of the hindsight). Because lease classification is not reassessed in applying the package of practical expedients:

- all existing leases classified as operating leases under current US GAAP will be classified as operating leases under Topic 842; and
- all existing leases classified as capital leases under current US GAAP will be classified as finance leases under Topic 842. [842-10-65-1(f)(2)]

Operating leases under current US GAAP

13.3.20 The following diagram gives an overview of the transition requirements for an operating lease, which are explained in this section, assuming a public business entity with a calendar year-end.



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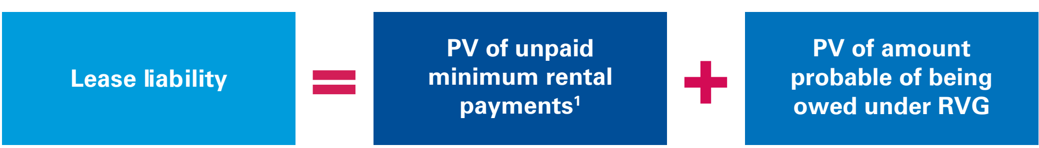
Lease liability – initial and subsequent measurement

13.3.30 Absent lease modifications or remeasurements, the lease liability is measured as follows, both at the transition date (see 13.2.30) and subsequently – i.e. for the remainder of the lease term. [842-10-65-1(l)]



Note 1:

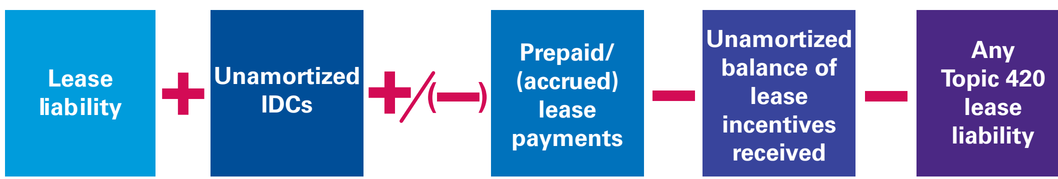
Minimum rental payments (as defined in current US GAAP).

13.3.40 The discount rate for the lease is measured as follows at the transition date.

- For public business entities, it is the rate implicit in the lease; if the implicit rate is not readily determinable, it is the lessee's incremental borrowing rate.
- For all other entities, a risk-free discount rate may be used if the lessee elects to do so for all of its leases. [842-10-65-1(l)]

Right-of-use asset – initial measurement

13.3.50 The right-of-use asset is measured as follows at the transition date (see 13.2.30). [842-10-65-1(m) – 65-1(n)]



13.3.60 Under current US GAAP, lessees are sometimes required to recognize a liability under Topic 420 (exit or disposal cost obligations) for (1) costs to terminate an operating lease before the end of its term, and/or (2) other costs associated with the operating lease that will continue to be incurred without economic benefit to the entity.

13.3.70 At the transition date, any existing Topic 420 liability reduces the initial measurement of the right-of-use asset recognized for the lease – regardless of whether the lease is classified as an operating lease or as a finance lease under Topic 842. If the lease is an operating lease, the accounting after the transition date is different from other operating leases. The right-of-use asset is amortized generally on a straight-line basis. The combined straight-line amortization of the right-of-use asset and the accretion of the lease liability on an effective interest basis each period is recognized as the single operating lease cost for the lease. [842-10-65-1(m), 65-1(o)]

Right-of-use asset – subsequent measurement

13.3.80 After initial recognition, the right-of-use asset is measured using the same lessee subsequent measurement guidance applicable to new operating leases entered into on or after the effective date (see section 6.4.2). [842-10-65-1(n)]

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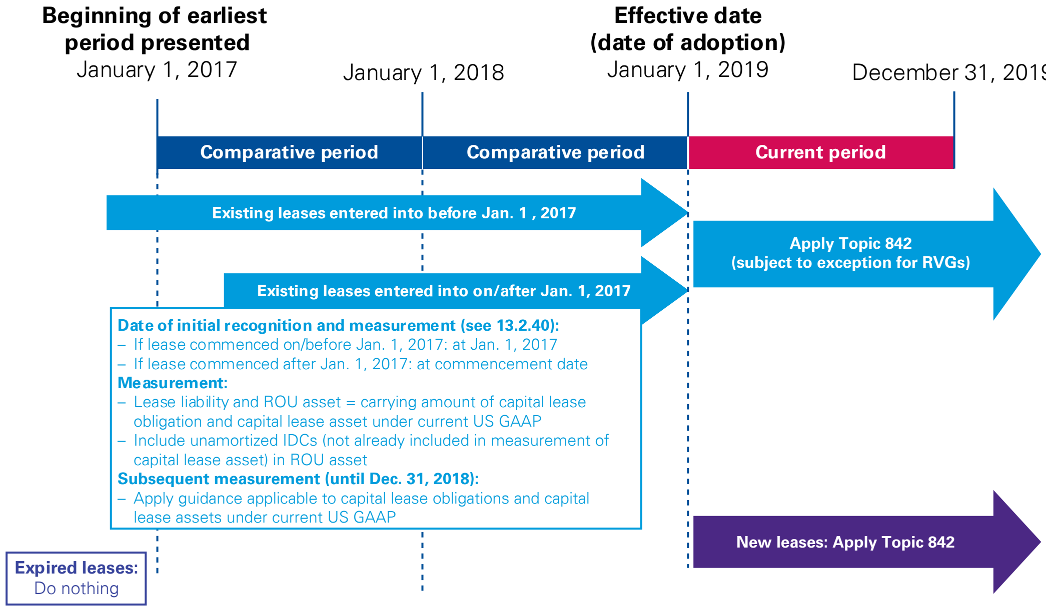
Capital leases under current US GAAP

13.3.90 The following diagram gives an overview of the transition requirements for a capital lease, which is explained in this section, assuming a public business entity with a calendar year-end.



Initial recognition and measurement

13.3.100 The lease liability and right-of-use asset are initially measured as follows at the transition date (see 13.2.30). [842-10-65-1(r)(1)]

Topic 842 item	Measurement
Lease liability	– Carrying amount of capital lease obligation under current US GAAP immediately before the transition date.
Right-of-use asset	– Carrying amount of the capital lease asset under current US GAAP immediately before the transition date. – Plus any unamortized initial direct costs not included in the capital lease asset under current US GAAP.

Subsequent measurement for periods before the effective date

13.3.110 A lessee subsequently measures the right-of-use asset and the lease liability in accordance with the subsequent measurement guidance in current US GAAP. [842-10-65-1(r)(4)]

Subsequent measurement beginning on the effective date

13.3.120 A lessee measures the right-of-use asset and the lease liability in accordance with the subsequent measurement guidance applicable to new finance leases under Topic 842. As an exception, a lessee does *not* remeasure the lease payments for changes in amounts probable of being owed under residual value guarantees unless the lease liability is remeasured for other reasons (e.g. because of a change in the lease term or in the assessment of a lessee purchase option). [842-10-65-1(r)(5)]

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Presentation and disclosure

13.3.130 A lessee presents the assets and liabilities under capital leases as right-of-use assets and lease liabilities arising from finance leases for presentation and disclosure purposes in all periods presented in the financial statements. [842-10-65-1(r)(6)]

Example 13.1

Lessee transition for an existing capital lease with practical expedients elected

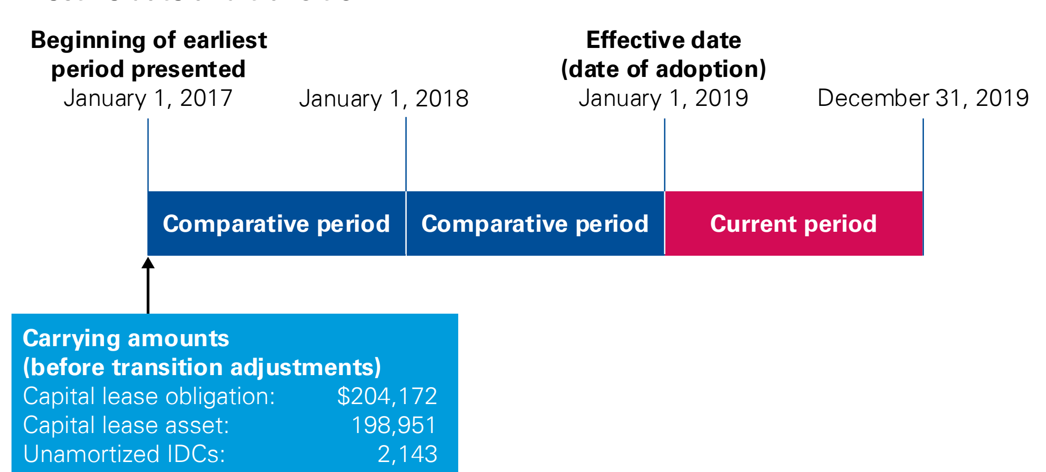
Scenario 1: Lease is not modified or remeasured on or after the effective date

About the lease

13.3.140 The following table summarizes relevant information about Lessee LE's lease of equipment.

Commencement date of the lease:	January 1, 2016
Lease term:	7 years
Lease payments (annual, paid in arrears):	$40,000
Residual value guarantee (lessee):	$6,000
Amount probable of being owed under the residual value guarantee (no change throughout lease term):	$2,000
Lease classification at inception under current US GAAP:	Capital lease
LE's incremental borrowing rate at lease inception:	5.5%
Initial direct costs, amortized on a straight-line basis over the lease term:	$2,500

Effective date and transition



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13.3.150 LE elects the package of practical expedients. Therefore, LE does not reassess whether the contract is or contains a lease, whether classification of the lease would be different under Topic 842, or whether the unamortized initial direct costs at January 1, 2017 would meet the definition of initial direct costs under Topic 842.

Worksheet at January 1, 2017 (beginning of earliest period presented)

Step	Amounts Debit/(credit)	Notes
Recognize lease liability	$(204,172)	Equal to existing capital lease obligation
Recognize right-of-use asset	201,094	Equal to existing capital lease asset ($198,951) + existing unamortized IDCs ($2,143)
Adjustment to equity	$ –	N/A – replacing existing assets and liabilities at the same amounts

Subsequent accounting for the lease

13.3.160 LE will account for the lease liability and right-of-use asset in accordance with the subsequent measurement guidance:

- in current US GAAP through December 31, 2018; and
- in Topic 842 from January 1, 2019 through the end of the lease term; as an exception, because the entire amount of the $6,000 residual value guarantee is already included in the lease liability, LE will not make any adjustments for changes in the amount that it is probable of owing under the residual value guarantee.

13.3.170 LE does not modify the lease or have to remeasure the lease liability (e.g. for a change in the lease term) subsequent to the effective date. The following tables show the effect of the lease accounting on the financial statements.

Balance sheet

13.3.180 LE recognizes the following amounts in its balance sheet through the end of the lease term.

Year ended	ROU asset arising from finance lease	Lease liability arising from finance lease
Dec. 31, 2018[1]	$135,396	$145,048
Dec. 31, 2019	102,547	113,026
Dec. 31, 2020	69,698	79,242
Dec. 31, 2021	36,849	43,601
Dec. 31, 2022	4,000	6,000

Note:

December 31, 2017 balance sheet is not shown because it is expected that LE will present only one comparative balance sheet (i.e. as of December 31, 2018) in its first set of financial statements issued after the effective date of Topic 842.

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13.3.190 At the end of the lease term, LE makes a payment under the residual value guarantee and credits cash for $2,000, debits the lease liability balance of $6,000, and credits the right-of-use asset of $4,000.

Income statement[1]

13.3.200 LE recognizes the following amounts in its income statement through the end of the lease term.

Year ended	Interest expense	Amortization of ROU asset
Dec. 31, 2017	$11,229	$32,849
Dec. 31, 2018	9,647	32,849
Dec. 31, 2019	7,978	32,849
Dec. 31, 2020	6,216	32,849
Dec. 31, 2021	4,359	32,849
Dec. 31, 2022	2,399	32,849

Note 1:

The interest expense on the lease liability and amortization of the right-of-use asset are not required to be presented as separate line items; rather each is presented in a manner consistent with how the entity presents other interest expense and depreciation or amortization of similar assets (see section 6.8).

Scenario 2: Lease liability is remeasured after the effective date

13.3.210 Changing the facts of Scenario 1, on January 1, 2020, LE remeasures the lease liability. The lease included a renewal option and LE now determines that it is reasonably certain to exercise the option based on the occurrence of a significant event that is within its control (see section 6.6.1).

13.3.220 As a result, LE applies the lease accounting guidance under Topic 842 beginning on the remeasurement date (January 1, 2020). The following table summarizes relevant information for the remeasurement of the lease liability.

Renewal period:	3 years
Remaining lease term:	6 years
Lease payments for the renewal period (annual, paid in arrears):	$43,000
Lease payments for the remainder of the original lease term (annual, paid in arrears):	$40,000
Amount probable of being owed under the residual value guarantee at the end of the revised lease term:	$1,500
LE’s incremental borrowing rate at January 1, 2020:	6.0%

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Lease liability remeasurement

13.3.230 In this example, LE identifies one difference between current US GAAP and Topic 842 that affects the measurement of the lease liability and the right-of-use asset: under Topic 840, *minimum lease payments* include the full amount of a lessee residual value guarantee (and therefore the capital lease obligation and the capital lease asset reflect the full amount of such guarantee) while the definition of *lease payments* under Topic 842 includes only amounts probable of being owed by the lessee to satisfy the guarantee.

13.3.240 LE remeasures the lease liability based on:

- three remaining payments of $40,000 (the remainder of the original lease term);
- three additional payments of $43,000 to reflect the renewal period; and
- a final payment of $1,500 to satisfy the residual value guarantee.

13.3.250 LE discounts the stream of lease payments at its incremental borrowing rate of 6.0% at January 1, 2020. This results in a remeasured lease liability of $204,483, or an increase of $91,457 compared to the lease liability balance immediately prior to the remeasurement date.

Journal entry

13.3.260 LE records the following journal entry at January 1, 2020.

	Debit	Credit
Right-of-use asset	91,457	
Lease liability		91,457
To remeasure the ROU asset and lease liability following reassessment of lease term		

Lease classification

13.3.270 LE also reassesses lease classification and determines that the lease is still a finance lease.

Subsequent accounting for the lease

13.3.280 LE prospectively accounts for the lease liability and the right-of-use asset using the guidance in Topic 842 for a finance lease (see section 6.4.1).

- The lease liability carrying amount is increased each period of the remaining lease term to reflect interest on the lease liability, and reduced to reflect the lease payments made during the period.
- The right-of-use asset is measured at cost less any accumulated amortization (and any accumulated impairment losses).

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Balance sheet

13.3.290 LE recognizes the following amounts in its balance sheet for its lease of equipment through the end of the revised lease term.

Year ended	ROU asset arising from finance lease	Lease liability arising from finance lease
Dec. 31, 2020	$161,670	$176,752
Dec. 31, 2021	129,336	147,357
Dec. 31, 2022	97,002	116,198
Dec. 31, 2023	64,668	80,170
Dec. 31, 2024	32,334	41,980
Dec. 31, 2025	–	1,500

13.3.300 At the end of the lease term, LE makes a payment under the residual value guarantee, debits the lease liability balance of $1,500, and credits cash for $1,500.

Income statement[1]

13.3.310 LE recognizes the following amounts in its income statement for its lease of equipment through the end of the revised lease term.

Year ended	Interest expense	Amortization of ROU asset
Dec. 31, 2020	$12,269	$32,334
Dec. 31, 2021	10,605	32,334
Dec. 31, 2022	8,841	32,334
Dec. 31, 2023	6,972	32,334
Dec. 31, 2024	4,810	32,334
Dec. 31, 2025	2,520	32,334

Note: 1

The interest expense on the lease liability and amortization of the right-of-use asset are not required to be presented as separate line items; rather each is presented in a manner consistent with how the entity presents other interest expense and depreciation or amortization of similar assets (see section 6.8).

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Example 13.2

Lessee transition for an existing operating lease with practical expedients elected

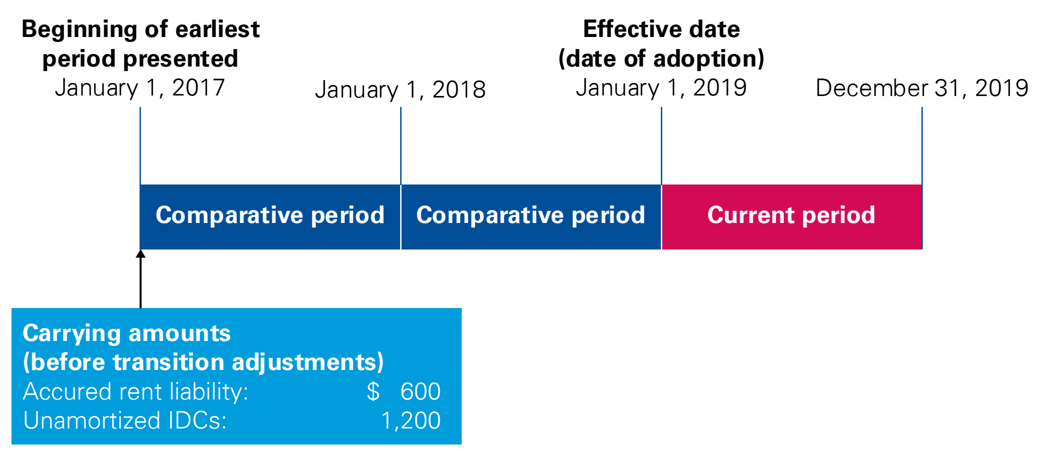
Scenario 1: Lease is not modified or remeasured on or after the effective date

About the lease

13.3.320 The following table summarizes relevant information about Lessee LE's lease of office space.

Commencement date of the lease:	January 1, 2016
Lease term:	5 years
Rental payments (annual, paid in arrears):	$28,000 first two years, $29,000 thereafter
Estimated amount of annual payment related to reimbursing the lessor's costs of property taxes and insurance:	$3,000
Minimum rental payments under current US GAAP:	$25,000 first two years, $26,000 thereafter
Lease classification at inception under current US GAAP:	Operating lease
Initial direct costs, amortized on a straight-line basis over the lease term:	$1,500

Effective date and transition



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13.3.330 Because LE elected the package of practical expedients, it does not reassess whether the contract is or contains a lease, whether classification of the lease would be different under Topic 842, or whether the unamortized initial direct costs at January 1, 2017 would meet the definition of initial direct costs under Topic 842.

Worksheet at January 1, 2017 (beginning of earliest period presented)

13.3.340 At January 1, 2017, LE's incremental borrowing rate is 5.0%.

Step	Amounts Debit/(credit)	Notes
Recognize lease liability	$(91,242)	Remaining minimum rental payments ($25,000 for Year 2 and $26,000 for each of Years 3–5) discounted at 5.0%
Recognize right-of-use asset	91,842	Sum of lease liability recognized, ($600) accrued rent liability, and $1,200 of unamortized IDCs
Derecognize accrued rent	600	Balance at transition under current US GAAP
Derecognize unamortized IDCs	(1,200)	Balance at transition under current US GAAP
Adjustment to equity	$ –	N/A

Subsequent accounting for the lease

13.3.350 LE subsequently measures the lease liability and right-of-use asset through the end of the lease term in a manner similar to how it determined the lease liability and right-of-use asset at January 1, 2017; unless the lease is modified or there is a remeasurement of the lease liability.

13.3.360 LE does not modify the lease and does not have to remeasure the lease liability on or after the effective date. There is also no impairment of the right-of-use through the remainder of the lease term.

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Balance sheet

13.3.370 LE recognizes the following amounts in its balance sheet for its lease of office space through the end of the lease term.

Year ended	ROU asset arising from operating lease	Lease liability arising from operating lease
Dec. 31, 2018[1]	$48,144	$48,344
Dec. 31, 2019	24,661	24,761
Dec. 31, 2020	–	–

Note 1:

December 31, 2017 balance sheet is not shown because it is expected that LE will present only one comparative balance sheet (i.e. as of December 31, 2018) in its first set of financial statements issued after the effective date of Topic 842.

Income statement[1]

13.3.380 LE recognizes the following amounts in its income statement for its lease of office space through the end of the lease term.

Year ended	Operating lease cost
Dec. 31, 2017	$25,900
Dec. 31, 2018	25,900
Dec. 31, 2019	25,900
Dec. 31, 2020	25,900

Note 1:

A lessee continues to present lease cost in a manner consistent with its presentation under current GAAP (e.g. SG&A expenses).

Scenario 2: Lease is modified after the effective date

13.3.390 Changing the facts of Scenario 1, on January 1, 2020 LE modifies the lease to extend the lease term for two additional years. The original lease agreement did not include any renewal options.

13.3.400 As a result, LE applies the lease accounting guidance under Topic 842 beginning on the effective date of the modification (January 1, 2020). Because the modification increases the lease term only, it does not grant LE an additional right of use, and therefore the modification cannot be accounted for as a separate contract. Accordingly, LE adjusts the original lease liability and records an equal and offsetting change to the existing right-of-use asset. The following table summarizes relevant information for the remeasurement of the lease liability.

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Extension period:	2 years
Remaining lease term, including the extension:	3 years
Lease payments during extension period of 2 years (annual, paid in arrears):	$30,000
Lease payments for the remaining 1 year of the original lease term (paid in arrears):	$29,000
Estimated amount of the remaining annual payments related to reimbursing the lessor's costs of property taxes and insurance:	$3,000
Additional initial direct costs associated with the lease modification:	None

13.3.410 At the effective date of the modification, $300 of the initial direct costs remain unamortized, and they meet the definition of initial direct costs under Topic 842.

Lease liability remeasurement

13.3.420 In this example, LE identifies only one difference between current US GAAP and Topic 842 that affects the remeasurement of the lease liability and the right-of-use asset: under Topic 840, minimum lease payments *exclude* payments related to reimbursing the lessor's costs of property taxes and insurance while the definition of lease payments under Topic 842 *includes* such amounts (see section 4.6).

13.3.430 Another difference would have existed if all or a portion of the $300 in unamortized initial direct costs at the effective date of the modification did not meet the definition of initial direct costs under Topic 842. If that were the case, those unamortized costs would be written off as an adjustment to equity.

13.3.440 LE remeasures the lease liability based on:

- one remaining lease payment of $29,000 (for the remainder of the original lease term), which includes the amounts estimated to relate to the lessor's property taxes and insurance; and
- two additional lease payments of $30,000 for the extension period.

13.3.450 LE discounts the stream of lease payments at its January 1, 2020 incremental borrowing rate of 5.5%. This results in a remeasured lease liability of $79,990, or an increase of $55,229 compared to the lease liability balance immediately prior to the effective date of the modification.

Journal entry

13.3.460 LE records the following journal entry at the effective date of the modification.

	Debit	Credit
Right-of-use asset	55,229	
Lease liability		55,229
To remeasure the ROU asset and lease liability following lease modification		

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Lease classification

13.3.470 LE reassesses lease classification and determines that the modified lease is still classified as an operating lease.

Subsequent accounting for the lease

13.3.480 LE calculates the remaining lease cost for the lease as follows.

Total lease payments (including those paid and those not yet paid), reflecting the adjustment resulting from the lease modification 12/31/2016 $28,000; 12/31/2017 $28,000; 12/31/2018 $29,000; 12/31/2019 $29,000; 12/31/2020 $29,000; 12/31/2021 $30,000; 12/31/2022 $30,000	$ 203,000
Plus: Total initial direct costs attributable to the lease	1,500
Less: Periodic lease cost recognized in prior periods calculated as (straight-line rent of $25,600 x 4 periods) plus (amortization of initial direct costs of $1,200) plus (reimbursement of lessor's costs of $3,000 x 4 periods)	(115,600)
Remaining lease cost for the lease	**$ 88,900**

13.3.490 LE recognizes a single lease cost, calculated so that the remaining cost of the lease is allocated over the remaining lease term on a straight-line basis (i.e. $29,633 per year for the remaining three years).

13.3.500 LE prospectively accounts for the lease liability and right-of-use asset from the effective date of the modification using the guidance in Topic 842 for an operating lease.

Balance sheet

13.3.510 LE recognizes the following amounts in its balance sheet for its lease of office space through the end of the lease term.

Year ended	ROU asset arising from operating lease	Lease liability arising from operating lease
Dec. 31, 2020	$54,656	$55,389
Dec. 31, 2021	28,069	28,435
Dec. 31, 2022	–	–

Income statement[1]

13.3.520 LE recognizes the following amounts in its income statement for its lease of office space through the end of the lease term.

Year ended	Operating lease cost
Dec. 31, 2020	$29,633
Dec. 31, 2021	29,633
Dec. 31, 2022	29,634

Note 1:

A lessee continues to present lease cost in a manner consistent with its presentation under current GAAP (e.g. SG&A expenses).

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13.3.2 Lessee does not elect package of practical expedients

Leases previously classified as operating leases under current US GAAP

Leases classified as operating leases under Topic 842

13.3.530 In general, the recognition, initial measurement, and subsequent measurement of the lease liability and right-of-use asset are the same as for a lessee that elects the package of practical expedients for its leases (see 13.3.30–80). As an exception, at the transition date, a lessee writes off as an adjustment to equity any unamortized initial direct costs that do not meet the definition of initial direct costs under Topic 842. This means that the initial and subsequent measurement of the lessee's right-of-use asset will differ for the effect of initial direct costs written off at the transition date. [842-10-65-1(k) – 65-1(n), 65-1(p)]

Leases classified as finance leases under Topic 842

Initial recognition and measurement

13.3.540 The lease liability is recognized and measured the same as for an existing operating lease that remains classified as an operating lease (see 13.3.530). [842-10-65-1(o)]

13.3.550 The right-of-use asset is recognized and measured using the formula in 13.3.50, except that the starting point is a *proportion of the original lease liability* – i.e. the lease liability as of the original commencement date – that is calculated as follows.

Note 1:

Topic 842 states that this amount can be 'imputed' from the remaining lease liability, rather than directly calculated. Example 13.3 demonstrates imputing the original lease liability and this is further discussed in the KPMG observation at 13.3.680–710. [842-10-65-1(o)]

Subsequent measurement

13.3.560 Subsequent to initial recognition and measurement, there is no difference in accounting for the finance lease in transition solely because it was previously classified as an operating lease under current US GAAP. Example 13.3 illustrates the accounting for an existing lease classified as an operating lease under current US GAAP but classified as a finance lease under Topic 842.

Leases previously classified as capital leases under current US GAAP

Leases classified as finance leases under Topic 842

13.3.570 In general, the recognition, initial measurement, and subsequent measurement of the lease liability and right-of-use asset are the same as for a lessee that elects the package of practical expedients for its leases. However, as an exception, at the transition date, a lessee writes off as an adjustment to equity any unamortized initial direct costs that do not meet the definition of initial direct costs under Topic 842 *and* that are not included in the measurement of the capital lease asset under current US GAAP. This means that the initial and subsequent measurement of the lessee's right-of-use assets will differ for the effect of initial direct costs written off at the transition date. [842-10-65-1(r), 65-1(t)]

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Leases classified as operating leases under Topic 842

Transition adjustments

13.3.580 At the transition date, a lessee:

- derecognizes the carrying amount of the capital lease asset and capital lease obligation determined under current US GAAP; the difference is accounted for as prepaid or accrued rent; and
- writes off as an adjustment to equity any unamortized initial direct costs that do not meet the definition of initial direct costs under Topic 842. [842-10-65-1(s)]

Initial recognition and measurement

13.3.590 The lessee initially measures the operating lease liability and operating right-of-use asset in the same manner as for a new lease that commences on or after the effective date, using the transition date instead of the commencement date. [842-10-65-1(s)(2) – 65-1(s)(3)]

Subsequent recognition and measurement

13.3.600 Subsequent to the transition date, the lessee accounts for the operating lease in the same manner as it accounts for any other operating lease under Topic 842. [842-10-65-1(s)(4)]

Example 13.3

Lessee transition for operating lease under current US GAAP classified as a finance lease under Topic 842 (i.e. package of practical expedients not elected)

About the lease

13.3.610 The following table summarizes relevant information about Lessee LE's lease of a machine.

Commencement date of the lease:	January 1, 2015
Lease term:	6 years
Minimum rental payments determined under Topic 840 (annual, paid in arrears):	$51,000 first 3 years $55,000 last 3 years
Lease classification at inception under current US GAAP:	Operating lease
Initial direct costs:	None

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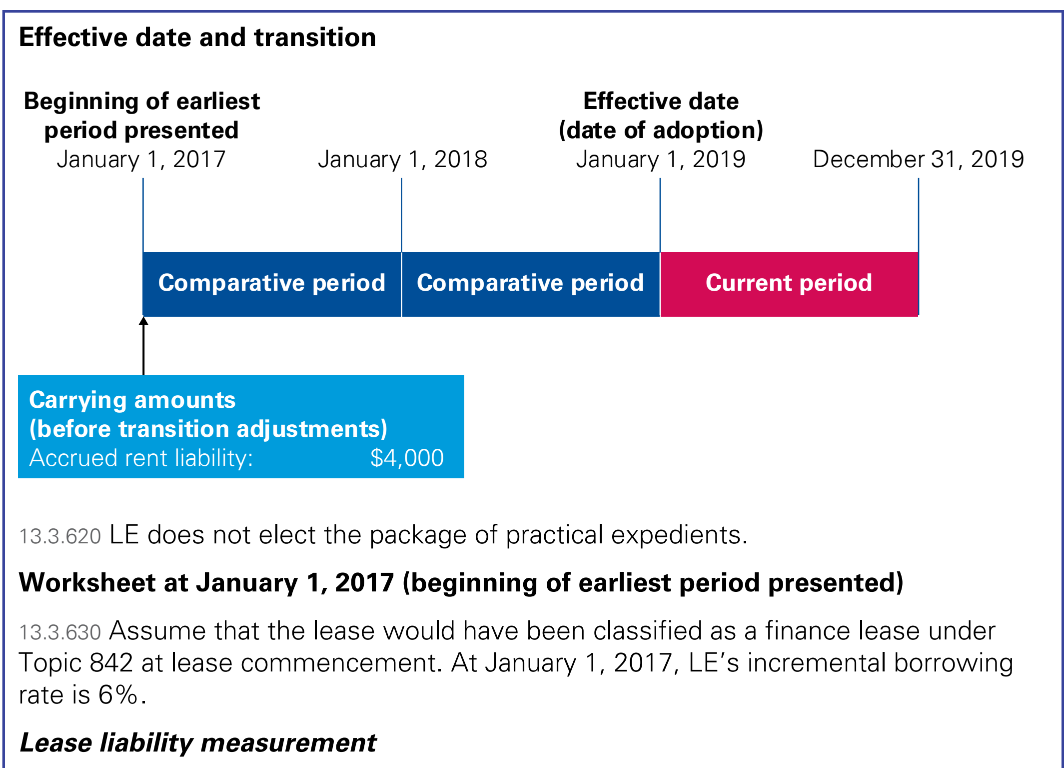
Effective date and transition



13.3.620 LE does not elect the package of practical expedients.

Worksheet at January 1, 2017 (beginning of earliest period presented)

13.3.630 Assume that the lease would have been classified as a finance lease under Topic 842 at lease commencement. At January 1, 2017, LE's incremental borrowing rate is 6%.

Lease liability measurement

13.3.640 On January 1, 2017, LE measures the finance lease liability as $186,807, which is the present value of one payment of $51,000, and three payments of $55,000, discounted at 6%.

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Right-of-use asset measurement

13.3.650 LE determines the carrying amount of the right-of-use asset at January 1, 2017 using the formula described in Topic 842 as follows.

Step 1:	Determine the minimum rental payments over the remaining lease term as of the transition date: \$51,000 + (\$55,000 × 3) = \$216,000
Step 2:	Determine the lease term at lease commencement: 6 years
Step 3:	Determine the remaining lease term as of the transition date: 4 years
Step 4:	Divide the amount determined in Step 1 by the amount determined in Step 3: \$216,000 ÷ 4 years = \$54,000 per year
Step 5:	Determine the present value of the periodic payment calculated in Step 4 over the lease term identified in Step 2 using the lessee's incremental borrowing rate at the transition date: \$54,000 per year in arrears for 6 years discounted at 6% = \$265,536
Step 6:	Multiply the amount in Step 5 by the ratio of the remaining lease term calculated in Step 3 divided by the lease term identified in Step 2: \$265,536 × (4 ÷ 6) = \$177,024
Step 7:	Add to the amount calculated in Step 6 the amount of any previously recognized prepaid rental payments (and subtract from that amount any accrued rental payments): \$177,024 - \$4,000 = \$173,024

Journal entry

13.3.660 The difference between the right-of-use asset and the lease liability on January 1, 2017 is an adjustment to opening retained earnings at that date. Lessee recognizes the following entry to reflect the transition of the operating lease to a finance lease.

	Debit	Credit
Right-of-use asset	173,024	
Accrued rent	4,000	
Retained earnings	9,783	
Lease liability		186,807
To recognize finance lease on transition		

Subsequent accounting for the lease

13.3.670 Subsequent to January 1, 2017, the lessee's accounting is no different from that illustrated in Example 13.1, Scenario 1.

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KPMG observation – Imputing the commencement date lease liability for a lease classified as an operating lease under current US GAAP and a finance lease under Topic 842

13.3.680 In specifying measurement of the right-of-use asset as a proportion of the *original* lease liability ("the lease liability at the commencement date"), Topic 842 states that the original lease liability "can be imputed from the lease liability" determined at the transition date. There is no additional guidance or an example of how to impute the original lease liability from the transition date lease liability. [842-10-65-1(o)]

13.3.690 This specific guidance is unchanged from the 2013 Exposure Draft, which included an illustrative example of how to impute the original lease liability from the transition date lease liability. Example 13.3 above imputes the original lease liability in the same manner as in the exposure draft. However, because the example was not carried forward to Topic 842, there may be other ways an entity could meet the requirements. In addition, in the exposure draft, the lease liability was not calculated based on the remaining minimum rental payments as required by paragraph 842-10-65-1(l).

13.3.700 For example, the guidance would not appear to prohibit the lessee in Example 13.3 from calculating the 'original lease liability' based on the *actual* minimum rental payments ($51,000 for the first three years; $55,000 for the final three years), rather than the derived lease payments of $54,000 illustrated. In that case:

- The original lease liability, using the discount rate determined in Example 13.3 (i.e. there is no mechanism in the transition guidance for using a discount rate for the lease established before the transition date), would be $259,761 (rather than $265,536).
- The lessee would then multiply that amount ($259,761) by the ratio of the remaining lease term calculated in Step 3 divided by the lease term identified in Step 2 ($259,751 × [4 ÷ 6] = $173,174).
- As in the example above, the lessee would reduce this amount ($173,174) by the amount of the accrued rent ($173,174 - $4,000 = $169,174).

13.3.710 Under this approach, at January 1, 2017 LE would record a slightly different journal entry than that recorded in Example 13.3.

	Debit	Credit
Right-of-use asset	169,174	
Accrued rent	4,000	
Retained earnings	13,633	
Lease liability		186,807
To recognize finance lease on transition		

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KPMG observation – No examples where the package of practical expedients is not elected

13.3.720 Topic 842 does not include an example of a lessee not electing the package of practical expedients. We believe that this may have been partially a function of limiting the number of examples overall, but also because the Board may believe that most entities will elect the package of practical expedients (see KPMG observation at 13.2.200–290).

KPMG observation – Changes in lease classification in transition

13.3.730 In general, we believe that it would be relatively infrequent that a lease classified as an operating lease under current US GAAP would be classified as a finance lease under Topic 842 or vice versa. However, the following are a few examples of changes in the lease classification guidance that could result in different outcomes.

- Four of the five classification tests in Topic 842 for determining if a lease is a finance lease are substantially similar to those in current US GAAP for determining if a lease is a capital lease. However, Topic 842 includes a fifth test (the 'alternative use' test – see section 6.2) that has no equivalent in current US GAAP. The introduction of this test *could* result in some leases being classified as finance leases if reassessed under Topic 842.
- Lessees under current US GAAP do not consider *either* the lease term or present value classification tests (see section 6.2) when the lease term falls within the last 25 percent of the total estimated economic life of the underlying asset. Topic 842 only includes a similar exemption for the lease term test (see section 6.2). Consequently, some leases for which the present value test in current US GAAP was not even considered would have to consider the similar present value test in Topic 842 and some of those leases *might* therefore be classified as finance leases.
- While Topic 842 *permits* entities to continue to use 75 and 90 percent as bright-line thresholds when evaluating the lease term compared to the remaining economic life of underlying asset and lease payments (and any lessee residual value guarantee) compared to the fair value of the underlying asset lease classification tests, respectively, it does not *require* use of those thresholds. Consequently, an entity not utilizing those thresholds could reach a different conclusion about the classification of some of its existing leases if it reassesses lease classification under Topic 842 (see section 6.2).

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13.3.740 In the first two examples in 13.3.730, the result of the changes to the lease classification guidance from current US GAAP to Topic 842 is that a previously classified operating lease might be classified as a finance lease. In the third example, in theory, the effect *could* be that a previously classified operating lease is classified as a finance lease *or* vice versa; however, it appears less likely that an entity could reasonably conclude that a lease term *greater than* 75 percent is not a 'major part' of the remaining economic life of the underlying asset or a present value of lease payments *greater than* 90 percent of the fair value of the underlying asset is not 'substantially all' of the fair value of the underlying asset than the opposite. See KPMG observation at 6.2.350–410.

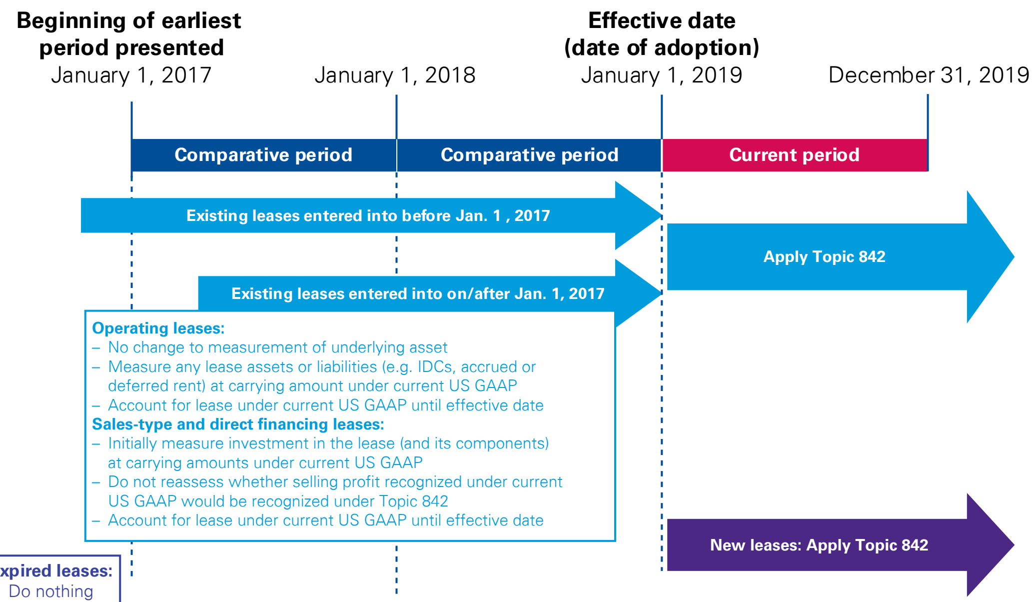
13.3.750 Based on our initial evaluation of the guidance, we believe that, to the extent some changes in lease classification would occur if a lessee were not to elect the package of practical expedients, most of those differences would be in the direction of previously classified operating leases becoming finance leases, rather than vice versa.

13.4 Transition for lessors

13.4.1 Lessor elects package of practical expedients

13.4.10 The following are the transition requirements applicable to a lessor that elects the transition practical expedients. Because lease classification is not reassessed in applying the package of practical expedients:

- all existing leases classified as operating leases under current US GAAP will be classified as operating leases under Topic 842; and
- all existing leases classified as sales-type or direct financing leases under current US GAAP will be classified as sales-type or direct financing leases under Topic 842. [842-10-65-1(f)(2)]



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Leases classified as operating leases under current US GAAP

13.4.20 At the transition date, a lessor:

- continues to recognize the underlying asset and any lease assets or liabilities (e.g. accrued or deferred rent income or initial direct cost assets) at their carrying amounts recognized in accordance with current US GAAP immediately prior to the transition date; and
- accounts for previously recognized securitized receivables as secured borrowings in accordance with other GAAP, if applicable. [842-10-65-1(v)]

13.4.30 After the transition date, the lessor accounts for the operating lease in accordance with Topic 840 for periods prior to the effective date; and starting on the effective date, in accordance with the operating lease guidance in Topic 842.

Leases previously classified as sales-type or direct financing leases under current US GAAP

13.4.40 A lessor:

- continues to recognize, at the transition date, a net investment in the lease at the carrying amount of the net investment at that date; this includes any unamortized initial direct costs capitalized as part of the net investment in the lease in accordance with current US GAAP; and
- after the transition date, accounts for the net investment in the lease under current US GAAP for periods prior to the effective date; and starting on the effective date, under the recognition, subsequent measurement, presentation, and disclosure guidance under Topic 842. [842-10-65-1(x)(1) – 65-1(x)(3)]

13.4.50 If the lease is modified (and that modification is not accounted for as a separate contract) on or after the effective date, a lessor applies Topic 842 beginning at the modification date and accounts for the modification under the lessor modifications guidance in Topic 842. A lessor does not remeasure the net investment in the lease after the effective date unless the lease is modified (and that modification is not accounted for as a separate contract). [842-10-65-1(x)(4)]

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13.4.2 Lessor does not elect package of practical expedients

Leases previously classified as operating leases under current US GAAP

Leases classified as operating leases under Topic 842

13.4.60 The accounting at, and subsequent to the transition date, is the same as that for a lessor that elects the package of practical expedients for its leases. As an exception, at the transition date, a lessor writes off as an adjustment to equity any unamortized initial direct costs that do not meet the definition of initial direct costs under Topic 842. [842-10-65-1(v)]

Leases classified as direct financing or sales-type leases under Topic 842

13.4.70 The objective is to account for the lease, beginning on the transition date, as if it had always been accounted for as a direct financing lease or a sales-type lease in accordance with Topic 842. Therefore, at the transition date a lessor:

- derecognizes the carrying amount of the underlying asset;
- recognizes a net investment in the lease as if the lease had been accounted for as a direct financing lease or a sales-type lease under Topic 842 since lease commencement; and
- records the difference between the carrying amount of the underlying asset derecognized and the net investment in the lease recognized as an adjustment to equity. [842-10-65-1(w)]

13.4.80 After the transition date, the lessor accounts for the lease in accordance with Topic 842. [842-10-65-1(w)(4)]

Leases previously classified as direct financing or sales-type leases under current US GAAP

Leases classified as direct financing or sales-type leases under Topic 842

13.4.90 The accounting at, and subsequent to the transition date, is the same as that for a lessor that elects the package of practical expedients for its leases (see section 13.4.1). [842-10-65-1(x)]

13.4.100 Initial direct costs included in the measurement of the net investment in the lease are *not* written off even if they do not meet the definition of initial direct costs under Topic 842. [842-10-65-1(x)(1)]

Leases classified as operating leases under Topic 842

13.4.110 The objective is to account for the lease, beginning at the transition date, as if it had always been accounted for as an operating lease in accordance with Topic 842. Therefore, at the transition date, a lessor:

- derecognizes the carrying amount of the net investment in the lease;
- recognizes the underlying asset at what the carrying amount would have been had the lease been classified as an operating lease under current US GAAP; and
- records any difference between the carrying amount of the underlying asset recognized and the net investment in the lease derecognized as an adjustment to equity. [842-10-65-1(y)(4)]

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13.4.120 A lessor subsequently accounts for the operating lease in accordance with Topic 842 and the underlying asset in accordance with other GAAP. [842-10-65-1(y)(4)]

Example 13.4

Lessor transition for operating lease under current US GAAP classified as sales-type lease under Topic 842 (i.e. package of practical expedients not elected)

About the lease

13.4.130 The following table summarizes relevant information about Lessor LR's lease of equipment.

Commencement date of the lease:	January 1, 2016
Lease term:	5 years
Renewal, termination, or purchase options:	None
Lease payments (annual, paid in arrears):	$17,000
Estimated residual value of the equipment at the end of the lease term:	$18,000
Residual value guarantee (provided by either lessee or third-party):	None
Fair value at January 1, 2016:	$77,000
Carrying amount at January 1, 2016:	$77,000
Remaining (and original) economic life of the equipment:	7 years
Useful life of the equipment:	7 years
Initial direct costs incurred by lessor under current US GAAP (only $800 would meet the definition of initial direct costs under Topic 842):	$2,000
Rate implicit in the lease under current US GAAP, which does not factor in initial direct costs:	9.368%
Rate implicit in the lease under Topic 842 (i.e. the rate that causes the sum of the present value of the lease payments and the present value of the expected residual value to equal the sum of the fair value of the underlying asset and capitalizable initial direct costs):	9.010%
Lease classification at inception under current US GAAP:	Operating lease

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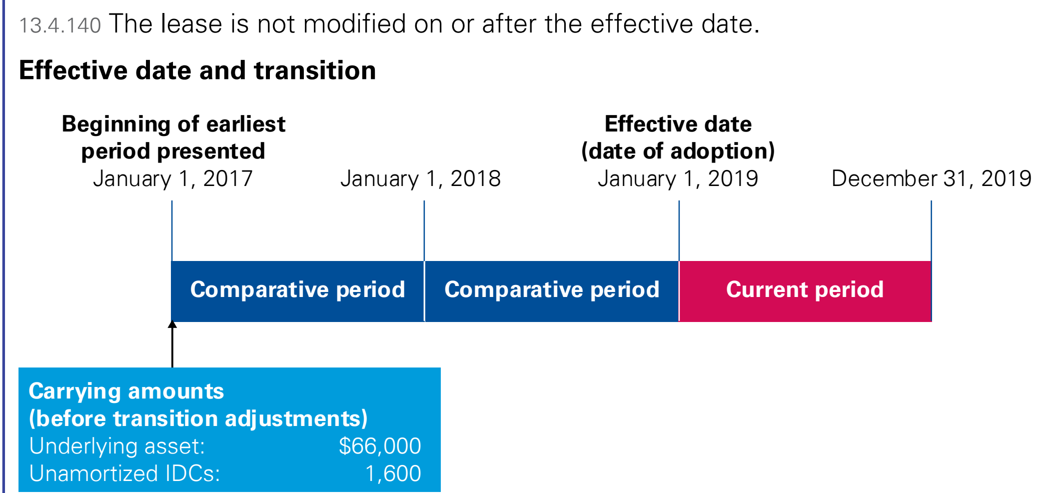
13.4.140 The lease is not modified on or after the effective date.

Effective date and transition



13.4.150 LR does not elect the package of practical expedients. Therefore it reassesses whether the arrangement is or contains a lease, whether classification of the lease would be different under Topic 842, and whether the unamortized initial direct costs of $1,600 at January 1, 2017 would have qualified for capitalization under Topic 842.

13.4.160 LR determines that the arrangement is still a lease. However, assume that the lease is classified as a sales-type lease under Topic 842 (see KPMG observation at 13.4.200–220). Only $800 of the $2,000 in initial direct costs under current US GAAP meet the definition of initial direct costs under Topic 842, but that $800 would also have been capitalized because the fair value of the underlying asset equaled its carrying amount at lease commencement.

Worksheet at January 1, 2017 (beginning of earliest period presented)

13.4.170 The objective of the transition guidance in this case is to account for the lease, beginning on January 1, 2017 (i.e. the transition date), as if it had always been a sales-type lease accounted for in accordance with Topic 842.

Step	Amounts Debit/(credit)	Notes
Derecognize the carrying amount of the underlying asset	$(66,000)	$77,000 original carrying amount - 1 year of depreciation ($77,000 ÷ 7-year useful life = $11,000)
Derecognize entire unamortized portion of originally capitalized IDCs	(1,600)	$2,000 original amount of IDCs capitalized - 1 year of IDCs amortization ($2,000 ÷ 5 year lease term = $400) *The portion capitalizable under Topic 842 will be included in the net investment in the sales-type lease*
Recognize a net investment in the lease as if the lease had been accounted for as a sales-type lease under Topic 842 since lease commencement	67,810	Commencement date net investment in the lease of $77,800 ($77,000 fair value of the underlying asset + $800 in capitalizable IDCs) - Year 1 lease payment of $17,000 + Year 1 interest on the net investment in the lease of $7,010 ($77,800 × 9.010%)
Adjustment to equity	**$ (210)**	

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13.4.180 Accordingly, LR records the following journal entry.

	Debit	Credit
Net investment in equipment lease	67,810	
Equipment		66,000
Unamortized initial direct costs		1,600
Retained earnings		210
To recognize sales-type lease on transition		

13.4.190 After January 1, 2017, LR accounts for the lease in accordance with Topic 842.

KPMG observation – Changes in lease classification on transition

13.4.200 Consistent with the KPMG observation at 13.3.730–750, we believe that it would be relatively infrequent that a lease classified as an operating lease under current US GAAP would have been classified as a sales-type or direct financing lease under Topic 842 or vice versa. The same examples outlined in 13.3.730 could result in a different classification of an existing lease for lessors if reassessed under the classification criteria in Topic 842, most likely from classification as an operating lease under current US GAAP to classification as a sales-type lease (or less frequently, to a direct financing lease).

13.4.210 In addition to the examples in 13.3.730, a lease classified as an operating lease under current US GAAP solely because either (1) collectibility of the minimum lease payments was not reasonably predictable, or (2) there were uncertainties surrounding the amount of unreimbursable costs yet to be incurred by the lessor under the lease would be classified as a sales-type lease under Topic 842. Topic 842 does not preclude sales-type lease classification when there are collectibility uncertainties or when there are significant uncertainties surrounding unreimburseable costs.

13.4.220 Consistent with our earlier lessee observations, it appears to us that, where lease classification might change for lessors if reassessed under Topic 842, it is most likely to involve operating leases being reassessed as sales-type or direct financing leases rather than the opposite.

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KPMG observation – Initial direct costs included in the net investment in a sales-type or direct financing lease

13.4.230 If a lessor does not elect the package of practical expedients, it is required to reassess only whether those unamortized initial direct costs at the transition date capitalized in connection with an *operating* lease under current US GAAP would meet the definition of initial direct costs under Topic 842.

13.4.240 Initial direct costs capitalized in connection with a *direct financing* lease under current US GAAP[1] are included in the lessor's net investment in the lease. Unamortized amounts are not reassessed even if the lessor does not elect the package of practical expedients. Those amounts are not reassessed because the Board decided that sales-type/direct financing lessors should carry forward the same net investment in the lease it had under current US GAAP to Topic 842 at the transition date. Reassessing unamortized initial direct costs for those leases would have rendered that impossible in most cases given the substantially different definitions of initial direct costs between current US GAAP and Topic 842. [842-10-65-1(x)(1)]

Note 1:

Initial direct costs are not capitalized in connection with a sales-type lease under current US GAAP.

13.5 Applying the guidance on components of a contract on transition

13.5.10 Neither the transition guidance in Topic 842, nor the basis for conclusions, explicitly discuss the effect of the new guidance on identifying, separating, and allocating the 'consideration in the contract' to components of a contract (see chapter 4) on transition. Therefore, it is unclear whether the Board expressly considered the effect of this guidance, which is significantly changed in some respects from the comparable guidance in current US GAAP, on entities' transition efforts.

13.5.20 However, we believe that the requirements with respect to the new components guidance in transition can be derived from other requirements in the transition guidance. The following table describes what we believe the effect (or non-effect) of this guidance is on the various transition scenarios presented.

13.5.30 Each of these scenarios assumes that the lease is *not* modified or remeasured (lessees only) on or after the effective date. If a lease is modified (and that modification is not accounted for as a separate contract) or remeasured on or after the effective date, all of the requirements of Topic 842 become applicable to that lease, including the guidance on accounting for components of a contract.

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Lessee

Operating ➔ Operating

13.5.40 Lessees will not re-evaluate their previous allocations to lease and non-lease elements of a lease. This is because, absent a post-effective date modification or remeasurement, the transition guidance requires lessees to use the minimum rental payments determined in accordance with current US GAAP to account for the lease. Revising previous decisions with respect to identification, separation, and allocation of contract consideration would change the amounts used to account for the lease, directly contradicting the explicit requirement to account for the lease based on the minimum rental payments as determined under current US GAAP.

Lessee

Operating ➔ Finance

13.5.50 The transition guidance applicable to this scenario requires the lessee to recognize and measure a new finance lease liability in the same way as for an operating lease that remains classified as an operating lease, and to derive the new finance lease right-of-use asset from the finance lease liability at the commencement date. Measurement of the lease liability is based on the minimum rental payments (as defined in current US GAAP). Revising previous decisions with respect to identification, separation, and allocation of contract consideration would change the amounts used to account for the lease, directly contradicting the explicit requirement to account for the lease based on the minimum rental payments as determined under current US GAAP.

Lessee

Finance ➔ Finance

13.5.60 Lessees will not re-evaluate their previous allocations to lease and non-lease elements of a lease. This is because the transition guidance requires lessees to measure the initial finance lease right-of-use asset and initial finance lease liability at the same amounts recognized immediately before the transition date for the capital lease asset and the capital lease obligation, respectively. In addition, absent a post-effective date modification or remeasurement, lessees will not remeasure those amounts; they will simply complete the accounting for the lease based on those initially-measured amounts. Similar to the operating lease to operating lease scenario in 13.5.40, revisions to decisions made about components of the contract would require the lessee *not* to follow the explicit measurement requirements for this scenario.

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Lessee

Finance ➔ Operating

13.5.70 The transition guidance applicable to this scenario requires the lessee to derecognize its existing capital lease asset and capital lease obligation and, at the transition date, recognize and measure a new operating lease liability in accordance with Topic 842 and derive the new operating lease right-of-use asset from that lease liability. Measurement of the lease liability in accordance with Topic 842 is based on the lease payments. Because the lease payments are a function of the separation and allocation guidance in Topic 842 if there are either (1) multiple separate lease components or (2) lease and non-lease components of the contract, lessees will need to apply the multiple-component separation and allocation guidance to comply with the transition measurement requirements.

Lessor

Operating ➔ Operating

13.5.80 The transition guidance requires lessors in this scenario to continue to recognize the underlying asset, as well as any other lease assets and liabilities (e.g. accrued rent assets or deferred rent liabilities), at the same amounts as immediately prior to the transition date under current US GAAP. If a contract that contains an operating lease includes multiple lease components and/or lease and non-lease components, revising the units of account and revising the allocation of the consideration in the contract (which might be different from the total contract consideration under current US GAAP if there are variable payments that specifically relate to non-lease components of the contract) would likely result in adjustments to any recognized lease assets or liabilities – i.e. a change would have resulted in a change to the lease payments, and therefore the accrued/deferred rent amount would typically be measured differently from that which resulted under current US GAAP.

Lessor

Sales-type/direct financing ➔ Sales-type/direct financing

13.5.90 Lessors will not re-evaluate their previous allocations to lease and non-lease elements of a contract. This is because the transition guidance requires lessors to measure their initial lease assets under Topic 842 at the same amount recognized immediately before the transition date under current US GAAP. In addition, absent a post-effective date modification, lessors in this scenario will not remeasure their lease assets; they will simply complete the accounting for the lease based on the initially measured amount for the net investment in the lease.

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$ Lessor

Operating → Sales-type/direct financing; or Sales-type/direct financing → Operating

13.5.100 The transition guidance states for either of these scenarios that "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 [a sales-type or direct financing] lease in accordance with this Topic." It therefore seems clear that this would include reassessing the lessor's accounting with respect to the components of the contract.

13.5.110 Taken as a whole, we believe that entities will only reassess their identification and accounting for components of a contract when the lease classification changes as a result of applying Topic 842 to the lease. If lease classification does not change or the entity elects the package of practical expedients, which means the entity will not reassess classification of its leases under Topic 842, entities will not reassess their identification of or accounting for multiple components of a contract. Avoiding the effort to reassess the accounting for components of a contract and avoiding the operational complexities that could arise from that exercise is another reason many entities will likely consider electing the package of practical expedients.

13.5.120 *However*, consistent with the discussion in the KPMG observation at 13.2.160 about identifying leases, the ability to not reassess identification of or accounting for multiple components of a contract presumes the entity applied the guidance in current US GAAP completely and accurately. For example, if an entity did not appropriately identify lease and non-lease components, or did not appropriately separate 'minimum rental payments' or 'minimum lease payments' from payments for non-lease components (e.g. services), the transition guidance does not excuse those errors.

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13.6 Leveraged leases under current US GAAP

13.6.10 For leases classified as leveraged leases under Topic 840 and for which the commencement date is before the effective date, a lessor continues its existing leveraged lease accounting. However, if a leveraged lease is modified on or after the effective date, it is accounted for as a new lease at the modification date in accordance with Topic 842. [842-10-65-1(z)]

13.6.20 If a lessee exercises an option to extend a leveraged lease that commenced before the effective date of Topic 842 that it was not previously reasonably assured of exercising, the exercise of that option is considered a lease modification. [842-50-15-1]

13.6.30 For further discussion of leveraged leases, including KPMG's observation and a comparison to IFRS, see section 7.5.

13.7 Sale-leaseback transactions

13.7.10 If a sale-leaseback transaction was previously accounted for as a sale and a leaseback under current US GAAP, an entity does not reassess whether the transaction would have qualified as a sale (or purchase) under Topic 842. This means that buyer-lessors will not revisit whether a purchase of the underlying asset occurred for any sale-leaseback transactions entered into before the effective date. [842-10-65-1(aa)]

13.7.20 If a previous sale-leaseback transaction was, and continues to be at the effective date, accounted for as a failed sale under current US GAAP, the entity reassesses whether a sale would have occurred at any point on or after the beginning of the earliest period presented in the financial statements in accordance with Topic 842. If so, the sale-leaseback transaction is accounted for on a modified retrospective basis – i.e. in accordance with the transition guidance applicable to sale and operating leasebacks – from the date a sale is determined to have occurred. [842-10-65-1(bb)]

13.7.30 An entity accounts for the leaseback in accordance with the lessee and lessor transition requirements outlined in sections 13.2–13.5. [842-10-65-1(cc)]

13.7.40 If a transaction was previously accounted for as a sale and capital (finance) leaseback under current US GAAP, a seller-lessee continues to amortize any deferred gain or loss existing at the later of the beginning of the earliest period presented or the date of sale of the underlying asset as follows.

- If the asset is land only, over the remaining lease term on a straight-line basis.
- If the asset is not land only:
  - in proportion to the amortization of the right-of-use asset if the leaseback is a finance lease; and
  - in proportion to total lease cost recognized in profit or loss if the leaseback is an operating lease. [842-10-65-1(dd)]

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13.7.50 If a transaction was previously accounted for as a sale and operating leaseback under current US GAAP, a seller-lessee:

- recognizes the portion of any deferred gain or loss not resulting from off-market terms as a cumulative-effect adjustment to equity at the later of the beginning of the earliest period presented (to equity) or the date of sale (to earnings of the comparative period presented).
- recognizes the portion of any deferred gain or loss that resulted from off-market terms as an adjustment to the leaseback right-of-use asset (if the sale price was below market) or as a remaining financial liability (if the sale price was above market) at the transition date. [842-10-65-1(ee)]

Example 13.5

Sale-leaseback transaction previously accounted for as a sale and an operating leaseback under current US GAAP

About the sale-leaseback transaction

13.7.60 The following table summarizes relevant information about Seller-Lessee SL's equipment sale-leaseback transaction with Buyer-Lessor BL. The transaction qualified as a sale and a leaseback – i.e. there was no failed sale.

Sale-leaseback transaction date:	January 1, 2018
Beginning of earliest period presented:	January 1, 2017
Leaseback term:	5 years
Leaseback payments (annual, paid in arrears):	$15,000
Sale price and fair value of equipment at transaction date:	$115,000
Carrying amount of equipment at transaction date:	$80,000
Remaining economic life of the equipment at transaction date:	9 years
Leaseback classification:	Operating lease
Initial direct costs:	None
Lessee residual value guarantee:	None

13.7.70 There is no automatic reversion of ownership to SL, nor does SL have an option to repurchase the equipment. SL retains more than a minor portion, but less than substantially all, of the remaining use of the equipment. Therefore, because the profit on the sale does not exceed the present value of the minimum lease payments under current US GAAP, the entire gain of $35,000 is deferred and will be recognized over the five-year leaseback term.

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Effective date and transition

13.7.80 SL and BL are calendar year-end public business entities that adopt Topic 842 on January 1, 2019.

13.7.90 SL and BL do not reassess whether the transaction would have qualified for sale/purchase accounting under Topic 842. BL does not adjust its previous accounting for the purchase of the asset in any manner. Upon adoption of Topic 842 SL will record the following journal entry to (1) recognize the full amount of the profit on the sale-leaseback transaction as of the sale date (January 1, 2018), which is later than the beginning of the earliest period presented, and (2) reverse the journal entry recorded under current US GAAP to recognize one-fifth of the deferred gain during calendar 2018 (the first year of the leaseback term):

	Debit	Credit
Deferred profit on sale-leaseback transaction	35,000	
Gain on sale-leaseback transaction		35,000
Amortization of sale-leaseback transaction gain	7,000	
Deferred profit on sale-leaseback transaction		7,000

Subsequent accounting for the leaseback

13.7.100 SL and BL account for the leaseback in the same manner as any other lease that commenced during the transition period.

KPMG observation – Limited adjustments to retained earnings for existing sale-leaseback transactions

13.7.110 Consistent with the transition requirements for lessees and lessors, the sale-leaseback transition requirements generally limit the implementation cost and complexity for preparers. A seller-lessee will recognize an adjustment to equity in transition only for sale and operating leasebacks for which there is a deferred gain or loss not resulting from off-market terms.

US GAAP different from IFRS – Transition for sale-leaseback transactions

13.7.120 Like Topic 842, entities do not assess whether an existing sale and leaseback transaction meets the 'sale' criteria under the new revenue recognition standard (IFRS 15). Also like Topic 842, entities will, in effect, continue pre-adoption accounting for existing sale and finance leasebacks. [IFRS 16.C16–C18]

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13.7.130 However, there are differences in the transition requirements applicable to sale and operating leasebacks and failed sale-leaseback transactions. The differences with respect to the former stem principally from differences between current US GAAP and IFRS; for example, while current US GAAP generally requires deferral of the gain on a sale and operating leaseback transaction, current IFRS generally requires recognition of the gain at the time of sale. With respect to the latter, Topic 842 includes specific transition guidance for failed sale-leaseback transactions, which are common under current US GAAP for real estate sale-leaseback transactions. IFRS 16 does not include similar guidance because current IFRS does not generally result in failed sale-leaseback transactions.

13.8 Build-to-suit lease arrangements

13.8.10 Current US GAAP addresses a lessee's involvement with the construction of an asset that the lessee will lease when construction is complete (i.e. build-to-suit lease accounting). Under that guidance, the transaction is subject to the sale-leaseback guidance if the lessee is deemed to be the accounting owner of the asset during the construction period because it has substantially all of the construction period risks (or meets other specified criteria).

13.8.20 Topic 842 supersedes the current build-to-suit lease accounting guidance and stipulates that a lessee is the accounting owner of an asset under construction when it *controls* that asset before the commencement date (see section 9.4). The new guidance about when a lessee controls an asset under construction that it will lease is similar to the guidance in Topic 606 about when a customer controls an asset under construction (or that is being modified) that it will purchase.

13.8.30 We believe that the new guidance will result in fewer instances where a lessee will be deemed the accounting owner of an asset under construction, but those instances will still occur.

13.8.40 A lessee applies a modified retrospective transition approach for leases accounted for as build-to-suit lease arrangements under current US GAAP that exist at, or are entered into after, the beginning of the earliest period presented. This approach does not require any transition accounting for build-to-suit leases that expired prior to the beginning of the earliest period presented.

- A lessee that recognized assets and liabilities solely as a result of a transaction's build-to-suit designation derecognizes those assets and liabilities at the later of (a) the beginning of the earliest period presented and (b) the date the lessee is determined to be the accounting owner of the asset under the current build-to-suit guidance. Any difference is recorded as an adjustment to equity at that date. A lessee then follows the general lessee transition guidance for the lease itself (see sections 13.2–13.3, and 13.5).
- For build-to-suit leases for which the construction period ended prior to the beginning of the earliest period presented and the transaction qualified for sale and leaseback accounting under existing guidance prior to that date, the entity applies the lessee transition requirements for the lease. [842-10-65-1(u)]

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KPMG observation – No transition provisions provided when lessee is deemed the accounting owner under Topic 842 but not under current US GAAP

13.8.50 Because an entity can still be the accounting owner of an asset under construction under Topic 842, there may be cases where a lessee would have reached the same conclusion that it was the accounting owner of an asset under construction based on the current US GAAP guidance and the new guidance in Topic 842. In addition, because the underlying principle for when a lessee is the accounting owner of an asset under construction is different from that in current US GAAP, there may be instances where a lessee is the accounting owner of an asset under construction under Topic 842 for which would *not* have been deemed the accounting owner under current US GAAP.

13.8.60 It does not appear that the Board considered either of these possibilities when providing transition guidance for build-to-suit leases. The transition guidance appears to contemplate only situations in which the lessee was deemed the accounting owner of the asset under construction under current US GAAP but would not be deemed the accounting owner under Topic 842.

13.8.70 In the absence of specific transition guidance, we believe that an entity may consider the following modified retrospective transition approach.

If the lessee was previously deemed the accounting owner under current US GAAP and would also be considered the accounting owner under Topic 842

- Continue to recognize the assets and liabilities arising as a result of the lessee being deemed the accounting owner of the asset under construction until they qualify for derecognition (i.e. a sale of the asset occurs) in accordance with the sale-leaseback requirements in Topic 842:
  - If that occurs after the effective date of Topic 842, apply the sale-leaseback guidance in Subtopic 842-40.
  - If a sale of the asset would have occurred after the beginning of the earliest period presented in the financial statements, but before the effective date, apply the sale-leaseback transition guidance in Topic 842 applicable to previously failed sales. [842-10-65-1(bb)]
  - If a sale of the asset would have occurred before the beginning of the earliest period presented, follow the build-to-suit transition requirements in Topic 842. Derecognize the assets and liabilities as of the beginning of the earliest period presented in the financial statements and account for the lease in accordance with the lessee transition requirements.
- If, between the beginning of the earliest period presented in the financial statements and the effective date, the entity had completed a sale-leaseback transaction in accordance with current US GAAP (i.e. a sale had been completed under Subtopic 840-40), the entity would not reassess whether a sale also would have occurred under Topic 842 (or whether that sale would have occurred at a different date – earlier or later).

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If the lessee was *not* previously deemed the accounting owner under current US GAAP but would be considered the accounting owner under Topic 842

– We believe that the Board did not contemplate an entity looking back to periods prior to the effective date to determine if it would have been the accounting owner of (i.e. controlled) an asset under construction, or that it would be the Board's intent for entities to do so. This would appear inconsistent with much of the Board's rationale for the transition approach in Topic 842 as a whole, and seemingly at odds with the guidance on sale-leaseback transactions under which an entity does not revisit whether a sale would have occurred prior to the effective date. Consequently, we believe that an entity is not *required* to undertake this evaluation. However, we believe that an entity generally would be required to evaluate, as of the effective date, any arrangement in which it is presently involved in the construction or design of an asset it will subsequently lease to determine whether it controls that asset.

– In contrast, we believe that the transition guidance applicable to build-to-suit leases does not *prohibit* an entity from evaluating whether it was the accounting owner of an asset under construction before the effective date. While we would expect it to be rare that an entity would choose to undertake this evaluation if not required to do so, if an entity chooses to do so, we believe that it would recognize the assets and liabilities arising as a result of the lessee being deemed the accounting owner of the asset under construction at the later of (1) the beginning of the earliest period presented, and (2) the date the lessee is determined to be the accounting owner of the asset under construction in accordance with Topic 842. From the date that the asset is recognized, the entity would account for the transaction in accordance with the sale-leaseback guidance in Topic 842.

13.9 Previous business combinations

13.9.10 If an entity previously recognized an asset (liability) relating to favorable (unfavorable) terms of an operating lease acquired as part of a business combination:

– a **lessee** derecognizes that asset (liability), and adjusts the carrying amount of the right-of-use asset recognized on transition by a corresponding amount.

– a **lessor** derecognizes that asset (liability) only if it arises from a sales-type or direct financing lease, and makes a corresponding adjustment to equity at the beginning of the earliest period presented in the financial statements. [842-10-65-1(h)]

13.9.20 A favorable operating lease asset or unfavorable operating lease liability is not written off in transition by operating lessors. Lessors will continue to recognize such favorable lease assets or unfavorable lease liabilities even after the adoption of the amendments to Topic 805 included in ASU 2016-02; for a discussion about leases acquired in a business combination, see chapter 11. [842-10-65-1(h)(1)]

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KPMG observation – Effect of previously recognized favorable lease asset or unfavorable lease liability on lessee's subsequent accounting

13.9.30 Topic 842 does not prescribe or illustrate the subsequent accounting for a lease of a lessee that, at the transition date, is affected by a previously recognized favorable lease asset or unfavorable lease liability, other than to say that the asset or liability is written-off as an adjustment to the transition date right-of-use asset. However, we believe that:

- a favorable lease asset would affect the accounting for the lease on and after the transition date in the same manner as initial direct costs – i.e. it would increase the lessee's right-of-use asset recognized at the transition date; and
- an unfavorable lease liability would affect the accounting for the lease after the transition date in the same manner as a lease incentive – i.e. it would decrease the lessee's right-of-use asset recognized at the transition date.

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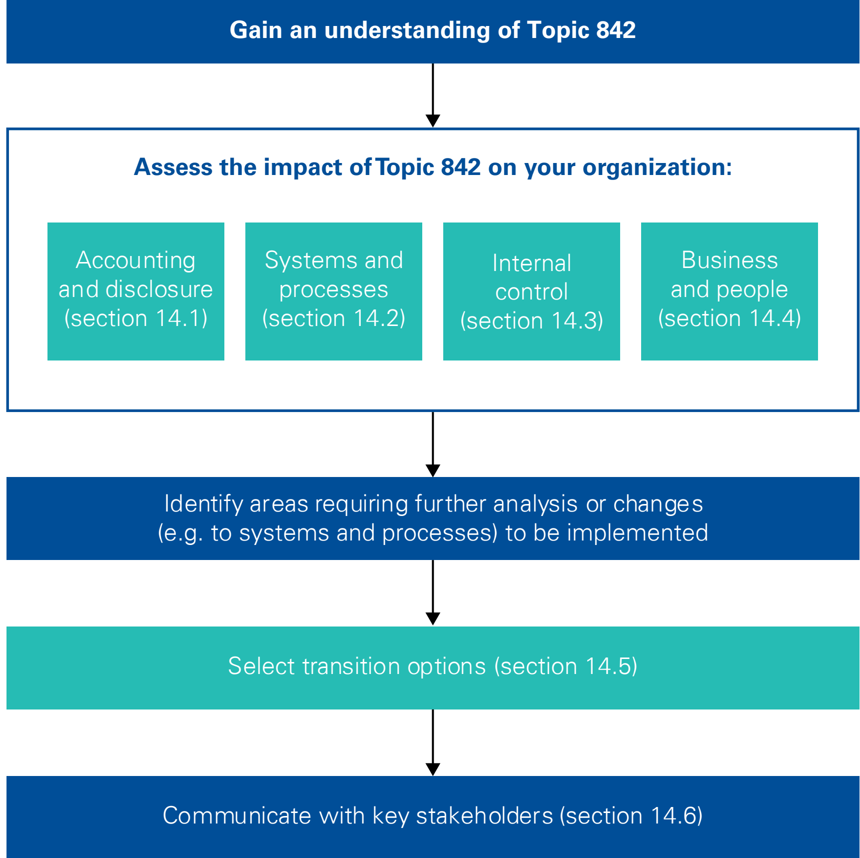
14 Next steps

An overview

The adoption of Topic 842 could have significant impacts – not just on the accounting and financial reporting, but also requiring changes in systems and processes used to account for lease transactions.

Entities may need to design and implement new internal controls or modify existing controls to address risk points resulting from new processes, judgments, and estimates. The change in accounting resulting from implementing Topic 842 could also impact entities' business decisions and the responsibilities of personnel and their training.

This chapter highlights the initial steps that an entity should take as a starting point to thinking about what kind of implementation process will be required.



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14.1 Accounting and disclosure

14.1.10 Topic 842 will require new judgments, estimates, and calculations. For example, entities may need to make new/different judgments about:

- whether a contract meets the definition of a lease,
- identifying components within lease agreements, and
- determining the lease term.

As changes in accounting policies and data availability are identified in the gap analysis, the areas that will require new policies, judgments, estimates, and/or calculations will need to be identified.

14.1.20 After gaining an understanding of Topic 842, entities should perform an analysis to identify accounting differences that will arise from changes from current US GAAP, accounting policies that may need to change or be implemented, and additional disclosures that will be required.

14.1.30 The following are some of the key factors to consider.

Definition of a lease

14.1.40 In many cases, lease identification based on the definition of a lease will be obvious, and a transaction that is a lease today will be a lease under Topic 842. However, there are significant changes in the definition of a lease that will need to be considered as to their effect on more complex types of arrangements – e.g. some outsourcing, power purchase, and transport agreements.

➜ See chapter 3.

Practical expedients

14.1.50 Entities have to decide whether to elect the exemption for short-term leases, and whether they can (and want to) apply portfolio-level accounting to any of their leases.

➜ See sections 6.3.1 and 5.8.

Transition options

14.1.60 Entities have to decide whether to elect the transition practical expedients, weighing the potential benefits against the effect on the entity's reported financial information both in the comparative periods in the first set of financial statements issued after the effective date of Topic 842 and for a period of time after the effective date.

➜ See section 14.5.

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Lease classification

14.1.70 While Topic 842 mostly retains the current US GAAP lease classification regime, there are some changes that may significantly affect some entities. For example, lessors that enter into longer-term arrangements with significant variable lease payments, or enter into leases with lower credit quality customers, may reach lease classification conclusions different from those reached under current US GAAP, and both lessees and lessors will have to consider changes resulting from a new lease classification test (i.e. the alternative use test – see section 6.2).

➔ See chapter 6 (lessees) and 7 (lessors).

14.1.80 Entities will need to develop accounting policies and procedures for lease classification and, if the transition practical expedients are not elected for existing leases, an approach for lease classification reassessment at transition.

Sale-leaseback transactions

14.1.90 Changes to the sale-leaseback guidance will require entities to first determine whether the transaction is a sale under Topic 606; the guidance in Topic 606 is indicator-based and markedly different from that applicable to sale-leaseback transactions under current US GAAP, requiring entities to make new judgments and determinations.

14.1.100 Entities will also need to assess whether the transaction includes specific provisions that would prevent accounting for the transaction as a sale – i.e. a purchase option at a strike price different from the underlying asset's fair value on the exercise date, a put option that the buyer-lessor has a significant economic incentive to exercise, or terms that would classify the leaseback as a finance lease.

14.1.110 Although the transaction may result in derecognizing the underlying asset – and, depending on the facts and circumstances, financing associated with the asset – seller-lessees will still recognize a right-of-use asset and lease liability for the leaseback unless the leaseback is a short-term lease.

➔ See chapter 9.

Disclosure requirements

14.1.120 In addition to recognizing leases on-balance sheet, lessees will have to provide significant additional qualitative and quantitative disclosures compared to current US GAAP.

➔ See chapter 12.

14.1.130 Entities will need to develop new processes and procedures for accumulating the relevant data and information necessary to meet those disclosure requirements.

Multi-jurisdictional financial reporting requirements

14.1.140 Because Topic 842 and the new International leasing standard, IFRS 16, are significantly different in a number of key areas (e.g. the accounting for lessee operating leases under Topic 842 and accounting for sale-leaseback transactions), entities that have to report under both US GAAP and IFRS will need to consider the impact that significantly different lease accounting requirements will have on their systems, process, and control needs.

➔ See Appendix for a summary.

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SEC registrants

14.1.150 Early on, SEC registrants will also need to consider their requirement to disclose the expected effect of Topic 842 on their financial statements. Generally, we would not expect entities, in particular lessees, to simply provide only boilerplate disclosure that they are "evaluating the effect of the new standard," without providing any more detailed information for very long after the issuance of ASU 2016-02. [SAB Topic 11-M]

14.2 Systems and processes

14.2.10 Complying with the requirements of Topic 842 will require most entities to both:

– gather or acquire information that has not been historically required to account for leases under current US GAAP – e.g. incremental borrowing rates for operating leases; and

– utilize information, some of which may not already be obtained for financial reporting purposes, for new purposes; for example, to recognize and measure operating lease liabilities and operating lease right-of-use assets, or to prepare new disclosures such as the weighted-average remaining lease term and weighted-average discount rate as of the balance sheet date.

14.2.20 Preparing an inventory of the information needed to apply Topic 842, mapping those needs to existing sources, and identifying gaps between the information needed and the information currently captured by existing sources will be critical steps early on in the implementation process. It is likely that, for most entities, additional information will need to be captured that is not already captured by entities' existing systems or processes. Entities should consider what new IT reporting packages, if any, need to be developed or acquired to meet the requirements of Topic 842.

14.2.30 To achieve a cost-effective solution, entities could evaluate the best way to source incremental information by:

– establishing the level of effort required to obtain new information from existing feeder systems and/or existing processes; and

– determining additional systems and/or process requirements that might be necessary.

14.2.40 Incremental IT systems capabilities *may* be needed for one or more of the following reasons:

– Existing leasing solutions are principally administrative in nature, rather than designed to meet accounting or financial reporting objectives, such that they do not accumulate or maintain information that will be necessary to meet the accounting and/or disclosure requirements in Topic 842. Even more sophisticated entities' lease administration systems likely were not designed to capture all of the information that will be needed.

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- Entities often use a spreadsheet-based solution either as their primary leasing tool or as a significant supplemental tool. Those entities may conclude that their spreadsheet lease administration is not well enough controlled to rely upon in applying Topic 842.
- The entity has significant US GAAP and IFRS reporting requirements and needs incremental system capabilities to help it report under the different US GAAP and IFRS lease accounting requirements.

14.2.50 Even if new IT systems capabilities are not necessary, new *processes* will still be necessary to capture, and ensure the completeness and accuracy of, the additional information needed to meet the requirements in Topic 842 from existing systems, and to provide the incremental disclosures about the entity's leasing activities required by Topic 842.

14.2.60 Entities should also assess how applying Topic 842 will affect *existing processes,* including how new contracts or modifications to existing contracts are reviewed and/or approved and accounted for, and how information is compiled for financial reporting purposes.

14.2.70 Processes may also need to be reconsidered to ensure that information is captured for financial reporting purposes on a timely basis (e.g. accounting personnel learn of new leases or lease modifications in a timely manner) and management judgment is properly exercised at key points as financial information is prepared, and internal controls are in place and functioning effectively around key information and key judgments. Some existing processes that are decentralized may need to be made more centralized to ensure that accounting effects are appropriately considered and identified on a timely basis.

14.3 Internal control

14.3.10 Entities will need to consider the potential effect of required changes or additions to their systems and processes on their internal control environment, including internal controls over financial reporting. Many entities will need to design and implement new internal controls or modify existing controls to address risk points resulting from new processes, judgments, and estimates.

14.3.20 New risk points may arise from changes to IT systems and reports that provide data inputs used to support new estimates and judgments. To the extent that data is needed to comply with the accounting or disclosure requirements of Topic 842, entities will need to consider the internal controls necessary to ensure the completeness and accuracy of this information – especially if it was not previously collected, or was collected outside of the financial reporting environment (e.g. only for HR or legal purposes).

14.3.30 Because Topic 842 may require new judgments and perhaps different analyses, entities should consider the skill level, resource capacity, and training needs of employees who will be responsible for performing the new or modified controls; as well as the need for new management review controls if new processes and/or judgments will be performed by lower-level employees.

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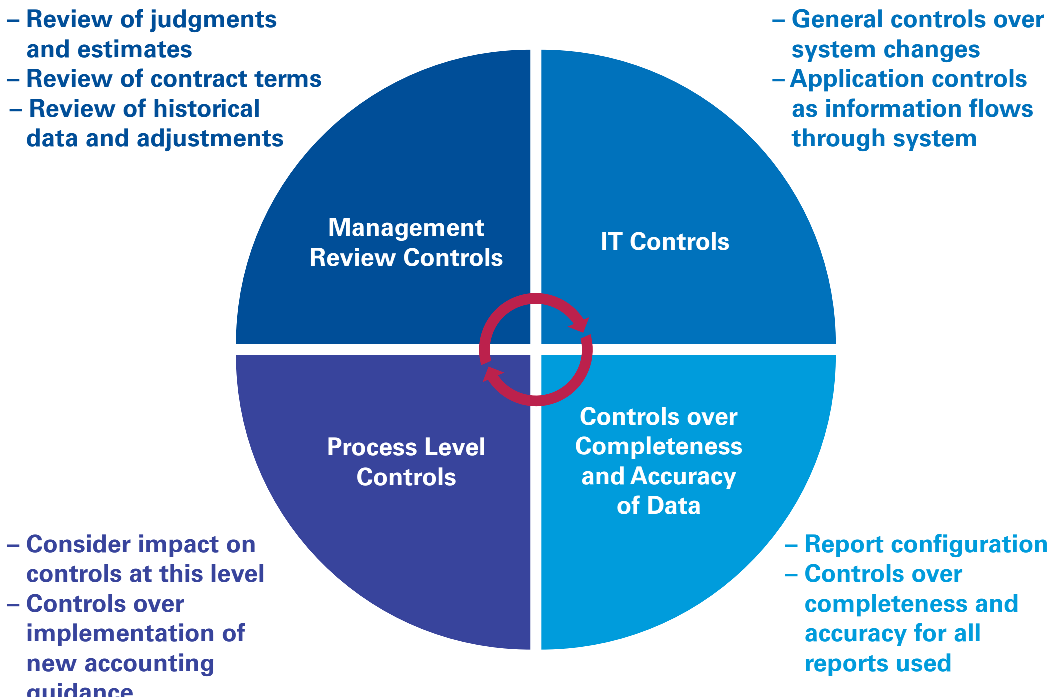
14.3.40 The following chart provides examples of different internal controls that may be affected.



14.3.50 Early in planning implementation, entities should also consider what processes and related internal controls should be designed and implemented to assess the impact of, and record accounting adjustments arising on, application of Topic 842. For example, new internal controls may be required relating to:

- identifying changes to existing accounting policies;
- reviewing contracts for accounting adjustments on application of Topic 842;
- recording accounting adjustments that have been identified; and
- preparing new qualitative and quantitative disclosures.

14.3.60 SEC registrants will need to consider the potential effect of any changes in internal controls on management's requirement to make its quarterly and annual disclosures, and certifications about disclosure controls, procedures, and internal controls.

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14.4 Business and people

14.4.10 Entities should evaluate how Topic 842 will affect their organization and the users of their financial statements. Among other things, management should consider:

- the training that will be required for both finance and non-finance personnel, including the board, audit committee, senior management, and investor relations;
- the potential need to renegotiate current business contracts that include financial covenants linked to the current accounting for leases;
- the potential need to reassess buy-versus-lease decisions;
- what changes may be required to forecasting and budgeting processes;
- the need to set up a project management team and develop an efficient implementation plan early in the process; and
- communication plans to stakeholders, such as investors, creditors, board members, the audit committee, and some employees (see section 14.6).

14.4.20 Lessors will also likely need to consider the effect of Topic 842 on their customers, and therefore what that may mean for their businesses and their contracting practices. For example, a lessor's sales personnel should be aware that some lessees might want shorter lease terms or a more variable payment structure to limit recognized lease liabilities going forward; or might want to modify existing leases to limit the effect that Topic 842 will have on their financial statements.

14.4.30 When Topic 842 will have a significant effect on the entity (e.g. the entity is a lessee with a significant amount of leasing activity), effective governance will be a key element of a successful implementation. This includes input from and involvement of the audit committee, a steering committee, and a project management team.

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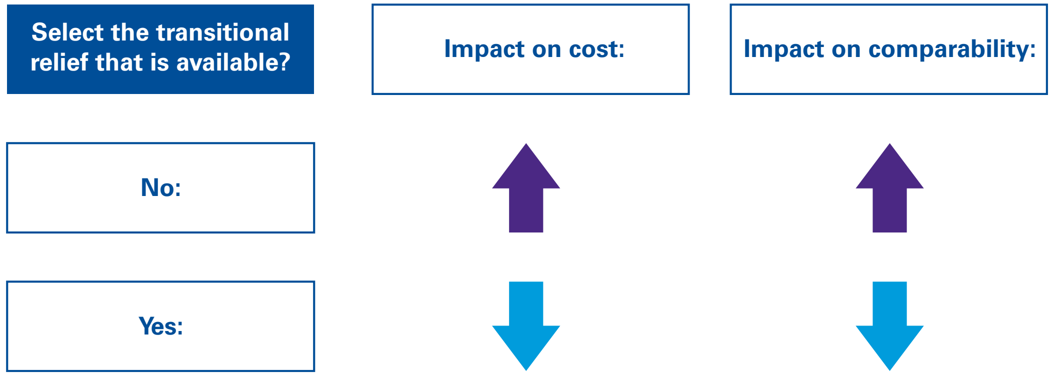
14.5 Select transition and accounting policy options

14.5.10 As discussed in section 13.2, in the financial statements in which an entity first applies Topic 842, the entity recognizes and measures all leases that exist at the beginning of the earliest comparative period presented using a modified retrospective transition approach. In addition, there are two optional practical expedients.

- A package of practical expedients that provides relief in respect of the definition of a lease, the classification of leases, and initial direct costs. This package must be elected on an all or nothing basis.
- A practical expedient that allows the use of hindsight in assessing the likelihood that a lessee will exercise extension, termination, and purchase options and in assessing right-of-use assets for impairment.

14.5.20 An entity's decisions about which, if any, transition practical expedients to adopt will have a significant effect on its implementation efforts. Therefore, determining the transition options that the entity intends to apply should be an early step in the implementation process. The trade-off is between the cost of implementation and comparability between periods.



14.5.30 In addition, entities should weigh the benefit in terms of implementation effort that electing the practical expedients generally will provide against the financial reporting effect of that election – both the quantitative effects of each transition option and relevant qualitative factors. The following are a few examples of circumstances in which the practical expedients might have a significant effect on the entity's financial reporting.

- While most leases under current US GAAP will be leases under Topic 842, that will not universally be the case. If an entity enters into contracts that were leases under current US GAAP, but will not be leases under Topic 842, a decision to apply the transition practical expedients could significantly affect comparability going forward – i.e. as similar arrangements are entered into on or after the effective date and determined not to be leases – and could result in significantly different balance sheet reporting (e.g. the recognition of significant lease assets and lease liabilities, including after the effective date of Topic 842, that would not be recognized under Topic 842).

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- An entity that today structures its leases to avoid capital lease classification (e.g. structuring lease terms to ensure that minimum lease payments are 89.9% of the fair value of the underlying asset) may decide, given that all of its leases will be on-balance sheet, that its investors and analysts would prefer finance lease accounting going forward. A decision to apply the transition practical expedients would affect comparability for a significant period of time if the entity continued to account for all of its existing leases as operating leases, but accounted for its leases entered into on or after the effective date as finance leases.
- If an entity has significant unamortized initial direct costs that would not qualify as initial direct costs under Topic 842 (see section 5.5), *not* electing the transition practical expedients would improve comparability between the accounting for existing leases and those leases entered into on or after the effective date. In addition, not electing the transition practical expedients would permit an entity to write off those unamortized initial direct costs that do not meet the definition of initial direct costs under Topic 842 to equity, and therefore improve their performance going forward.

14.5.40 Accounting policy elections not specific to transition will also affect an entity's implementation process. For example:

- A lessee that elects the short-term lease exemption for a class of underlying assets (see section 6.3.1), does not apply the lessee transition guidance applicable to other leases to those leases that meet the definition of a short-term lease within that class of underlying assets.
- An entity's decision about whether to use the bright-line thresholds for lease classification (see sections 6.2 and 7.2 for lessees and lessors, respectively) will affect the entity's transition accounting if the entity does not elect the package of practical expedients.

14.5.50 Advanced planning with respect to selecting transition and related accounting policy options will allow time to address unanticipated complexities and will offer greater flexibility in maximizing the use of internal resources by spreading the implementation effort over a longer period.

14.5.60 Entities should therefore take steps to understand Topic 842 and then to evaluate the effects of applying the transition expedients and other accounting policy alternatives (e.g. the short-term lease exemption) on their financial reporting. If the expected effects of Topic 842 and/or the effects of selecting or not selecting transition practical expedients and accounting policy options are limited, it may be appropriate to wait longer to make these decisions.

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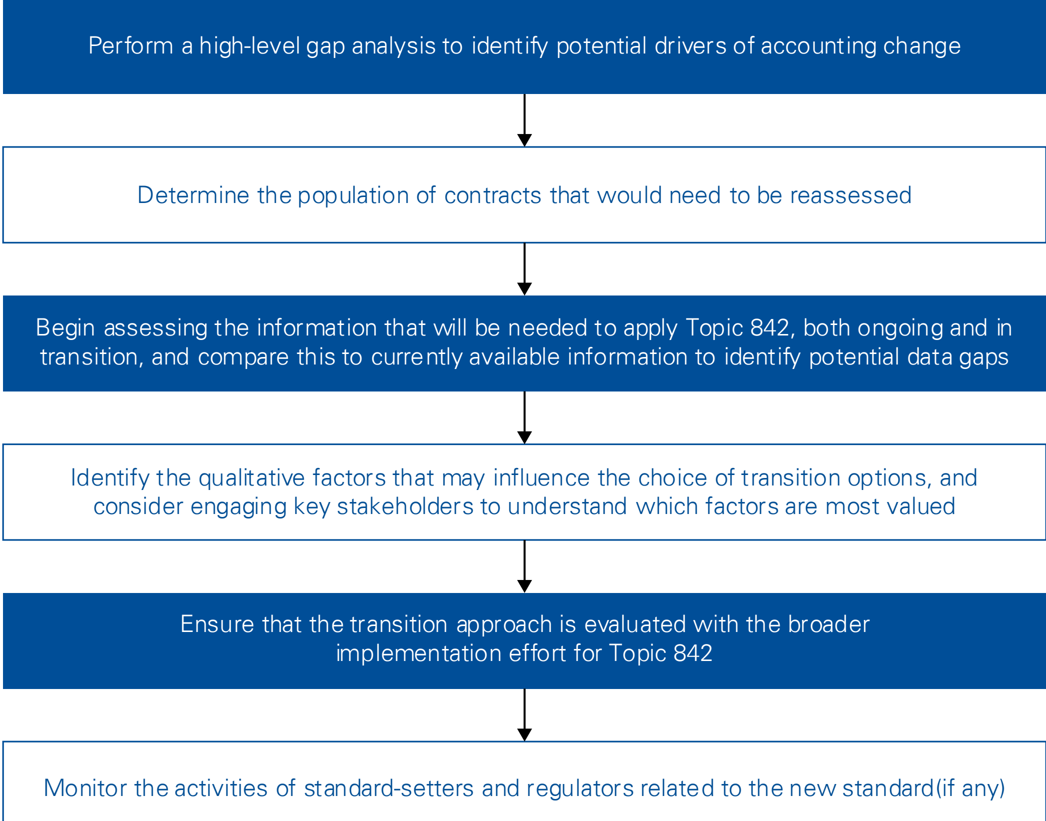
14.5.70 The following diagram highlights the decisions to be made about transition in the broader context of implementation.



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14.6 Communication with key stakeholders

14.6.10 Communication between management, the audit committee, and the external auditor is key to a successful implementation. Management may want to discuss key transition issues with the audit committee, including:

- whether there is a significant change expected to current accounting policies and disclosures;
- historical data availability and the importance of showing a consistent story about financing trends;
- investors' needs on lease-related financial information;
- the entity's readiness for change, including IT systems and accounting, legal, business, and tax knowledge of Topic 842; and
- whether the entity has long-term contracts, including their volume, duration, uniqueness, and significance.

14.6.20 As entities proceed with implementing Topic 842, they will also need to consider the timing and detail of communications to investors, analysts, and other key stakeholders, including:

- the expected impact of Topic 842 on the entity;
- the transition approach that will be applied; and
- when Topic 842 will be adopted.

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Appendix

Summary of similarities and differences between US GAAP and IFRS

On January 13, 2016, the IASB issued IFRS 16, *Leases*, which requires lessees to present right-of-use assets and lease liabilities on-balance sheet for most leases of assets that are not of low value when new (e.g. $5,000 or less). IFRS 16 introduces a single, on-balance sheet accounting model that is similar to the current accounting under IFRS for finance leases (and US GAAP for capital leases). Lessor accounting will remain similar to current practice.

IFRS 16 is effective for entities that apply IFRS for annual periods beginning on or after January 1, 2019. Earlier application is permitted for entities that apply IFRS 15, *Revenue from Contracts with Customers*, on or before the date of initial application of IFRS 16.

The following table provides a summary comparison between the requirements of Topic 842 and IFRS 16. Differences between the two standards are discussed in more detail throughout this Issues In-Depth. For more information about the requirements of IFRS 16, visit the leases topic page at kpmg.com/ifrs.

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US GAAP versus IFRS	
Topic 842	**IFRS 16**
Definition of a lease (see chapter 3)	
– A contract contains a lease if: » There is an identified asset; and » The contract conveys the right to control the use of that asset for a period of time	
– A customer controls the use of an identified asset if it has the right, throughout the period of use, to: » Direct the use of the asset; and » Obtain substantially all of the economic benefits from use of the asset	
Practical expedients and targeted reliefs (see sections 5.8 and 6.3.1)	
– Optional lessee recognition and measurement exemption for short-term leases – i.e. leases with a lease term of ≤ 12 months (elected by class of underlying asset)	
– If a lease includes a purchase option that the lessee is reasonably certain to exercise, it is not a short-term lease	– If a lease includes a purchase option, it is not a short-term lease
– Portfolio-level accounting permitted if it does not differ materially from applying the requirements to individual leases (e.g. discount rate or lease term)	
– No exemption for leases of low-value assets.	– Optional lessee recognition and measurement exemption for leases of low-value assets (e.g. $5,000 or less when new), even if material in aggregate
Lessee accounting model (see chapter 6)	
– Dual-lease accounting model	– Single lease accounting model
– Lease classification test based on current US GAAP classification criteria	– No lease classification test
– All leases on balance sheet: lessees recognize a right-of-use (ROU) asset and lease liability » Finance leases treated as the purchase of an asset on a financed basis » Operating leases generally have straight-line recognition of total lease cost	– All leases on balance sheet: lessees recognize a right-of-use (ROU) asset and lease liability » All leases treated as the purchase of an asset on a financed basis.

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US GAAP versus IFRS	
Topic 842	**IFRS 16**
Lessor accounting model (see chapter 7)	
– Dual lease accounting model	
– Lease classification test based on current US GAAP/IFRS classification criteria	
– Operating lease accounting model based on current operating lease accounting under both US GAAP and IFRS	
– Sales-type and direct financing lease accounting model based on current US GAAP accounting for sales-type and direct financing leases with recognition of net investment in lease comprising lease receivable and unguaranteed residual asset » Selling profit not recognized on commencement of leases classified as direct financing leases, even if the carrying amount and fair value of the underlying asset are different; selling profit recognized over the lease term	– Finance lease accounting model based on current IFRS finance lease accounting with recognition of net investment in lease comprising lease receivable and unguaranteed residual asset » No restriction on recognizing selling profit on commencement for finance leases
– Leveraged leases that have commenced prior to the effective date are grandfathered and exempt from applying the new standard unless modified on or after the effective date	– N/A – leveraged lease accounting does not exist under IFRS
Related party leasing transactions (see section 9.2 and chapter 12)	
– Account for leases between related parties based on their contractual terms, even if those terms are different from the substance of the arrangement	– N/A – the IASB did not address related party leasing transactions
– Disclose lease transactions between related parties	– N/A
Lease term and purchase options (see sections 5.3 and 5.4.4)	
– Payments for optional (e.g. renewal) periods and purchase options included in lease accounting if it is *reasonably certain* that the lessee will exercise those options, consistent with the high threshold in current US GAAP and IFRS	
– Lessees reassess renewal and purchase options if there is a significant event or significant change in circumstances that is within the control of the lessee and directly affects the assessment of whether the lessee will exercise an option (e.g. construction of significant leasehold improvements)	
– No reassessment of renewal and purchase options by lessors	

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<table>
<tr><th colspan="2">US GAAP versus IFRS</th></tr>
<tr><th>Topic 842</th><th>IFRS 16</th></tr>
<tr><td colspan="2">Initial direct costs (see section 5.5)</td></tr>
<tr><td colspan="2">– IDCs include only incremental costs that an entity would not have incurred if it had not obtained the lease (e.g. commissions or payments made to existing tenants to obtain the lease)</td></tr>
<tr><td colspan="2">– Lessees include IDCs in the initial measurement of the ROU asset and amortize the costs over the lease term</td></tr>
<tr><td colspan="2">– Lessors capitalize IDCs for operating leases and amortize the costs over the lease term in the same pattern as lease income</td></tr>
<tr><td>– Lessors capitalize IDCs as part of the net investment in the lease for sales-type leases when the fair value of the underlying asset equals its carrying amount at lease commencement, and for direct financing leases. Otherwise, IDCs are expensed at lease commencement</td><td>– Non-manufacturer/dealer lessors capitalize IDCs as part of the net investment in the lease for finance leases
– Manufacturer/dealer lessors expense IDCs arising from finance leases at lease commencement</td></tr>
<tr><td colspan="2">Discount rate (see section 5.6)</td></tr>
<tr><td colspan="2">– The lessee's discount rate is the rate implicit in the lease (implicit rate), if readily determinable; otherwise, it is the lessee's incremental borrowing rate</td></tr>
<tr><td>» The incremental borrowing rate is the rate a lessee would have to pay to borrow on a collateralized basis over a similar term an amount equal to the lease payments in a similar economic environment</td><td>» The incremental borrowing rate is the rate a lessee would have to pay to borrow over a similar term, and with a similar security, the funds necessary to obtain an asset of a similar value to the ROU asset in a similar economic environment</td></tr>
<tr><td colspan="2">– Lessees reassess the discount rate when there is:
» A change in the lease term or the assessment of whether the lessee is, or is not, reasonably certain to exercise a purchase option
» A lease modification that is not accounted for as a separate contract</td></tr>
<tr><td>» N/A</td><td>» A change in future lease payments as a result of a change in floating interest rates</td></tr>
<tr><td>– Nonpublic business entity lessees permitted to elect as an accounting policy to use a risk-free discount rate</td><td>– N/A – no unique guidance for nonpublic business entities</td></tr>
</table>

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<tr><th colspan="2">US GAAP versus IFRS</th></tr>
<tr><th>Topic 842</th><th>IFRS 16</th></tr>
<tr><td colspan="2">– The lessor's discount rate is the rate implicit in the lease. The rate implicit in the lease is the rate of interest that causes the aggregate present value of (a) the lease payments and (b) the amount that a lessor expects to derive from the underlying asset following the end of the lease term to equal the sum of (1) the fair value of the underlying asset (US GAAP only: minus any related investment tax credit retained and expected to be realized by the lessor), and (2) any capitalizable initial direct costs of the lessor</td></tr>
<tr><td colspan="2">– Lessors reassess the discount rate for the modified lease when there is a lease modification not accounted for as a separate contract</td></tr>
<tr><th colspan="2">Variable lease payments (see section 5.4.1)</th></tr>
<tr><td colspan="2">– Lease payments used in the initial measurement of lease assets and lease liabilities include:
» Variable payments based on an index or rate using prevailing (spot) rates or indices at lease commencement; and
» Variable payments that represent in-substance fixed payments (consistent with current practice)</td></tr>
<tr><td colspan="2">– Variable payments that are not based on an index or rate and are not in-substance fixed payments are excluded from the measurement of lease assets and liabilities and recognized as an expense when incurred or income as earned</td></tr>
<tr><td colspan="2">– No reassessment of variable lease payments by lessors</td></tr>
<tr><td>– Lessees reassess variable lease payments based on an index or rate only when lease payments are remeasured for other reasons (e.g. a reassessment due to a change in the lease term)</td><td>– Lessees reassess variable lease payments based on an index or rate on the date that:
» lease payments are remeasured for other reasons (e.g. a reassessment due to a change in the lease term); or
» there is a contractual change in the cash flows (i.e. when an adjustment to the lease payments based on an index or rate takes effect under the lease's terms)</td></tr>
<tr><th colspan="2">Arrangements with lease and non-lease components (see chapter 4)</th></tr>
<tr><td colspan="2">– Activities (or costs of the lessor) that do not transfer a good or service to the lessee (e.g. taxes and insurance on the property) are not components of a contract and, therefore, do not receive an allocation of the consideration in the contract (i.e. all or a portion of these costs will be included in the lease payments)</td></tr>
<tr><td colspan="2">– Lessors always separate lease and non-lease components and allocate consideration in the contract using the new revenue recognition standard's transaction price allocation guidance (i.e. on a relative stand-alone selling price basis)
» Reallocate consideration when there is a contract modification that is not accounted for as a separate contract</td></tr>
</table>

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<tr><th>Topic 842</th><th>IFRS 16</th></tr>
<tr><td colspan="2">– Lessees elect an accounting policy by class of underlying asset to either:
» Separate lease from non-lease components and allocate consideration in the contract based on the relative stand-alone prices of the separate lease and non-lease components to maximize the use of observable information
– Reallocate consideration when: (a) there is a remeasurement of the lease liability (e.g. because of a change in the lease term); or (b) there is a contract modification that is not accounted for as a separate contract
» Account for non-lease components together with the separate lease component to which they relate as a single lease component</td></tr>
<tr><th colspan="2">Contract combinations (see section 4.7)</th></tr>
<tr><td colspan="2">– Two or more contracts entered into at or near the same time with the same counterparty (or related parties) are combined into a single transaction if:
» The contracts are negotiated as a package with a single commercial objective;
» The amount of consideration to be paid in one contract depends on the price or performance of the other contract; or
» The rights to use underlying assets conveyed in the contracts (or some of the rights of use conveyed in the contracts) are a single lease component</td></tr>
<tr><th colspan="2">Lease modifications (see sections 6.7 and 7.7)</th></tr>
<tr><td colspan="2">– Lease modifications are defined 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 (e.g. a change to the terms and conditions of the contract that adds or terminates the right to use one or more underlying assets or extends or shortens the contractual lease term)</td></tr>
<tr><td colspan="2">– A modification is accounted for as a separate contract when it grants the lessee an additional ROU that was not included in the original lease and the lease payments increase commensurate with the stand-alone price for the additional ROU, adjusted for the circumstances of that particular contract (IFRS: except for lessor operating lease modifications)</td></tr>
<tr><td>» N/A</td><td>» A lessor accounts for an operating lease modification as a new lease at the effective date of the modification (i.e. does not account for the modification as a separate contract under any circumstances)</td></tr>
<tr><td colspan="2">– For lessees, when a modification is not considered a separate contract:
» If the modification does not fully or partially terminate the existing lease, the ROU asset is adjusted by the amount of the adjustment to the lease liability
» If the modification fully or partially terminates the lease (e.g. reduces the assets subject to the lease, such as reducing an office space lease from two floors to one floor), the ROU asset is decreased on a basis proportionate to the full or partial termination of the existing lease. Any difference between the adjustment to the lease liability and the adjustment to the ROU asset is recognized in the income statement.</td></tr>
</table>

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<tr><th>Topic 842</th><th>IFRS 16</th></tr>
<tr><td colspan="2">– For lessors, when a modification is not a separate contract (IFRS: N/A for operating leases; operating lease modifications can never be accounted for as a separate contract), lease classification is reassessed and:</td></tr>
<tr><td>– Operating lease modifications
» If the modified lease is a sales-type or direct financing lease, the lessor derecognizes prepaid or accrued rent as an adjustment to the selling profit or selling loss
» If the modified lease is an operating lease, the lessor considers prepaid or accrued rent as part of the lease payments for the new lease</td><td>– Operating lease modifications
» A lessor accounts for an operating lease modification as a new lease at the effective date of the modification (prepaid or accrued lease payments from the original lease are considered lease payments for the new lease)</td></tr>
<tr><td>– Direct financing lease modifications
» If the modified lease is a sales-type lease, the lessor accounts for the modified lease as other sales-type leases, commencing at the effective date of the modification
» If the modified lease is a direct financing lease, the lessor adjusts the discount rate for the modified lease so that the initial net investment in the modified lease equals the carrying amount of the net investment in the original lease
» If the modified lease is an operating lease, the lessor recognizes the underlying asset at the carrying amount of the net investment in the original lease
– Sales-type lease modifications
» If the modified lease is a sales-type lease or a direct financing lease, the lessor adjusts the discount rate for the modified lease so that the initial net investment in the modified lease equals the carrying amount of the net investment in the original lease
» If the modified lease is an operating lease, the lessor recognizes the underlying asset at the carrying amount of the remaining net investment in the original lease</td><td>– Finance lease modifications
» If the modified lease would have been classified as an operating lease at inception, the lessor accounts for the modified lease as a new lease and recognizes the underlying asset at the carrying amount of the net investment in the original lease
» If the modified lease would have been classified as a finance lease at inception, the lessor applies IFRS 9, Financial Instruments</td></tr>
</table>

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US GAAP versus IFRS	
Topic 842	**IFRS 16**
Subleases (see chapter 8)	
– A lessee-sublessor accounts for the head lease and the sublease as two separate contracts unless those contracts meet the criteria for combining » The head lease is accounted for using the requirements for lessee accounting » The sublease is accounted for using the requirements for lessor accounting	
– A lessee-sublessor does not offset lease liabilities and assets arising from a head lease and sublease unless they meet the financial instruments requirements for offsetting in US GAAP or IFRS	
– A lessee-sublessor does not offset lease income from a sublease and lease cost from a head lease unless it meets the requirements for offsetting in other US GAAP or IFRS (e.g. the new revenue recognition standard)	
– A sublessor considers the underlying asset rather than the ROU asset to be the leased asset in determining the classification of the sublease	– A sublessor considers the ROU asset to be the leased asset in determining the classification of the sublease
Sale-leaseback transactions (see chapter 9)	
Determining whether a sale has occurred	
– A sale-leaseback of the underlying asset is recognized if the buyer-lessor obtains control of the underlying asset using the requirements in the new revenue recognition standard. The existence of the leaseback does not, on its own, result in a conclusion that control of the asset has not been conveyed to the buyer-lessor	
– If the leaseback would be classified as a finance lease or a sales-type lease, then sale recognition is precluded	– N/A – single model approach for lessee accounting
– A repurchase option held by the seller-lessee in a sale-leaseback transaction precludes sale recognition unless: » The strike price to repurchase the asset is its fair market value at the date of option exercise; and » Assets that are substantially the same as the underlying asset are readily available	– If the seller-lessee has a substantive repurchase option with respect to the underlying asset, sale recognition is precluded
– Both the seller-lessee and the buyer-lessor account for a sale-leaseback transaction that does not qualify for sale accounting as a financing transaction	

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<tr><th>Topic 842</th><th>IFRS 16</th></tr>
<tr><td colspan="2">Accounting for a sale/purchase</td></tr>
<tr><td colspan="2">– A buyer-lessor accounts for the purchase of an asset in a sale-leaseback transaction that qualifies for sale accounting consistent with the applicable US GAAP or IFRS for the purchase of a nonfinancial asset</td></tr>
<tr><td colspan="2">– A seller-lessee accounts for any loss on a sale-leaseback transaction that qualifies for sale accounting consistent with the guidance that applies to any other sale resulting in a loss</td></tr>
<tr><td colspan="2">– A seller-lessee recognizes any gain on the sale of the underlying asset (the amount of the gain is different under Topic 842 and IFRS 16) at the time the sale is completed</td></tr>
<tr><td>– The gain on the sale is measured consistent with the guidance that applies to any other sale (i.e. the difference between the sale price and the carrying amount of the asset), subject to any adjustment for off-market terms</td><td>– The gain on the sale is restricted to the amount of the difference between the sale price and the carrying amount of the asset, as adjusted for off-market terms, that relates to the buyer-lessor's residual interest in the underlying asset</td></tr>
<tr><td colspan="2">Accounting for the leaseback</td></tr>
<tr><td colspan="2">– If a sale-leaseback transaction qualifies for sale accounting, the leaseback is accounted for in the same manner as other leases</td></tr>
<tr><td colspan="2">Accounting for off-market terms</td></tr>
<tr><td colspan="2">– Any potential off-market adjustment is measured as the more readily determinable of:
» The difference between the fair value of the underlying asset and the sale price, or
» The difference between the present value of fair-market value lease payments and the present value of the contractual lease payments</td></tr>
<tr><td colspan="2">– A deficiency in the transaction terms versus market terms is accounted for as a prepayment of rent</td></tr>
<tr><td colspan="2">– An excess in the transaction terms versus market terms is accounted for as additional financing provided by the buyer-lessor to the seller-lessee</td></tr>
<tr><td colspan="2">Lessee presentation – balance sheet (see section 6.8)</td></tr>
<tr><td colspan="2">– Lessees present finance lease ROU assets and lease liabilities either as separate line items on the balance sheet or disclose them separately in the notes to the financial statements</td></tr>
<tr><td>– If not separately presented on the balance sheet, lessees disclose in the notes the line items on the balance sheet in which finance lease ROU assets and lease liabilities are included and their amounts</td><td>– If not separately presented on the balance sheet, lessees:
» Present ROU assets as if the underlying asset were owned
» Disclose in the notes the line items on the balance sheet in which ROU assets and lease liabilities are included and their amounts</td></tr>
</table>

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US GAAP versus IFRS	
Topic 842	**IFRS 16**
– Lessees do not include operating lease ROU assets and lease liabilities in the same line items as finance lease ROU assets and lease liabilities on the balance sheet » If not separately presented on the balance sheet, lessees disclose in the notes the line items on the balance sheet in which operating lease ROU assets and lease liabilities are included and their amounts	– N/A – no operating lease classification
Lessee presentation – statement of cash flows (see section 6.8)	
– Lessees classify cash paid for: » Principal on finance lease liabilities as financing activities » Interest on finance lease liabilities based on the requirements relating to interest paid under Topic 230 » Operating leases, variable lease payments, and leases that are not recognized on-balance sheet (e.g. some short-term leases) as operating activities	– Lessees present cash paid for: » Principal on lease liabilities as financing activities » Interest on lease liabilities as either operating or financing activities based on the lessee's accounting policy choice under IAS 7 » Variable lease payments and leases that are not recognized on-balance sheet (e.g. some short-term leases) as operating activities
Lessee disclosures (see chapter 12)	
– *Objective*: Enable financial statement users to assess the amount, timing, and uncertainty of cash flows arising from leases	– *Objective*: Disclose information that, together with the information in the balance sheet, income statement, and statement of cash flows, gives a basis for users of financial statements to assess the effect that leases have on the lessee's financial position, financial performance, and cash flows

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<table>
<tr><th colspan="2">US GAAP versus IFRS</th></tr>
<tr><th>Topic 842</th><th>IFRS 16</th></tr>
<tr><td>– Lessees disclose the following qualitative information:
» Nature of leases (and subleases)
» Leases that have not yet commenced, but that create significant rights/ obligations, including involvement in construction or design of the underlying asset
» Significant lease accounting judgments and assumptions
» Main terms and conditions of sale-leaseback transactions
» If applicable, that the lessee elected the short-term lease exemption and the class(es) of underlying asset(s) for which it made that election. If short-term lease expense is not representative of lessee's short-term lease commitments, disclose that fact and amount.
» If applicable, that the lessee elected the practical expedient not to separate lease from non-lease components and the class(es) of underlying asset(s) for which it made that election</td><td>– Lessees disclose additional information, in addition to the required quantitative disclosures, in sufficient detail to satisfy the lessee disclosure objective. This may include, but is not limited to:
» Nature of leases (and subleases)
» Information about future cash flows to which the lessee is exposed (e.g. from variable lease)
» Payments or residual value guarantees)
» Main terms and conditions of sale-leaseback transactions
» Restrictions or covenants imposed by leases
» If applicable, that the lessee elected the short-term lease exemption. If short-term lease expense is not representative of lessee's short-term lease commitments, disclose the amount.
» If applicable, that the lessee elected the low-value assets lease exemption</td></tr>
<tr><td>– Lessees disclose the following quantitative information (in any format the lessee considers appropriate):</td><td>– Lessees disclose the following quantitative information (in a tabular format, unless another format is more appropriate):</td></tr>
<tr><td colspan="2">» Amortization of ROU assets and interest on lease liabilities (including amounts capitalized)</td></tr>
<tr><td>– For finance leases only
» N/A
» N/A</td><td>– Amortization split by class of underlying asset
» Additions to ROU assets
» Carrying amount of ROU assets, split by class of underlying asset</td></tr>
<tr><td colspan="2">» Short-term lease cost (when the lease term is > one month)
» Variable lease cost
» Sublease income (on gross basis)
» Gains (losses) from sale-leaseback transactions, net</td></tr>
</table>

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US GAAP versus IFRS	
Topic 842	**IFRS 16**
» Operating lease cost	» N/A
» N/A	» Expense relating to leases of low-value assets
» Cash paid for lease payments, separately for finance and operating leases and segregated between operating and financing cash flows	» Total cash outflow for leases
» Supplemental noncash information on lease liabilities exchanged for ROU assets, separately for finance and operating leases	» N/A
» Weighted-average remaining lease term, separately for finance and operating leases	» N/A
» Weighted-average discount rate as of the balance sheet date, separately for finance and operating leases	» N/A
» A maturity analysis of lease liabilities for each of the first five years after the balance sheet date and in total thereafter, including a reconciliation of undiscounted cash flows to lease liabilities on the balance sheet, separately for finance leases and operating leases	» A maturity analysis of lease liabilities using IFRS 7, separate from the maturity analysis for other financial liabilities
– N/A	– If ROU assets meet the definition of investment property under IAS 40, provide applicable disclosures. In this case, the lessee is not required to disclose quantitative information about ROU assets and sublease income in IFRS 16.
– N/A	– If the lessee measures ROU assets at revalued amounts under IAS 16, provide applicable disclosures

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US GAAP versus IFRS	
Topic 842	**IFRS 16**
Lessor presentation – balance sheet (see section 7.8)	
– Lessors present assets from sales-type and direct financing leases as an aggregate net investment in the lease. The net investment is presented separately from other assets. » Lease assets are subject to the same current/non-current classification requirements as other assets	– Lessors present assets held under a finance lease as a net investment in the lease
– Lessors present underlying assets subject to an operating lease in accordance with other GAAP (e.g. Topic 360)	– Lessors present underlying assets subject to operating leases according to the nature of the underlying asset
Lessor presentation – income statement (see section 7.8)	
– Lessors either present in the income statement, or in the notes, income arising from leases (and if disclosing in the notes, which line item(s) include lease income) – Lessors present selling profit or loss recognized at lease commencement in a manner that best reflects the lessor's business model	– Manufacturer and dealer lessors present selling profit or loss in accordance with their policy for outright sales under the new revenue recognition standard
Lessor presentation – statement of cash flows (see section 7.8)	
– Lessors classify all cash inflows from all leases (i.e. operating, sales-type and direct financing leases) as operating activities in the statement of cash flows	– N/A
Lessor disclosures (see chapter 12)	
– *Objective*: Enable financial statement users to assess the amount, timing, and uncertainty of cash flows arising from leases	– *Objective*: Disclose information that, together with the information in the balance sheet, income statement, and statement of cash flows, gives a basis for users of financial statements to assess the effect that leases have on the lessor's financial position, financial performance, and cash flows

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<tr><th>Topic 842</th><th>IFRS 16</th></tr>
<tr><td>– Lessors disclose the following qualitative information:
» Nature of leases
» Information about managing the risk associated with the residual asset
» Significant lease accounting judgments and assumptions</td><td>– Lessors disclose qualitative and quantitative information, in addition to the required quantitative disclosures, in sufficient detail to satisfy the lessor disclosure objective. This may include, but is not limited to:
» Nature of leases
» Information about managing the risk associated with the residual asset</td></tr>
<tr><td colspan="2">– Lessors disclose the following quantitative information:
» A table of lease income recognized during the reporting period
– For finance leases, disclose:
• Profit or loss recognized at lease commencement
• Interest income on net investment in leases
• Lease income related to variable lease payments not included in net investment in leases
– For operating leases, disclose lease income related to lease payments, separately disclosing income on variable lease payments not based on an index or rate
» A maturity analysis of (a) the undiscounted cash flows comprising a lessor's lease receivables (for finance leases), and (b) the undiscounted future lease payments (for operating leases) for each of the first five years and a total thereafter
– For finance leases, the amounts included in the maturity analysis are reconciled to the balance of lease receivables presented separately in the balance sheet or disclosed separately in the notes
– A lessor presents the operating lease maturity analysis separately from the maturity analysis required for finance leases</td></tr>
<tr><td colspan="2">Operating leases
– General property, plant, and equipment disclosures by significant class of underlying asset separately from those disclosures for the lessor's other owned assets</td></tr>
<tr><td>Direct financing leases</td><td>Finance leases</td></tr>
<tr><td>– An explanation of the significant changes in the balance of unguaranteed residual assets and deferred selling profit</td><td>– A qualitative and quantitative explanation of the significant changes in the net investment in finance leases during the reporting period</td></tr>
</table>

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US GAAP versus IFRS	
Topic 842	**IFRS 16**
Lesseee transition (see section 13.3)	
– Modified retrospective transition: » Required for all leases existing at, or entered into on or after, the beginning of the earliest comparative period presented in the financial statements » Does not require transition accounting for leases that expired prior to the date of initial application	– Full retrospective approach or modified retrospective approach: » Under the modified retrospective approach, a lessee does not restate comparative information » At initial application date, recognize the cumulative effect of application as an adjustment to the opening balance of retained earnings (or other equity component as appropriate)
– Lessees may elect specified reliefs, which must be elected as a package and applied to all of the entity's leases (including those for which the entity is a lessor): » Not to reassess whether expired or existing contracts contain leases » Not to reassess lease classification for expired or existing leases » Not to reassess initial direct costs for existing leases	– Lessees may elect not to reassess whether contracts contain leases at the date of initial application, which must be elected and applied to all of the lessee's contracts
– Lessees may use hindsight in evaluating whether payments for lease renewals and purchase options should be included in lease payments, and in assessing impairment of the entity's right-of-use assets, when accounting for existing leases. This practical expedient may be elected separately or in conjunction with the package of specified reliefs, and must be applied to all leases.	– Lessees may use one or more of the following practical expedients when applying the modified retrospective approach to leases previously classified as operating leases under current IFRS, which can be elected on a lease-by-lease basis: » Use hindsight, such as in determining the lease term » Rely on their assessment of whether leases are onerous under IAS 37 immediately before the date of initial application instead of performing an impairment review » Apply a single discount rate to a portfolio of leases with reasonably similar characteristics » Elect not to apply the transition requirements to leases for which the lease term ends within 12 months of the date of initial application » Exclude initial direct costs from the ROU asset at the date of initial application

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<tr><th>Topic 842</th><th>IFRS 16</th></tr>
<tr><th colspan="2">Lessor transition (see section 13.4)</th></tr>
<tr><td>– Modified retrospective transition
» Required for all leases existing at, or entered into on or after, the beginning of the earliest comparative period presented in the financial statements
» Does not require any transition accounting for leases that expired prior to the date of initial application
– Lessors may elect specified reliefs, which must be elected as a package and applied to all of the entity's leases (including those for which the entity is a lessee)
» Not to reassess whether expired or existing contracts are or contain leases
» Not to reassess lease classification for expired or existing leases
» Not to reassess initial direct costs for existing leases</td><td>– Continue to apply existing accounting for any leases that are ongoing at the date of initial application, except for intermediate lessors in a sublease
– Intermediate lessors in subleases reassess each ongoing operating sublease at the date of initial application to determine whether under the new standard it is classified as an operating lease or a finance lease, based on the remaining contractual terms of the head lease and the sublease
– For subleases that were classified as operating leases under current IFRS guidance on leases, but finance leases under the new standard, account for the sublease as a new finance lease entered into on the date of initial application
– Lessors may elect not to reassess whether contracts are or contain leases at the date of initial application, which must be elected and applied to all of the lessor's contracts</td></tr>
<tr><td>– Lessors may use hindsight in evaluating whether payments for lease renewals and purchase options should be included in lease payments when accounting for existing leases. This practical expedient may be elected separately or in conjunction with the package of specified reliefs, and must be applied to all leases.</td><td>– N/A</td></tr>
</table>

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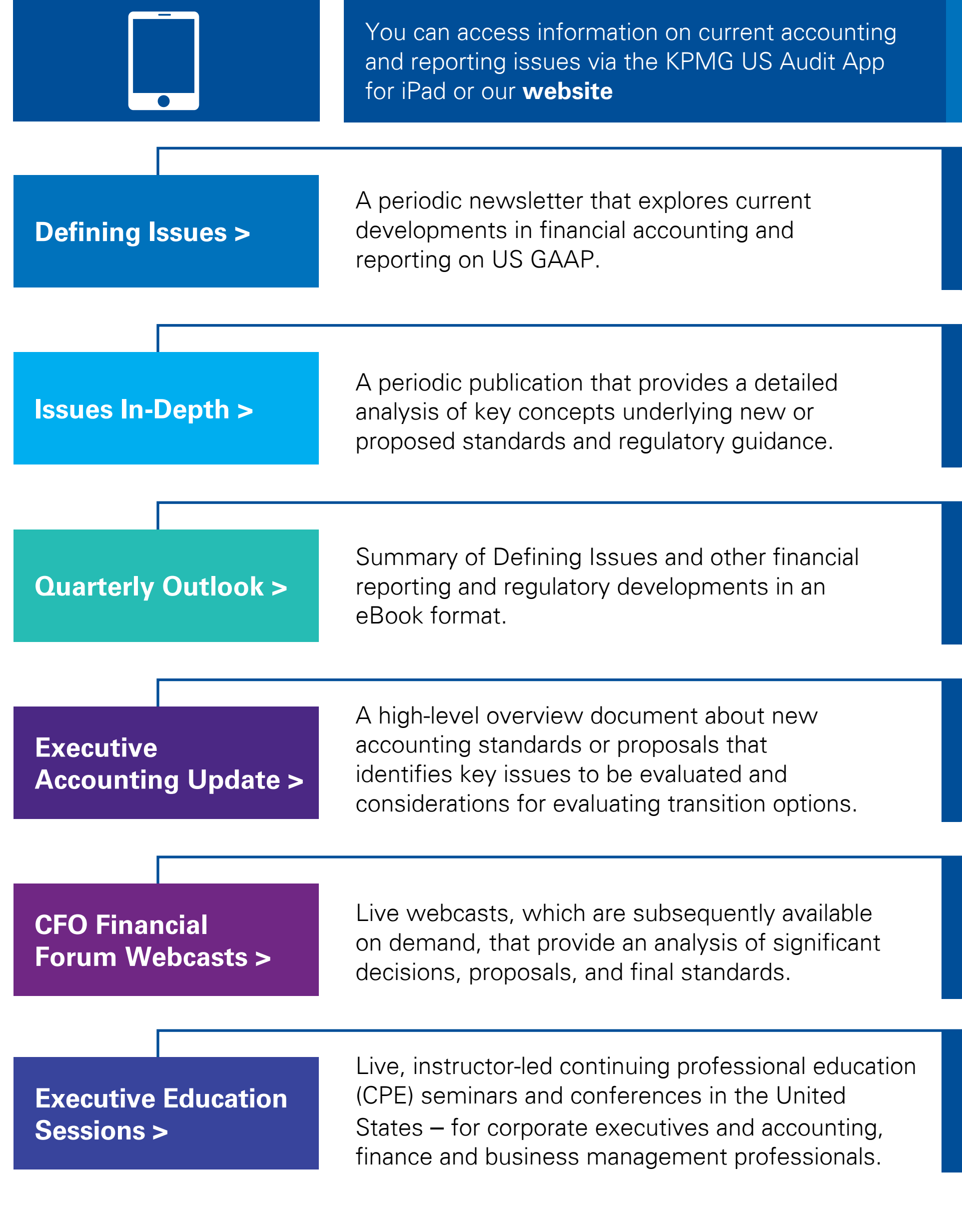

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