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# The Bottom Line on the Lease Accounting Requirements

AICPA & CIMA Staff



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By AICPA & CIMA Staff

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# Determining Whether a Contract Contains a Lease

## Learning objectives

- Determine whether an arrangement contains a lease under FASB *Accounting Standards Codification* (ASC) 842, *Leases*.
- Identify considerations with respect to substitution rights.
- Differentiate between various decision-making rights.

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# Overview

This is an overview of the FASB ASC 842 lease accounting standard and specifically how it relates to the determination of whether an arrangement contains a lease. We will discuss topics such as whether there is an identified asset, whether control is obtained over that asset, and the consideration of substitution rights and other topics such as decision-making rights. We will continue with several examples that illustrate the application of the lease accounting standard for determining whether a contract contains a lease.

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# Determining whether an arrangement contains a lease

One of the first considerations with respect to lease guidance is whether an arrangement an entity enters into is considered a lease and is within the scope of the new FASB ASC 842. Determining whether an arrangement contains a lease or another type of agreement (like a service agreement for example) is critical because there are significant differences in accounting for each type of arrangement.

## What is a lease?

FASB ASC 842 notes that at an entity should determine at the inception of a contract whether that contract is or contains a lease.[1] However, an even more fundamental question is, “What is a lease under the lease standard?” The exhibit "Lease definition”  provides the FASB ASC 842 definition of a lease.



### Exhibit: Lease definition

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.

You can see several key concepts in this definition. First, the definition refers specifically to a contract and includes mention that a lease can be viewed as being only part of contract. Second, the definition includes the term “control” within the context of the lease. Third, the definition includes mention of the fact that a lease requires an “exchange of consideration.”

FASB noted the following with respect to the determination of whether a contract contains a lease: [2]

> In most cases, the assessment of whether a contract contains a lease should be straightforward. A contract either will fail to meet the definition of a lease by failing to meet many of the requirements or will clearly meet the requirements to be a lease without requiring a significant amount of judgment. However, the board added guidance (to FASB ASC 842) to make it easier for entities to make the lease assessment for more complicated scenarios.

## Does a contract contain a lease?

Now that we have a fundamental understanding of what is considered a lease it’s important to review the steps involved in determining whether a contract is a lease or contains one. FASB has included a helpful

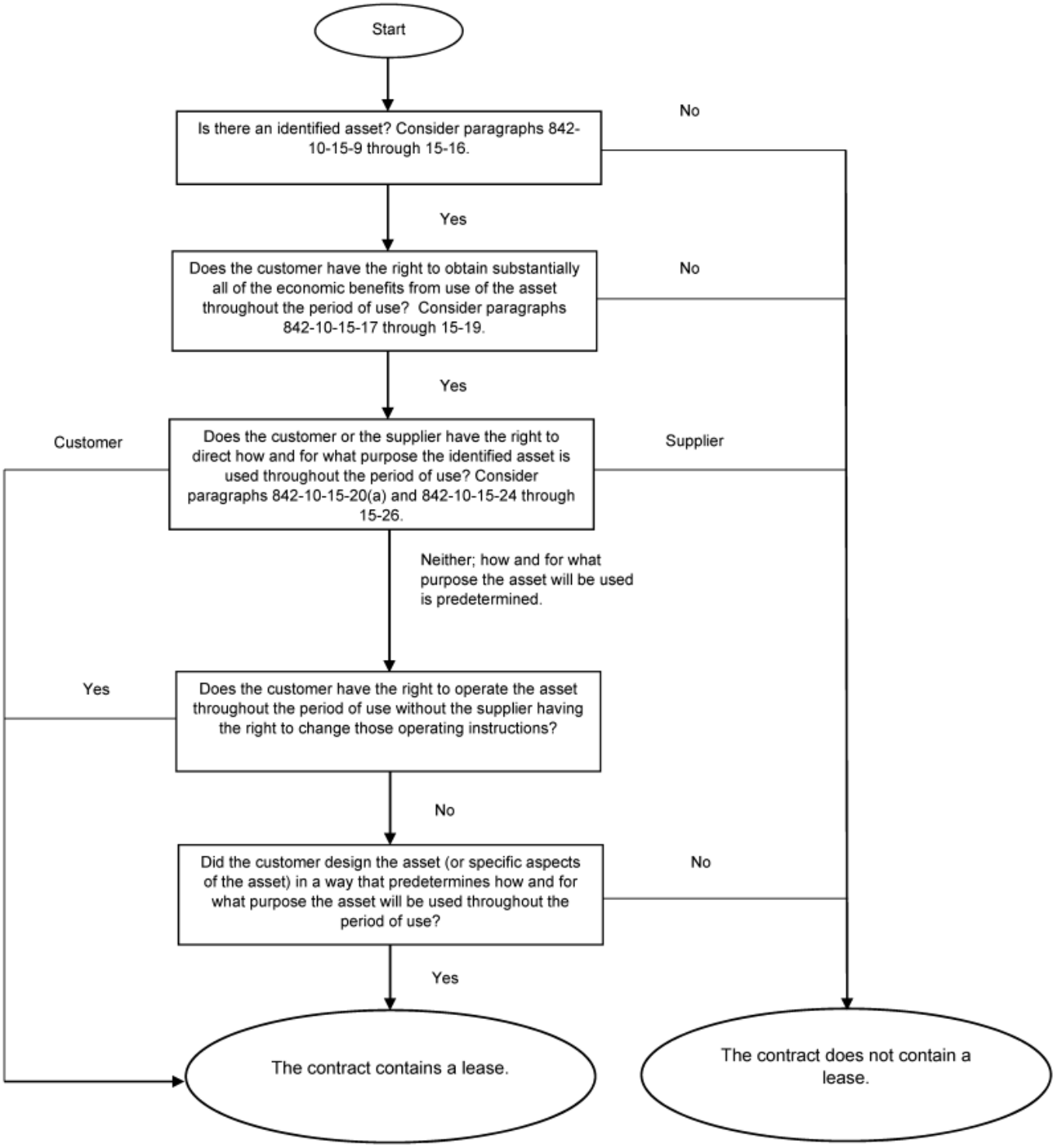
[1] FASB ASC 842-10-15-2.

[2] FASB Accounting Standards Update (ASU) No. 2016-02, section C, paragraph BC127.

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flowchart in FASB ASC 842-10-55-1 (the implementation guidance section) to help with this determination.

Identifying a lease




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## Identified asset

As you can see in the "Identifying a lease" flowchart, the first step in assessing whether a contract is a lease is to determine whether an asset has been identified. The determination of whether an asset has been identified within a contract can be made either explicitly or implicitly. In the former case, a particular asset may be identified within a contract. For example, a specific cargo ship for a transportation arrangement. However, the key point to note is that when assessing whether there is an identified asset, an entity does not necessarily have to be able to identify the particular asset in order to conclude that there is an identified asset. In other words, an entity simply needs to know whether an asset is needed to fulfill the contract from commencement to meet this first requirement.

Another significant consideration in determining whether an asset is specified within a contract relates to substitution rights. Simply put, an entity cannot conclude that it has the right to use an identified asset if the supplier has the substantive right to substitute the asset throughout the period of use.[3] Two conditions must exist within the contract for a supplier's substitution rights to be considered substantive:[4]

- The supplier has the practical ability to substitute alternative assets throughout the period of use.
- The supplier would benefit economically from the exercise of its right to substitute the asset.

The "practical ability" to substitute alternative assets mentioned in the first condition would be a situation in which a customer cannot prevent the supplier from substituting an asset. Additionally, these other assets that can be substituted in for the identified asset in the contract must be readily available. Said another way, though the supplier may have the ability to substitute an asset for the one specified in the contract, if that particular asset is so specialized or has a significant lead time for its construction, then the supplier does not have substantive substitution rights. The economic benefit mentioned in the second condition involves the supplier comparing the economic benefits of substituting the asset and determining whether these benefits would exceed the costs of performing the substitution.

The overall principle with respect to substitution rights is that they should be evaluated based on the facts and circumstances at the inception of the contract and should not consider certain future events that are not likely to occur. FASB provides examples of these future events that should not be considered:[5]

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

An additional consideration of substitution rights is how easily substitution of the asset can actually be performed. Is the asset located at the customer's premises or elsewhere? In general, the costs are higher

[3] FASB ASC 842-10-15-10.
[4] FASB ASC 842-10-15-10.
[5] FASB ASC 842-10-15-11.

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when the asset is located at the customer's premises than if it were located at the supplier's premises and in turn, are more likely to exceed the benefits associated with substituting the asset.[6]

As you can likely note from the discussion of substitution rights, the determination of whether the rights are substantive requires professional judgment. Furthermore, there may be instances in which an entity is not able to decide whether the supplier's substitution rights are substantive. FASB's basis for conclusions as documented in ASU No. 2016-02, *Leases*, notes the following:[7]

> "Stakeholders raised concerns that in some cases it would be difficult, if not impossible, for a customer to determine whether a supplier's substitution right is substantive. Difficulties may arise because the customer often does not have information about the costs of substitution that would be incurred by the supplier. Based on that feedback, the board decided to add guidance stating that if a customer cannot readily determine whether a supplier has a substantive substitution right, the customer should presume that any substitution right is not substantive."

As the "Identifying a lease" flowchart shows, failing to meet the first requirement of identifying the asset automatically results in the conclusion that the contract does not contain a lease. However, if the asset is identified either explicitly or implicitly, an entity must then decide whether the contract conveys the right to control the use of the identified asset.

## Right to control the use of the asset

After concluding that a contract involves the use of an identified asset, the next step is to determine whether an entity has the right to control the use of that asset. In the leasing standard, this assessment is twofold and comprises the consideration of both power and benefits regarding use of the asset. FASB noted that this twofold consideration is now consistent in many respects with the concept of control in FASB ASC 606, *Revenue from Contracts with Customers*, and FASB ASC 810, *Consolidations*.[8]

Under FASB ASC 842, an entity is required to not only assess the benefits received from the asset, but to also assess whether the entity can direct the use of the asset. Said another way, an entity obtains control of the asset if it has both the power to direct the use and receives substantially all the economic benefits from the use of the asset.

An entity obtaining substantially all the economic benefits of the use of the asset can be accomplished in several ways. One way would be that an entity has exclusive use of the asset throughout the period, which provides an entity with a distinct competitive advantage. This determination will generally be readily apparent to an entity.

The right to use (that is, control) is the fundamental assessment that an entity is required to consider when determining whether a contract contains a lease. If an entity determines that it has the right to direct the use of the asset, the contract is a lease. Alternatively, if an entity makes the determination

[6] FASB ASC 842-10-15-12.
[7] ASU No. 2016-02, section C, paragraph BC132.
[8] ASU No. 2016-02, section C, paragraph BC134.

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based on the facts and circumstances of the contract that the supplier has the right to direct the use of the asset, the contract is not a lease.

An entity has the right to direct the use of the asset throughout the period of use in either of the following situations:[9]

- The entity has the right to direct how and for what purpose the asset is used throughout the period of use.
- The decisions about how and for what purpose the asset will be used are predetermined and at least one of the following conditions exists:
  - The entity has the right to operate the asset (or direct others to operate) throughout the period of use without the supplier having the right to change those operating instructions.
  - The customer designed the asset (or specific aspects of it) in a way that predetermines how and for what purpose the asset will be used throughout the period of use.

FASB notes that "the decisions about how and for what purpose an asset is used are more important in determining control of the use of an asset than other decisions to be made about use, including decisions about operating and maintaining the asset."[10] The decision of "how and for what use" should generally be viewed as a single concept and should not be assessed separately. Additionally, although likely to occur only in rare cases as noted by FASB, there may be instances in which these decisions about how and for what purpose are predetermined.

Another important point to note here is that in assessing whether an entity has the right to direct the use of an asset, this assessment should consider only the rights to make decisions about the use of the asset during the period of use (unless the customer designed the asset). As a result, an entity should not consider decisions that are predetermined before the period of use.[11] FASB noted the following with respect to this consideration of predetermined rights: [12]

> "In the board's view, if a customer specifies the output from an asset at or before the beginning of the period of use (for example, within the terms of the contract) and cannot change those specifications during the period of use, it generally does not control the use of an asset. In that case, it would have no more decision-making rights than any customer in a typical supply or service contract."

*Decision-making rights* is another term that is commonly used within the leasing standard to describe power. In making the assessment of whether an entity can direct how and for what purpose an asset is used throughout the period specified in the contract, an entity should consider those decision-making rights that are most relevant.

The principle about decision-making rights is simple in terms of its assessment of power, but how does an entity make the determination that its decision-making rights are

[9] FASB ASC 842-10-15-20.
[10] ASU No. 2016-02, section C, paragraph BC137.
[11] FASB ASC 842-10-15-22.
[12] ASU No. 2016-02, section C, paragraph BC140.

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relevant when they affect the economic benefits to be derived from the use of the asset.[13] The important point to note here is that decision-making rights are very likely to be different from contract to contract and industry to industry. See the exhibit "Examples of decision-making rights" for some practical examples from FASB 842-10-15-25 of decision-making rights that would suggest that an entity has the power to direct the use of an asset.



### Exhibit: Examples of decision-making rights

**Right to change the type of output**
An example of this right is deciding whether to use a shipping container to transport goods or for storage. Another example is deciding on the mix of products sold from a retail unit.

**Right to change when the output is produced**
An example of this right is deciding when an item of machinery or a power plant will be used.

**Right to change where the output is produced**
An example of this right is deciding on the destination of a truck or ship. Another example is deciding on where a piece of furniture will be used or deployed.

**Right to change whether the output is produced**
An example of this right is deciding whether to produce energy from a power plant and specifically how much energy to produce from that power plant.

We have established a firm understanding of what a decision-making right is that supports the conclusion that an entity can direct the use of an asset. Now let's contrast this with a decision-making right that does not result in an entity concluding it has the power to direct the use of the asset. Operating and maintaining an asset is an example of this type of situation. Although rights to operate or maintain an asset often are essential to the efficient use of an asset, they are not rights to direct how and for what purpose the asset is used and often are dependent on the decisions about how and for what purpose the asset is used.[14]

[13] FASB ASC 842-10-15-24.
[14] FASB ASC 842-10-15-26.

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## Knowledge check

1. Which is a key concept included in the definition of a lease under FASB ASC 842?

    a. Protective rights.
    b. Reasonably certain.
    c. Replacement value of an identified asset.
    d. A lease requires an exchange of consideration.

2. Deciding to produce energy from a power plant and, specifically, how much energy to produce is an example of which type of decision-making right?

    a. Right to change the type of output.
    b. Right to change whether the output is produced.
    c. Right to change where the output is produced.
    d. Right to change when the output is produced.

### Illustrative examples — Does it contain a lease?

The following sections summarize and provide illustrative examples of application guidance prescribed within FASB ASC 842. These examples illustrate situations that do and do not contain a lease across various industries and different types of contracts, including the following:

- Rail cars
- Concession space
- Fiber-optic cable
- Retail unit
- Truck rental
- Ship
- Aircraft
- Contract for shirts
- Energy or power
- Network services

Though a comprehensive review of each of these examples is outside the scope of this course, we do offer examples of several of them to further solidify your understanding of applying the lease accounting standard.

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## Example: Rail cars[15]

### Case A — Contract contains a lease

A contract between Customer and a freight carrier (Supplier) provides Customer with the use of 10 rail cars of a particular type for 5 years. The contract specifies the rail cars and the cars are owned by Supplier. However, Customer determines when, where, and which goods are to be transported using the cars. When the cars are not in use, they are kept at Customer's premises and Customer can use the cars for other purposes (for example, storage) if it so chooses. However, the contract specifies that Customer cannot transport particular types of cargo (for example, explosives)

If a car needs to be serviced or repaired, Supplier is required to substitute a car of the same type. Otherwise, and other than on default by Customer, Supplier cannot retrieve the cars during the five-year period. In addition, the contract also requires Supplier to provide an engine and a driver when requested by Customer. Supplier keeps the engines at its premises and provides instructions to the driver detailing Customer's requests to transport goods. Additionally, Supplier can choose to use any one of a number of engines to fulfill each of Customer's requests, and one engine could be used to transport not only Customer's goods, but also the goods of other customers (for example, if other customers require the transport of goods to destinations close to the destination requested by Customer and within a similar timeframe, Supplier can choose to attach up to 100 rail cars to the engine).

### Lease analysis

The contract contains a lease of rail cars. There are 10 identified cars specified in the contract. Once delivered to Customer, the cars can be substituted only when they need to be serviced or repaired. The engine used to transport the rail cars is not an identified asset because it is neither explicitly specified nor implicitly specified in the contract.

Customer has the right to control the use of the 10 rail cars throughout the 5-year period of use because it has the right to obtain substantially all the economic benefits from use of the cars over the 5-year period of use. Additionally, Customer has exclusive use of the cars throughout the period of use, including when they are not being used to transport Customer's goods. Customer also has the right to direct the use of the cars. Note that the contractual restrictions on the cargo that can be transported by the cars are protective rights of the supplier and define the scope of Customer's right to use the cars. Within the scope of its right of use defined in the contract, Customer makes the relevant decisions about how and for what purpose the cars are used by being able to decide when and where the rail cars will be used and which goods are transported using the cars. Finally, Customer also determines whether and how the cars will be used when not being used to transport its goods (for

[15] FASB ASC 842-10-55-41 through 842-10-55-51.

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### Example: Rail cars (continued)

example, whether and when they will be used for storage) and has the right to change these decisions during the five-year period of use.

#### Case B — Contract does not contain a lease

The contract between Customer and Supplier requires Supplier to transport a specified quantity of goods by using a specified type of rail car in accordance with a stated timetable for a period of five years. The timetable and quantity of goods specified are equivalent to Customer having the use of 10 rail cars for five years. Supplier provides the rail cars, driver, and engine as part of the contract. The contract states the nature and quantity of the goods to be transported (and the type of rail car to be used to transport the goods).

Supplier has a large pool of similar cars that can be used to fulfill the requirements of the contract. Similarly, Supplier can choose to use any one of a number of engines to fulfill each of Customer's requests, and one engine could be used to transport not only Customer's goods, but also the goods of other customers. The cars and engines are stored at Supplier's premises when not being used to transport goods.

#### Lease analysis

The contract does not contain a lease of rail cars. The rail cars and the engines used to transport Customer's goods are not identified assets. Supplier has the substantive right to substitute the rail cars and engine because the Supplier has the practical ability to substitute each car and the engine throughout the period of use. Alternative cars and engines are readily available to Supplier, and Supplier can substitute each car and the engine without Customer's approval.

In addition, Supplier would benefit economically from substituting each car and the engine. There would be minimal, if any, cost associated with substituting each car or the engine because the cars and engines are stored at Supplier's premises and Supplier has a large pool of similar cars and engines. Supplier benefits from substituting each car or the engine in contracts of this nature because substitution allows Supplier to, for example, (1) use cars or an engine to fulfill a task for which the cars or engine are already positioned to perform (for example, a task at a rail yard close to the point of origin) or (2) use cars or an engine that would otherwise be sitting idle because they are not being used by a customer.

Accordingly, Customer does not direct the use and does not have the right to obtain substantially all the economic benefits from use of an identified car or an engine. Supplier directs the use of the rail cars and engine by selecting which cars and engine are used for each delivery and obtains substantially all the economic benefits from use of the rail cars and engine. Supplier is providing only freight capacity.

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### Example: Fiber-optic cable[16]

#### Case A — Contract contains a lease

Customer enters into a 15-year contract with a utilities company (Supplier) for the right to use three specified, physically distinct dark fibers within a larger cable connecting Hong Kong to Tokyo. Customer makes the decisions about the use of the fibers by connecting each end of the fibers to its electronic equipment (for example, Customer "lights" the fibers and decides what data and how much data those fibers will transport). If the fibers are damaged, Supplier is responsible for the repairs and maintenance. In addition, Supplier owns extra fibers but can substitute those for Customer's fibers only for reasons of repairs, maintenance, or malfunction (and is obliged to substitute the fibers in these cases).

#### Lease analysis

The contract contains a lease of fiber-optic cable. Customer has the right to control the use of the fibers throughout the 15-year period of use because Customer has the right to obtain substantially all the economic benefits from use of the fibers over the 15-year period of use. In addition, Customer has exclusive use of the fibers throughout the period of use. In addition, Customer has the right to direct the use of the fibers. For example, Customer makes the relevant decisions about how and for what purpose the fibers are used by deciding when and whether to light the fibers and when and how much output the fibers will produce (that is, what data and how much data those fibers will transport). Additionally, Customer has the right to change these decisions during the 15-year period of use.

Although Supplier's decisions about repairing and maintaining the fibers are essential to their efficient use, those decisions do not give Supplier the right to direct how and for what purpose the fibers are used. As a result, Supplier does not control the use of the fibers during the period of use.

#### Case B — Contract does not contain a lease

Customer enters into a 15-year contract with Supplier for the right to use a specified amount of capacity within a cable connecting Hong Kong to Tokyo. The specified amount is equivalent to Customer having the use of the full capacity of three strands within the cable (the cable contains 15 fibers with similar capacities). Supplier makes decisions about the transmission of data (that is, Supplier lights the fibers and makes decisions about which fibers are used to transmit Customer's traffic and about the electronic equipment that Supplier owns and connects to the fibers).

[16] FASB ASC 842-10-55-55 through 842-10-55-62.

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### Example: Fiber-optic cable (continued)

**Lease analysis**
The contract does not contain a lease of fiber-optic cable. Supplier makes all decisions about the transmission of its customers' data, which requires the use of only a portion of the capacity of the cable for each customer. The capacity portion that will be provided to Customer is not physically distinct from the remaining capacity of the cable and does not represent substantially all the capacity of the cable. Consequently, Customer does not have the right to use an identified asset.

Now that you have had a chance to work through two of the examples of application of lease determination in FASB ASC 842, see the case study "T-Shirt Manufacturer."

### Case study: T-Shirt Manufacturer[17]

Review the following facts and circumstances about T-Shirt Manufacturer and determine whether the arrangement contains a lease.

**Facts:**
Customer enters into a contract with T-Shirt Manufacturer to purchase a particular type, quality, and quantity of shirts for a three-year period, all of which are specified within an executed contract. T-Shirt Manufacturer has only one factory that can meet the needs of Customer and T-Shirt Manufacturer is unable to supply the shirts from another factory or source the shirts from a third-party supplier. Furthermore, the capacity of the factory exceeds the output for which Customer has contracted (that is, Customer has not contracted for substantially all the capacity of the factory). T-Shirt Manufacturer makes all decisions about the operations of the factory, including the production level at which to run the factory and which customer contracts to fulfill with the output of the factory that is not used to fulfill Customer's contract.

The following examples, entitled "Ship" and "Contract for energy or power," help further address the lease determination process.

[17] FASB ASC 842-10-55-100 through 842-10-55-107.

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### Example: Ship[18]

#### Case A — Contract does not contain a lease

Customer enters into a contract with a ship owner (Supplier) for the transport of cargo from Rotterdam to Sydney on a specified ship. The ship is explicitly specified in the contract, and Supplier does not have substitution rights. The cargo will occupy substantially all the capacity of the ship and the contract specifies the cargo to be transported on the ship and the dates of pickup and delivery. Supplier operates and maintains the ship and is responsible for the safe passage of the cargo onboard the ship. Customer is prohibited from hiring another operator for the ship or operating the ship itself during the term of the contract.

#### Lease analysis

The contract does not contain a lease. There is an identified asset and Supplier does not have the right to substitute. Additionally, Customer has the right to obtain substantially all the economic benefits from use of the ship over the period of use. Finally, its cargo will occupy substantially all the capacity of the ship, thereby preventing other parties from obtaining economic benefits from use of the ship.

However, Customer does not have the right to control the use of the ship because it does not have the right to direct its use. In other words, Customer does not have the right to direct how and for what purpose the ship is used. How and for what purpose the ship will be used (that is, the transport of specified cargo from Rotterdam to Sydney within a specified time frame) are predetermined in the contract. Customer has no right to change how and for what purpose the ship is used during the period of use. Additionally, Customer has no other decision-making rights about the use of the ship during the period of use (for example, it does not have the right to operate the ship) and did not design the ship. As a result, Customer has the same rights regarding the use of the ship as if it were one of multiple customers transporting cargo on the ship.

[18] FASB ASC 842-10-55-79 through 842-10-55-91.

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## Example: Ship (continued)

### Case B — Contract contains a lease

Customer enters into a contract with Supplier for the use of a specified ship for a five-year period. The ship is explicitly specified in the contract, and Supplier does not have substitution rights. Customer decides what cargo will be transported and whether, when, and to which ports the ship will sail, throughout the five-year period of use, subject to restrictions specified in the contract. Those restrictions prevent Customer from sailing the ship into waters at a high risk of piracy or carrying hazardous materials as cargo. Supplier operates and maintains the ship and is responsible for the safe passage of the cargo onboard the ship. Customer is prohibited from hiring another operator for the ship or operating the ship itself during the term of the contract.

### Lease analysis

The contract contains a lease and Customer has the right to use the ship for five years. There is an identified asset, the ship is explicitly specified in the contract, and Supplier does not have the right to substitute that specified ship. Customer has the right to control the use of the ship throughout the five-year period of use because Customer has the right to obtain substantially all the economic benefits from use of the ship over the five-year period of use and Customer has exclusive use of the ship throughout the period of use. Additionally, Customer has the right to direct the use of the ship. The contractual restrictions about where the ship can sail and the cargo to be transported by the ship define the scope of Customer's right to use the ship. They are protective rights that protect Supplier's investment in the ship and Supplier's personnel. Within the scope of its right of use, Customer makes the relevant decisions about how and for what purpose the ship is used throughout the five-year period of use because it decides whether, where, and when the ship sails, as well as the cargo it will transport. Customer has the right to change these decisions throughout the five-year period of use. Finally, although the operation and maintenance of the ship are essential to its efficient use, Supplier's decisions in this regard do not give it the right to direct how and for what purpose the ship is used. Instead, Supplier's decisions are dependent on Customer's decisions about how and for what purpose the ship is used.

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## Example: Contract for energy or power[19]

### Case A — Contract contains a lease (1st example)

A utility company (Customer) enters into a contract with a power company (Supplier) to purchase all the electricity produced by a new solar farm for 20 years. The solar farm is explicitly specified in the contract and Supplier has no substitution rights. The solar farm is owned by Supplier, and the energy cannot be provided to Customer from another asset. Customer designed the solar farm before it was constructed — Customer hired experts in solar energy to assist in determining the location of the farm and the engineering of the equipment to be used. Supplier is responsible for building the solar farm to Customer's specifications and then operating and maintaining it. There are no decisions to be made about whether, when, or how much electricity will be produced because the design of the asset has predetermined these decisions. Supplier will receive tax credits relating to the construction and ownership of the solar farm and Customer will receive renewable energy credits that accrue from use of the solar farm.

### Lease analysis

The contract contains a lease. Customer has the right to use the solar farm for 20 years and there is an identified asset because the solar farm is explicitly specified in the contract and Supplier does not have the right to substitute the specified solar farm. Additionally, Customer has the right to control the use of the solar farm throughout the 20-year period of use because Customer has the right to obtain substantially all the economic benefits from use of the solar farm over the 20-year period of use. Additionally, Customer has exclusive use of the solar farm; it takes all the electricity produced by the farm over the 20-year period of use as well as the renewable energy credits that are a by-product from use of the solar farm. Although Supplier will be receiving economic benefits from the solar farm in the form of tax credits, those economic benefits relate to the ownership of the solar farm rather than the use of the solar farm and, thus, are not considered in this assessment.

Additionally, Customer has the right to direct the use of the solar farm. Neither Customer nor Supplier decides how and for what purpose the solar farm is used during the period of use because those decisions are predetermined by the design of the asset (that is, the design of the solar farm has, in effect, programmed into the asset any relevant decision-making rights about how and for what purpose the solar farm is used throughout the period of use). Customer does not operate the solar farm; Supplier makes the decisions about the operation of the solar farm. However, Customer's design of the solar farm has given it the right to direct the use of the farm. Because the design of the solar farm has predetermined how and for what purpose the asset will be used throughout the period of use, Customer's control over that design is substantively no different from Customer controlling those decisions.

[19] FASB ASC 842-10-55-108 through 842-10-55-123.

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## Example: Contract for energy or power (continued)

### Case B — Contract contains a lease (2nd example)

Customer enters into a contract with Supplier to purchase all the power produced by an explicitly specified power plant for 10 years. The contract states that Customer has rights to all the power produced by the plant (that is, Supplier cannot use the plant to fulfill other contracts). Customer issues instructions to Supplier about the quantity and timing of the delivery of power. If the plant is not producing power for Customer, it does not operate. Supplier operates and maintains the plant daily in accordance with industry-approved operating practices.

### Lease analysis

The contract contains a lease as the Customer has the right to use the power plant for 10 years. There is an identified asset as the power plant is explicitly specified in the contract, and Supplier does not have the right to substitute the specified plant. Customer has the right to control the use of the power plant throughout the 10-year period of use because Customer has the right to obtain substantially all the economic benefits from use of the power plant over the 10-year period of use. Additionally, Customer has exclusive use of the power plant; it has rights to all the power produced by the power plant throughout the 10-year period of use.

Furthermore, Customer has the right to direct the use of the power plant. Customer makes the relevant decisions about how and for what purpose the power plant is used because it has the right to determine whether, when, and how much power the plant will produce (that is, the timing and quantity, if any, of power produced) throughout the period of use. Because Supplier is prevented from using the power plant for another purpose, Customer's decision-making about the timing and quantity of power produced, in effect, determines when and whether the plant produces output.

Although the operation and maintenance of the power plant are essential to its efficient use, Supplier's decisions in this regard do not give it the right to direct how and for what purpose the power plant is used. Consequently, Supplier does not control the use of the power plant during the period of use. Instead, Supplier's decisions are dependent on Customer's decisions about how and for what purpose the power plant is used.

### Case C — Contract does not contain a lease

Customer enters into a contract with Supplier to purchase all the power produced by an explicitly specified power plant for three years. The power plant is owned and operated by Supplier. Supplier is unable to provide power to Customer from another plant. The contract sets out the quantity and timing of power that the power plant will produce throughout the period of use, which cannot be changed in the absence of extraordinary circumstances (for example, emergency situations). Supplier operates and maintains the plant daily in

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### Example: Contract for energy or power (continued)

accordance with industry-approved operating practices. Supplier designed the power plant when it was constructed some years before entering into the contract with Customer; Customer was not involved in that design.

Lease analysis

The contract does not contain a lease. There is an identified asset because the power plant is explicitly specified in the contract and Supplier does not have the right to substitute the specified plant. Customer has the right to obtain substantially all the economic benefits from use of the identified power plant over the three-year period of use and Customer will take all the power produced by the power plant over the three-year term of the contract.

However, Customer does not have the right to control the use of the power plant because it does not have the right to direct its use. Customer does not have the right to direct how and for what purpose the plant is used. How and for what purpose the plant is used (that is, whether, when, and how much power the plant will produce) are predetermined in the contract. Customer has no right to change how and for what purpose the plant is used during the period of use, nor does it have any other decision-making rights about the use of the power plant during the period of use (for example, it does not operate the power plant) and did not design the plant. Supplier is the only party that can make decisions about the plant during the period of use by making the decisions about how the plant is operated and maintained. Customer has the same rights regarding the use of the plant as if it were one of many customers obtaining power from the plant.

Read the case study "Truck rental" and decide whether the contract contains a lease.

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### Case study: Truck rental[20]

Facts:
Customer enters into a contract with Supplier for the use of a truck for one week to transport cargo from New York to San Francisco. Supplier does not have substitution rights and only cargo specified in the contract is permitted to be transported on this truck for the period of the contract.

The contract specifies a maximum distance that the truck can be driven but Customer is able to choose the details of the journey (speed, route, rest stops, and so forth) within the parameters of the contract. Customer does not have the right to continue using the truck after the specified trip is complete and the cargo to be transported and the timing and location of pickup in New York and delivery in San Francisco are specified in the contract. Customer is responsible for driving the truck from New York to San Francisco.

As you can see, the determination of whether an arrangement contains a lease is one of the more important areas of the leasing standard.

## Knowledge check

3. Which is the first question to address when assessing whether a contract contains a lease?

    a. Does the customer have rights to operate the asset?
    b. Is there an identified asset in the contract?
    c. Did the customer design the asset?
    d. Does the customer obtain substantially all the economic benefits?

[20] FASB ASC 842-10-55-72 through 842-10-55-78.

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# Summary

Determining whether a contract contains or is a lease is an important step in initiating proper accounting for a contract. The “Identifying a lease” flowchart provides a summary of a thought process that can be helpful in making this determination. Key elements of the thought process are determining whether there is an identified asset and determining who has the right to control the use of the identified asset.

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# Solutions

## Determining Whether a Contract Contains a Lease

### Case study solutions

1. *Case study: T-Shirt Manufacturer*

The contract does not contain a lease. Although the factory is an identified asset and the factory is implicitly specified because Supplier can fulfill the contract only through the use of this asset, the 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 could decide to use the factory to fulfill other customer contracts during the period of use. The customer also does not control the use of the factory because it does not have the right to direct the use of the factory. As a result, the customer does not have the right to direct how and for what purpose the factory is used during the three-year period of use. The customer's rights are limited to specifying output from the factory in the contract with the Supplier. The customer has the same rights regarding the use of the factory as other customers purchasing shirts from the factory. The Supplier has the right to direct the use of the factory because Supplier can decide how and for what purpose the factory is used.

*2. Case study: Truck rental*

The contract contains a lease of a truck. Customer has the right to use the truck for the duration of the specified trip. There is an identified asset. The truck is explicitly specified in the contract, and Supplier does not have the right to substitute the truck. Customer has the right to control the use of the truck throughout the period of use because the customer has the right to obtain substantially all of the economic benefits from the use of the truck over the period of use and has exclusive use of the truck throughout the period of use. In addition, the customer has the right to direct the use of the truck. How and for what purpose the truck will be used (that is, the transport of specified cargo from New York to San Francisco within a specified time frame) are predetermined in the contract. Customer directs the use of the truck because it has the right to operate the truck (for example, speed, route, and rest stops) throughout the period of use. Finally, the customer makes all of the decisions about the use of the truck that can be made during the period of use through its control of the operations of the truck.

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## Knowledge check solutions

1.

a. Incorrect. Protective rights are certain conditions made by the asset supplier that can prohibit the customer from using the asset in a way that could be illegal or protects the client's interest. These do not necessarily negate a contract being a lease.

b. Incorrect. Reasonably certain is not a key concept in the definition of a lease under FASB ASC 842. The concept of being reasonably certain is a consideration in evaluating the likelihood of exercising an option to renew a lease.

c. Incorrect. Replacement value of an identified asset is a consideration undertaken by business outside the structure of a lease and is not a key concept in the definition of a lease under FASB ASC 842.

d. Correct. Under FASB ASC 842, a key concept is that a lease requires an exchange of consideration. A transaction that does not involve an exchange of consideration is not a lease.

2.

a. Incorrect. An example of the right to change the type of output is deciding whether to use a shipping container to transport goods or for storage. Deciding whether to produce energy is not an example of a right to change the output.

b. Correct. Deciding whether to produce energy from a power plant and specifically how much energy to produce is an example of a right to change whether the output is produced. This right is one of four examples of decision-making rights.

c. Incorrect. An example of the right to change the where the output is produced is deciding on where a particular piece of furniture will be used or deployed. Deciding whether to produce energy is not an example of a right to change where the output is produced.

d. Incorrect. An example of the right to change when the output is produced is deciding when an item of machinery or a power plant will be used. Deciding whether to produce energy is not an example of a right to change when the output is produced.

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3.

a. Incorrect. This would be the fourth step and is twofold and comprises the consideration of both power and benefits regarding use of the asset.
b. Correct. Determining whether there is an identified asset is the first determination to be made when determining if a contract contains a lease. It is important to note that identification of an asset within a contract can be either made explicitly or implicitly.
c. Incorrect. Determining whether the customer designed the asset is not the first determination to be made when determining if a contract contains a lease. However, this is an important consideration that must be assessed when concluding whether a contract does in fact contain a lease.
d. Incorrect. This step would be the second consideration. However, this is an important consideration that must be assessed when concluding whether a contract does in fact contain a lease.

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# Lessee Accounting

## Learning objectives

- Identify the recognition criteria for finance leases and operating leases.
- Identify the considerations around short-term leases.
- Apply the recognition and measurement requirements under FASB *Accounting Standards Codification* (ASC) 842, *Leases*.
- Recognize the impairment considerations for right-of-use assets.

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# Overview

This is an overview of the accounting for leases for lessees. We will consider what happens after a lessee has determined that an arrangement should be accounted for under FASB ASC 842; but first, we'll discuss the reasons a service contract is different than a lease.

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# Lease classification

FASB ASC 842-20 lays out the lessee accounting model and associated requirements. However, it is also important to note that both lessees and lessors must follow the requirements in FASB ASC 842-10.

## Service contracts versus leases

It is important to know that service contracts give rise to different rights and obligations compared to those of a lease contract, and as a result, are accounted for in completely different ways. Simply put, in a lease contract, the lessee continues to benefit throughout the lease term from the lessor's performance of making the associated asset subject to the lease available to the lessee. This type of continuing benefit is very similar in most respects to a license of intellectual property.

When a lessor makes available (for example, delivers) the asset to be used by the lessee, the lessor has fulfilled its obligation to transfer this right-of-use. In this situation, the lessee now controls that asset and has created an obligation to pay for that right to use the asset. As a result, a lease liability has been created by this transfer and the lessee cannot simply return the asset without breaching the contract and potentially incurring significant termination penalties. As well, the lessor cannot take back the leased asset from the lessee without a similar breach of contract. This arrangement serves as the foundation of a lease and is the reason FASB ASC 842 requires the recognition of a right-of-use asset and an associated lease liability.

In typical service contracts, on the other hand, the customer obtains economic benefits from the service only as the supplier performs the service prescribed within the contract. In other words, the supplier's performance does not continue to benefit the customer, as is the case with a lease, throughout the remaining service period. In a typical service contract, the vendor has a remaining obligation to perform until it has provided all the service to its customer. In turn, the customer typically has an obligation to pay only for the services provided to date.

As FASB deliberated the FASB ASC 842 leasing standard, there were mixed viewpoints about these distinctions, and in turn the accounting recognition, from that of service contracts as noted in the following:[1]

> For some of those Board members, the decision not to require the recognition of assets and liabilities arising from services in a contract that contains a lease was because they did not want to introduce changes to the accounting for services on a piecemeal basis in the leasing guidance (that is, only for services entered into in conjunction with a lease). In their view, changes to recognize assets and liabilities arising from arrangements for services would need to be addressed more comprehensively.

[1] ASU No. 2016-02, section C, paragraph BC43.

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## Lessee lease classification

Out with the old and in with the new (mostly). FASB ASC 840, *Leases*, the previous lease standard, prescribed two different recognition models for a lessee as many are aware. The operating lease and the much to be avoided, balance sheet recognized, capital lease. Under FASB ASC 842, no longer is a lessee able to avoid balance sheet recognition of an operating lease (except in certain cases, to be discussed shortly). The capital lease term and its associated "bright lines" are also a thing of the past. However, the concepts for that type of recognition are mostly retained in FASB ASC 842.

The biggest change in FASB ASC 842 is the fact that now a lessee must recognize both a right-of-use asset and an associated lease liability on the balance sheet for all leases (other than short-term leases for which the lessee elects the recognition and measurement exemption). But how did FASB conclude that a lessee should reflect operating leases on the balance sheet? Refer to the exhibits "FASB's view on lessee accounting and asset recognition" and "FASB's view on lessee accounting and liability recognition" for an overview of this determination, which is the justification for and foundation of the FASB ASC 842 lease accounting standard.



### Exhibit: FASB's view on lessee accounting and asset recognition

FASB Concepts Statement No. 6

"Assets are probable future economic benefits obtained or controlled by a particular entity as a result of past transactions or events."

FASB's view

In its Basis for Conclusions[2], FASB notes that a lessee's right to use the underlying asset meets the definition of an asset because of the following:

- The lessee's right-of-use permits the lessee to obtain substantially all the benefits from use of the asset during the lease term and to control others' access to the identified underlying asset through its right to control the use of the underlying asset throughout the lease term.
- The lessee's control of an asset resulting from its right-of-use is demonstrated by its ability to determine how and when it uses the underlying asset and, therefore, how it obtains future economic benefits from that right-of-use.
- The lessee's control of the right-of-use arises from a past event—the lessor's performance of making the underlying asset available for use by the lessee at the commencement date.

[2] ASU No. 2016-02, section C, paragraph BC38.

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### Exhibit: FASB's view on lessee accounting and liability recognition (continued)

FASB Concepts Statement No. 6

"Liabilities are probable future sacrifices of economic benefits arising from present obligations of a particular entity to transfer assets or provide services to other entities in the future as a result of past transactions or events."

FASB's view

In its Basis for Conclusions,[3] FASB notes that a lessee's obligation to make lease payments meets the definition of a liability based on Concepts Statement No. 6 because of the following:

- The lessee has a present obligation to make lease payments once the underlying asset has been delivered (or made available) to the lessee. In accordance with Concepts Statement No. 6, that obligation arises from a past event—the lessor's performance in delivering (or making available) the underlying asset for use by the lessee. The lessee has no contractual right to cancel the lease and avoid the contractual lease payments (or termination penalties) before the end of the lease term. In addition, unless the lessee breaches the contract, the lessor has no contractual right to take possession of, or prevent the lessee from using, the underlying asset until the end of the lease term.
- The obligation results in a future outflow of economic benefits from the lessee—typically contractual cash payments—in accordance with the terms and conditions of the contract.

Although FASB attempted initially to adopt a single framework for lease accounting with one type of lease recognition, this was problematic given that many stakeholders indicated that a single-approach lease accounting model may not best reflect the economics of all lease transactions. As a result, FASB concluded that the FASB ASC 842 lease accounting standard should have two different lease models, consistent with FASB ASC 840.

[3] ASU No. 2016-02, section C, paragraph BC34.

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## Knowledge check

1. FASB concluded that a lessee's obligation to make lease payments meets the definition of a liability based on its Concepts Statement No. 6 because

    a. The obligation results in a future cash outflow of economic benefits from the lessee.
    b. The lessee's right-of-use permits it to obtain substantially all the asset's benefits.
    c. The lessee has control over the asset to obtain future economic benefit.
    d. The lessor has a contractual right to take possession of the asset at the end of the lease term.

## The new capital lease — Finance lease

Although FASB ASC 842 is the focus of this course, it is also important to contrast the classification criteria for the former capital lease with the current classification criteria for finance leases. Based on the previous lease standard, a lease was classified as a capital lease if it met any of the following conditions:[4]

- The lease transfers ownership of the property to the lessee by the end of the lease term.
- The lease contains a bargain purchase option.
- The lease term is equal to 75% or more of the estimated economic life of the leased property.
- The present value at the beginning of the lease term of the minimum lease payments, excluding that portion of the payment representing executory costs such as insurance, maintenance, and taxes to be paid by the lessor, including any profit thereon, equals or exceeds 90%.

On a quick pass, the lease classification criteria for a finance lease presented in the exhibit "Finance lease" look to be nearly identical to those for capital leases in FASB ASC 840 as outlined previously. However, upon closer inspection, some apparent differences yield a modified approach to lease classification assessment.

[4] FASB ASC 840-10-25-1, paragraph superseded by ASU No. 2016-02.

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### Exhibit: Finance lease

**Finance lease — FASB ASC master glossary**

"From the perspective of a lessee, a lease that meets one or more of the criteria in paragraph 842-10-25-2"

**Recognition criteria**

A lessee is required to classify a lease as a finance lease when it meets any one of the following criteria:[5]

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

As noted, although several of the characteristics of the FASB ASC 840 capital lease criteria have been incorporated into the finance lease criteria, in FASB ASC 842, there are several key differences. For starters, you will note that there are no "bright lines" incorporated into the finance lease criteria. Specifically, FASB ASC 842 does not mandate or prescribe the 75% of useful life and 90% minimum lease payment threshold that many entities used to structure a contract to avoid balance sheet recognition. Instead, although these two criteria have been retained in principle, they have been replaced with more judgmental terms such as *major part of the remaining economic life* and *substantially all of the fair value of the underlying asset*.

Also worthy of mention is that FASB ASC 842 does not use the term *bargain purchase option*. Instead, this term has been replaced with terminology that implies a bargain purchase option if a lessee is reasonably certain to exercise.

Finally, you will note that FASB ASC 840 had four capital lease criteria. FASB ASC 842 finance lease criteria has retained those four and added the "specialized nature that it is expected to have no alternative use to the lessor" criterion. Refer to the exhibit "Alternative-use criterion" for discussion of this additional criterion from the implementation guidance.

[5] FASB ASC 842-10-25-2.

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### Exhibit: Alternative-use criterion[6]

In assessing whether an underlying asset has an alternative use to the lessor at the end of the lease term, an entity should consider the effects of contractual restrictions and practical limitations on the lessor's ability to readily direct that asset for another use (for example, selling it or leasing it to an entity other than the lessee).

A contractual restriction on a lessor's ability to direct an underlying asset for another use must be substantive for the asset not to have an alternative use to the lessor. A contractual restriction is substantive if it is enforceable. A practical limitation on a lessor's ability to direct an underlying asset for another use exists 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 or would only be able to sell or re-lease the asset at a significant loss.

For example, a lessor may be practically limited from redirecting assets that either have design specifications that are unique to the lessee or that are located in remote areas. The possibility of the contract with the customer being terminated is not a relevant consideration in assessing whether the lessor would be able to readily direct the underlying asset for another use.

Several noteworthy comments about the revised finance lease criteria were included in FASB's basis for conclusions in FASB ASU No. 2016-02. A sample of these comments are summarized in the exhibit "Comments from FASB's basis for conclusions."

[6] FASB ASC 842-10-55-7.

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## Exhibit: Comments from FASB's basis for conclusions

### The elimination of bright lines

"The Board observed that the bright-line classification thresholds were one of the area's most frequently criticized in previous GAAP. Those criticizing the bright-line thresholds often noted that transactions that were only immaterially different were accounted for very differently. Consequently, the Board decided that it should not mandate bright-line thresholds for the lease classification test in Topic 842.[7]

"The Board included implementation guidance in Topic 842 that states that one reasonable application of the lease classification guidance in that Topic is to conclude, consistent with previous GAAP, that 75% or greater is a 'major part' of the remaining economic life of an underlying asset, a lease term that commences within the last 25% of the economic life of the underlying asset is commencing 'at or near' the end of the economic life of the underlying asset, and that 90% or greater is 'substantially all' the fair value of the underlying asset (and that anything less than those amounts is not a major part, at or near the end of the economic life of the underlying asset, or substantially all, respectively). Although the Board acknowledges that this largely retains some, but not all, of the 'bright lines' in the lease classification test in previous GAAP, it does not mandate those bright lines."[8]

### Alignment with previous GAAP

"Despite evaluating whether the lease is economically similar to the purchase of a nonfinancial asset from the perspective of control rather than from the perspective of risks and benefits of ownership (as was the basis in previous GAAP), the classification approach in Topic 842 is substantially similar to that in previous GAAP for determining whether a lease is a capital lease or an operating lease and will be applied similarly in most circumstances."[9]

### Costs and complexity

"The Board concluded that, in the absence of a compelling rationale for any other classification approach, of which many were considered during the course of the leases project, retaining an approach that is substantially similar to that in previous GAAP will reduce the costs and complexity of applying a new leases standard."[10]

One of the key points to note relates to FASB's discussion of the elimination of the bright-line tests of FASB ASC 840. Although FASB ASC 842 does not prescribe a quantitative percentage threshold for two of the classification criteria that FASB ASC 840 did, an entity is not precluded from establishing these internally as a policy application and applying them as such. This is an important point to note as many

[7] ASU No. 2016-02, section C, paragraph BC73.
[8] ASU No. 2016-02, section C, paragraph BC73.
[9] ASU No. 2016-02, section C, paragraph BC72.
[10] ASU No. 2016-02, section C, paragraph BC72.

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who apply lease accounting standards under FASB ASC 842 will undoubtedly be left with concern about how to define terms such as *reasonably certain*, *major part*, *substantially all*, and so on.

However, before an entity excitedly jumps to establish finance lease criteria thresholds that are aligned with the numerical percentage based criteria in FASB ASC 840, note that even if an entity is able to avoid finance lease recognition, an operating lease is still going to be recorded on an entity's balance sheet. FASB preemptively addressed this apparent opportunity in its basis for conclusions:[11]

> "The Board also observed that, to some extent, criticism of the previous bright-line thresholds will likely be mitigated solely by the fact that all leases (other than short-term leases for which a lessee elects the recognition and measurement exemption) are required to be recognized on the balance sheet under Topic 842."

## The operating lease

FASB ASC 842 simply notes that if a lease is not considered a finance lease, it is an operating lease. The definition of an operating lease in the FASB ASC master glossary was changed only to account for the change from *capital lease* to *finance lease*. As a result, the definition now simply reads that an operating lease is "from the perspective of a lessee, any lease other than a finance lease."

Although the definition of the term *operating lease* was only slightly changed, from a measurement and recognition perspective, it's a whole new world, and the changes from a financial reporting perspective are dramatic, as we will discuss shortly.

## The short-term lease exception

Refer to the exhibit "Short-term lease exception" for an overview of the short-term lease definition and related accounting guidance in FASB ASC 842.



### Exhibit: Short-term lease exception

**What is a short-term lease?**

"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."[12]

**FASB ASC 842-20-25-2**

"As an accounting policy, a lessee may elect not to apply the recognition requirements in this Subtopic to short-term leases. Instead, a lessee may recognize the lease payments in profit or loss on a straight-line basis over the lease term and variable payments in the period in

[11] ASU No. 2016-02, section C, paragraph BC73.
[12] FASB ASC master glossary.

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which the obligation for those payments is incurred. The accounting policy election for short-term leases shall be made by class of underlying asset to which the right-of-use relates."

Given that the FASB ASC 842 leasing standards allow for this short-term lease exception, the obvious next question is, "What would preclude an entity from structuring all of its leases as short-term leases to circumvent the balance sheet recognition?" FASB deliberated this situation and as a result, noted the following:[13]

> The Board considered that leases could be structured to obtain short-term lease accounting. For example, a lease that ultimately extends for 10 years or more could be structured as a 1-year lease with a series of 1-year renewal options, which could result in the lease never being recognized on a lessee's statement of financial position. However, the Board concluded that there are significant economic disincentives to both parties to entering into a series of short-term leases in place of longer-term leases such that there is not a significant structuring risk throughout the system. For example, lessees may have to pay a premium rental price to compensate the lessor for its increased residual asset risk, and some lessors will be unable to enter into short-term leases depending on the terms of the financing they obtained to acquire the underlying asset.



### Example: Short-term lease illustration[14]

#### Facts

Lessee has made an accounting policy election not to recognize right-of-use assets and lease liabilities that arise from short-term leases for any class of underlying asset. Lessee enters into a 12-month lease of a vehicle, with an option to extend for another 12 months. Lessee has considered all relevant factors and determined that it is not reasonably certain to exercise the option to extend. Because at lease commencement Lessee is not reasonably certain to exercise the option to extend, the lease term is 12 months.

#### Conclusion

The lease meets the definition of a short-term lease because the lease term is 12 or fewer months. Consequently, consistent with Lessee's accounting policy election, Lessee does not recognize the right-of-use asset and the lease liability arising from this lease.

[13] ASU No. 2016-02, section C, paragraph BC381.
[14] FASB ASC 842-20-55-13 through FASB ASC 842-20-55-16.

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### Connected concepts — Related-party informal agreements

An issue that may be encountered in applying FASB ASC 842 is informal arrangements or agreements involving related parties. For example, how should an informal month-to-month arrangement for rental payments between related parties be accounted for under FASB ASC 842?

FASB ASC 842-10-55-12 states that "leases between related parties should be classified in accordance with the lease classification criteria applicable to all other leases on the basis of legally enforceable terms and conditions of the lease." Therefore, under the standard an informal month-to-month arrangement would be classified and accounted for as a short-term lease with appropriate related-party transaction disclosures. If treatment other than that is desired, the related parties should either 1) enter into a legally enforceable contract that defines the intended terms and conditions, which can then be accounted for in accordance with the standard, or 2) consider the guidance in ASU No. 2023-01, *Leases (Topic 842), Common Control Arrangements*, which is summarized as follows.

## Knowledge check

2. Criteria for classification of a lease as a finance lease under FASB ASC 842 is similar to criteria for classification of which lease accounted for under FASB ASC 840?

    a. Capital lease.
    b. Operating lease.
    c. Alternative lease.
    d. Short-term lease.

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## Common control arrangements

Amendments in ASU No. 2023-01, *Leases (Topic 842), Common Control Arrangements*, effective for fiscal years beginning after December 15, 2023, (with early adoption permitted) provide a practical expedient that private companies (those that are not a public business entity) and not-for-profit entities (those that are not conduit bond obligors) may use the written terms and conditions of a related-party arrangement between entities under common control (a common control arrangement) to determine:

1. whether a lease exists and, if so,
2. the classification of and accounting for that lease.

This practical expedient may be applied on an arrangement-by-arrangement basis. If no written terms and conditions exist (including in situations in which an entity does not document unwritten terms and conditions in writing upon transition to the practical expedient), an entity is prohibited from applying the practical expedient and must evaluate the enforceable terms and conditions to apply Topic 842.[15] Prospective or retrospective application are permitted.

The guidance in ASU No. 2023-01 was issued as a result of the FASB's Post-Implementation-Review (PIR) process, including the evaluation of issues arising during the implementation and application of FASB ASC 842.

[15] "Pending Content" in FASB ASC 842-10-15-3A and FASB ASC 842-1015-3B

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# Lease recognition and measurement

## Lease versus nonlease components

Before embarking on a discussion about how a lessee reflects the right-of-use asset and associated liability related to a lease contract, it is important to first consider situations where a lease contract has both lease and nonlease components. FASB notes that "many contracts contain both lease and nonlease (generally, but not always, service) components, such as a contract for a lease of equipment that includes maintenance services. In addition, there are contracts that contain multiple lease components, such as a lease of a port that can incorporate the lease of land, buildings, and equipment."[16]

The important point to note here is that in FASB ASC 842, the distinction between these lease and nonlease components becomes more important as these components are accounted for differently. As a result, after a lessee has made the determination that a contract contains a lease, an entity is required to identify the separate lease components within a contract and consider the right to use an underlying asset to be a separate lease component if both of the following conditions are met:[17]

- The lessee can benefit from the right-of-use either on its own or together with other resources that are readily available to the lessee.
- The right-of-use is neither highly dependent on nor highly interrelated with the other right(s) to use underlying assets in the contract.

Not all lease contracts contain multiple lease components. However, when a contract does contain more than one lease component, an entity is required to allocate consideration in the contract (for example, fixed and any other variable lease payments) to each separate lease component and nonlease component. However, the important point here is that only those items or activities that transfer a good or service to the lessee can be considered a component. Accordingly, the following are not considered lease components and should not receive an allocation of the consideration:[18]

- Administrative tasks to setup a contract or initiate the lease that do not transfer a good or service to the lessee
- Reimbursement or payment of the lessor's costs

The overall principle here is that a lessee should consider the respective components. One of these components can also be of a nonlease nature. However, in this instance, FASB permitted the use of a practical expedient as an accounting policy election by class of underlying asset for an entity to simply include the nonlease components as part of the lease components.[19] In other words, instead of going through the potential administrative burden of allocating a portion of the consideration of a contract to a nonlease component (which could be fairly immaterial in some instances), an entity is allowed to bypass this allocation and instead just account for the nonlease component as a lease component. Although

[16] ASU No. 2016-02, section C, paragraph BC143.

[17] FASB ASC 842-10-15-28.

[18] FASB ASC 842-10-15-30.

[19] FASB ASC 842-10-15-37.

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generally these practical expedients within certain accounting standards benefit entities to apply certain requirements, the use of this practical expedient would actually result in an entity recognizing additional lease liabilities on the balance sheet. FASB included the following in its basis for conclusions:[20]

> The availability of the practical expedient to a lessee is not affected by the relative size of the lease and the nonlease components. However, given that the result of electing this practical expedient is to record additional lease liabilities, the Board concluded that lessees will, in general, elect this expedient only in arrangements with less significant service components.

# Initial measurement

## Measurement of lease payments

The commencement date of a lease is the date on which a lessor makes an underlying asset available for use by a lessee.[21] Although this may be obvious, this date is important. At the commencement of a lease, an entity should first determine its total lease payments and what is and is not included in lease payments. In other words, the entity must know what its total lease payments are so that it can use this payment stream over the lease term to determine the present value of future minimum lease payments (for purposes of recording the lease liability and right-of-use asset). The following should be included in lease payments relating to an underlying asset over its lease term:[22]

- Fixed payments, or in-substance fixed payments, less any lease incentives paid or payable to lessee
- Variable lease payments that depend on an index or rate (such as the Consumer Price Index or a market interest rate), initially measured using the index or rate at the commencement date
- Exercise price of a reasonably certain option to purchase the underlying asset
- Payments for penalties for terminating the lease if the lease term reflects the lessee exercising an option to terminate the lease
- Amounts being owed under a residual value guarantee

Additionally, the following components should not be included within lease payments:[23]

- Certain other variable lease payments
- Guarantee by the lessee of the lessor's debt
- Amounts allocated to nonlease components

Examples of certain other variable lease payments that should not be included within lease payments for purposes of determining the lease liability and related right-of-use asset at the commencement date include the following:

- Real estate taxes
- Building insurance
- Increase in payments as a result of increases in index or rate since commencement date

[20] ASU No. 2016-02, section C, paragraph BC150.

[21] FASB ASC master glossary.

[22] FASB ASC 842-10-30-5.

[23] FASB ASC 842-10-30-6.

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- Lease payments determined based on a percentage of sales of lessee

The variable lease payments previously listed will be recognized and reported as variable lease costs in the statement of operations in the period in which the changes in facts and circumstances on which the variable lease payments are based occur.

## Lease term

The definition and determination of the lease term in FASB ASC 842 is critical to understand. FASB ASC 842 prescribes that a lease term should be the sum of the noncancelable period of the lease along with any periods covered by an option to extend the lease if the lessee is reasonably certain to exercise that option, as well as any periods covered by options to extend or terminate that would be controlled only by a lessor.

Finally, there are also certain instances that may occur during a lease that would require the lessee to reassess the lease term, such as the following:[24]

- A significant event or a significant change in circumstances that is within the control of the lessee directly affects whether the lessee is reasonably certain to exercise or not to exercise an option to extend or terminate the lease or to purchase the underlying asset.
- An event written into the contract obliges the lessee to exercise (or not to exercise) an option to extend or terminate the lease.
- The lessee elects to exercise an option even though the entity had previously determined that the lessee was not reasonably certain to do so.
- The lessee elects not to exercise an option even though the entity had previously determined that the lessee was reasonably certain to do so.

## Lessee reassessment of lease classification

Based on the facts and circumstances, if as a result of reassessment there is a change in lease term or the assessment of a lessee option to purchase the underlying asset, as described previously, lease classification will be reassessed by the lessee as of the date the reassessment is required.

## Early termination penalties

An additional consideration about the determination of the lease term relates to early termination penalties. Refer to the example “Termination penalties” for an illustration of how early termination penalties are considered in the lease term determination.

[24] FASB ASC 842-10-35-1.

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### Example: Termination penalties[25]

**Facts**

Lessee enters into a 10-year lease of an asset, which it can terminate at the end of each year beginning at the end of year 6. Lease payments are $50,000 per year during the 10-year term, payable at the beginning of each year. If Lessee terminates the lease at the end of year 6, Lessee must pay a penalty to Lessor of $20,000. The termination penalty decreases by $5,000 in each successive year.

At the commencement date, Lessee concludes that it is not reasonably certain it will continue to use the underlying asset after year 6, having considered both the significance of the termination penalty (in absolute terms and in relation to the remaining lease payments after the date the termination option becomes exercisable) and the other factors.

**Conclusion**

Accordingly, Lessee determines that the lease term is six years. At the commencement date, Lessee measures the lease liability on the basis of lease payments of $50,000 for six years plus the penalty of $20,000 payable at the end of year 6.

### Case study: Lease term

Review the following facts and circumstances about the lease contract and make an assessment on the total lease term for purposes of measuring the lease liability and right-of-use asset at the lease commencement date.

**Facts**

Lessee has entered into a contract with Lessor to lease a specialized piece of manufacturing equipment for use within Lessee's operations. The lease includes an initial noncancelable term of five years. During the fourth year of the lease, Lessor has the unilateral ability to extend the lease for another two years at the conclusion of the initial five-year term. In addition, Lessee is provided with two three-year options to extend the lease. However, at the commencement date, Lessee is not sure whether it will extend the lease.

[25] FASB ASC 842-10-55-235 through FASB ASC 842-10-55-238.

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## Measurement of right-of-use asset and lease liability

Once an entity has made a determination of the lease payments to be included in the calculation, the entity should now record the lease liability and corresponding right-of-use asset. The lessee is required to measure and record both of the following:[26]

- The lease liability at the present value of the lease payments not yet paid, discounted using the discount rate for the lease
- The right-of-use asset that consists of the following: 27
  - The amount of the measurement of the initial lease liability
  - Any lease payments made to the lessor at or before the commencement date, minus any lease incentives received
  - Any initial direct costs incurred by the lessee

## Discount rate

The rate that an entity uses to discount future lease payments should be the rate implicit in the lease if it is readily determinable. However, if this rate is not determinable, an entity should use its incremental borrowing rate.[28] Additionally, a lessee that is not a public business entity is permitted, as a practical expedient, to use a risk-free discount rate for a comparable lease term. The election to use the risk-free discount rate may be made for all leases, or upon election by class of underlying asset (e.g., machinery and equipment). However, the entity must always use the rate implicit in the lease if it is readily determinable. The following example provides an illustration of a portfolio approach to establishing the discount rate for a lease.



### Example: Portfolio approach to establishing the discount rate for lease[29]

Lessee, a public entity, is the parent of several consolidated subsidiaries. During the current period, two subsidiaries entered into a total of 400 individual leases of large computer servers, each with terms ranging between four and five years and annual payments ranging between $60,000 and $100,000, depending on the hardware capacity of the servers. In aggregate, total lease payments for these leases amount to $30 million.

[26] FASB ASC 842-20-30-1.
[27] FASB ASC 842-20-30-5.
[28] FASB ASC 842-20-30-3.
[29] FASB ASC 842-20-55-17 through FASB ASC 842-20-55-20.

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### Example: Portfolio approach to establishing the discount rate for lease[30] (continued)

The individual lease contracts do not provide information about the rate implicit in the lease. Lessee is Better Business Bureau credit rated and actively raises debt in the corporate bond market. Both subsidiaries are unrated and do not actively engage in treasury operations in their respective markets. On the basis of its credit rating and the collateral represented by the leased servers, Lessee's incremental borrowing rate on $60,000 through $100,000 (the range of lease payments on each of the 400 leases) would be approximately 4%. Lessee notes that five-year zero-coupon U.S. Treasury instruments are currently yielding 1.7% (a risk-free rate). Because Lessee conducts its treasury operations centrally (that is, at the consolidated group level), it is reasonably assumed that consideration of the group credit standing factored into how each lease was priced.

Lessee may determine the discount rate for the lease for the 400 individual leases entered into on different dates throughout the current period by using a portfolio approach. That is, Lessee can apply a single discount rate to the portfolio of new leases. This is because during the period, the new leases are all of similar terms (four to five years), and Lessee's credit rating and the interest rate environment are stable. Because the pricing of the lease is influenced by the credit standing and profile of Lessee rather than the subsidiaries (that is, because Lessee conducts treasury operations for the consolidated group), Lessee concludes that its incremental borrowing rate of 4% is an appropriate discount rate for each of the 400 leases entered into by Lessee's two subsidiaries during the period. Because Lessee is a public entity, it is not permitted to use a risk-free discount rate.

## Initial direct costs

Initial direct costs, by definition, are those types of costs that would not have been incurred if the lease had not been obtained. From a lessee perspective (but the same applies to a lessor), this generally represents either commissions or payments made to an existing tenant to incentivize that tenant to terminate the lease.[31] Alternatively, there are specific examples of costs within FASB ASC 842, *Leases* that are not identified as initial direct costs. These include the following (note these may either be incurred by a lessee, a lessor, or both):[32]

- General overheads such as depreciation, occupancy and equipment costs, unsuccessful origination efforts, and idle time
- Costs related to activities performed by the lessor for advertising, soliciting potential lessees, servicing existing leases, or other ancillary activities

[30] FASB ASC 842-20-55-17 through FASB ASC 842-20-55-20.
[31] FASB ASC 842-10-30-9.
[32] FASB ASC 842-10-30-10.

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- Costs related to activities that occur before the lease is obtained, such as costs of obtaining tax or legal advice, negotiating lease terms and conditions, or evaluating a prospective lessee's financial condition

The example "Initial direct costs," sourced from the implementation guidance, illustrates the application of guidance and resulting accounting recognition.



### Example: Initial direct costs[33]

#### Facts

In connection with a potential lease, a lessee incurs a total of $42,000 which is detailed as follows:

- External legal fees: $15,000
- Allocation of employee costs for time negotiating terms and conditions: $7,000
- Payments to existing tenant to obtain the lease: $20,000

#### Initial cost determination

The $20,000 payment to the existing tenant is an initial direct cost because that cost is incurred only upon obtaining the lease; it would not have been owed if the lease had not been executed. None of the other costs incurred by Lessee meet the definition of initial direct costs because they would have been incurred even if the lease had not been executed (for example, the employee salaries are paid regardless of whether the lease is obtained, and Lessee would be required to pay its attorneys for negotiating and drafting the lease even if the lease was not executed).

#### Accounting recognition

Lessee includes $20,000 of initial direct costs in the initial measurement of the right-of-use asset. Lessee amortizes those costs ratably over the lease term as part of its total lease cost. Throughout the lease term, any unamortized amounts from the original $20,000 are included in the measurement of the right-of-use asset.

[33] FASB ASC 842-10-55-239 through FASB ASC 842-10-55-242.

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## Knowledge check

3. Which time period is required to be included in the lease term when a lessee is calculating the right-of-use asset and lease liability?

    a. Any options to extend that are controlled by the lessee.
    b. Cancellable periods during which the penalty is material.
    c. Any options to extend that are controlled by the lessor.
    d. Options that a lessee is more than likely to exercise.

4. Which is an example of an initial direct cost for a lease?

    a. Payments to a tenant to incentivize that tenant to terminate an existing lease.
    b. Unsuccessful origination efforts.
    c. Tax or legal advice.
    d. Costs of negotiating lease terms and conditions.

5. Which amount is excluded from initial measurement of a right-of-use asset?

    a. Fixed payments.
    b. In-substance fixed payments.
    c. Initial direct costs incurred by the lessee.
    d. Any lease incentives payable to the lessee.

## Subsequent measurement

Recognition and measurement for both finance leases and operating leases have not significantly changed from FASB ASC 840, with one exception: operating leases greater than 12 months are reflected on an entity's balance sheet. In general, FASB decided on a cost measurement basis for the lease liability and right-of-use asset, with cost measured at the present value of the lease payments. FASB concluded that this would provide useful information to users of financial statements while minimizing costs as compared with other approaches.[34]

### Finance lease

In many ways, the right-of-use asset in a finance lease is economically similar to other nonfinancial assets. As a result, FASB ASC 842 requires that the asset be measured at cost, net of accumulated amortization, and be amortized on a straight-line basis from the commencement date to the end of the lease term. With respect to the subsequent measurement of the lease liability, an entity should recognize interest on the lease liability such that at all points during the lease, the lease liability reflects the present value of all remaining lease payments.

As a result, both the amortization of the right-of-use asset along with interest on liability is reflected in an entity's income statement. From a balance sheet perspective, the liability should be increased to reflect the interest on the lease liability and should be reduced to reflect lease payments made during the period. One important point to note here is that the total periodic expense (the sum of interest expense and

[34] ASU No. 2016-02, section C, paragraph BC187.

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amortization) will generally be higher in the earlier periods of a finance lease (think of this similar to the interest component of a home mortgage).

### Operating lease

With respect to the subsequent measurement of the lease liability, there is no difference in the requirements for an operating lease versus a finance lease. As a result, the lease liability should be adjusted such that it reflects the present value of all remaining lease payments using the discount rate applied when it was initially measured and recorded. However, the subsequent measurement for the right-of-use asset for an operating lease is different from that of the finance lease previously discussed.

After the commencement date of a lease, a lessee is required to recognize in its income statement, 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 (unless another systematic basis is more representative of the benefit pattern), variable lease payments not included in the lease liability and any impairment of the right-of-use asset.[35] More specifically, an entity subsequently measures the asset at the amount of the remeasured lease liability adjusted for the following: [36]

- Cumulative prepaid or accrued rent if the lease payments are uneven throughout the lease term
- Unamortized lease incentives
- Unamortized initial direct costs
- Any impairment of the right-of-use asset

## Illustrative examples

Before proceeding, it is important to reflect on the information presented up to this point and review how the guidance presented is actually applied to a real-world example. The example “Initial and subsequent measurement of right-of-use asset and lease liability” provides an example of the initial and subsequent measurement of the right-of-use asset and lease liability for both a finance lease and operating lease scenario. The example “Recognition and initial and subsequent measurement by a lessee in an operating lease” provides a more comprehensive example of an operating lease scenario.

[35] FASB ASC 842-20-25-6.
[36] FASB ASC 842-20-35-3.

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### Example: Initial and subsequent measurement of the right-of-use asset and the lease liability[37]

Facts

A lessee enters into a 10-year lease of an asset, with an option to extend for an additional five years. The lease payments are $50,000 per year during the initial term and $55,000 per year during the optional period, all payable at the beginning of each year. The lessee incurs initial direct costs of $15,000. At the commencement date, the lessee concludes that it is not reasonably certain to exercise the option to extend the lease and, therefore, determines the lease term to be 10 years. The rate implicit in the lease is not readily determinable. The lessee's incremental borrowing rate is 5.87%, which reflects the fixed rate at which Lessee could borrow a similar amount in the same currency, for the same term, and with similar collateral as in the lease at the commencement date. At the commencement date, the lessee makes the lease payment for the first year, incurs initial direct costs, and measures the lease liability at the present value of the remaining nine payments of $50,000, discounted at the rate of 5.87%, which is $342,017. The lessee also measures a right-of-use asset of $407,017 (the initial measurement of the lease liability plus the initial direct costs and the lease payment for the first year).

Example journal entry: Lease at commencement date

| Date | Account name | Debit | Credit |
|---|---|---|---|
| 01/01/20Y1 | Right-of-use asset | 407,017 | |
| | Lease liability | | 342,017 |
| | Cash | | 65,000 |
| To record right-of-use asset and related lease liability and cash transactions | | | |

During the first year of the lease, the lessee recognizes lease expense depending on how the lease is classified as follows.

[37] FASB ASC 842-20-55-22 through FASB ASC-20-55-30.

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## Example: Initial and subsequent measurement of the right-of-use asset and the lease liability (continued)

### Lease classified as a finance lease

The lessee depreciates its owned assets on a straight-line basis. Therefore, the right-of-use asset would be amortized on a straight-line basis over the 10-year lease term. The lease liability is increased to reflect the year 1 interest on the lease liability in accordance with the interest method. As such, in year 1 of the lease, the lessee recognizes the amortization expense of $40,702 ($407,017 ÷ 10) and the interest expense of $20,076 (5.87% × $342,017). At the end of the first year of the lease, the carrying amount of Lessee's lease liability is $362,093 ($342,017 + $20,076), and the carrying amount of the right-of-use asset is $366,315 ($407,017 – $40,702).

| Year | Amortization | ROU | Payment | Interest | Lease liability |
|---|---|---|---|---|---|
| 0 | | 407,017 | 50,000 | | 342,017 |
| 1 | 40,702 | 366,315 | | 20,076 | 362,093 |
| 2 | 40,702 | 325,613 | 50,000 | 18,320 | 330,413 |
| 3 | 40,702 | 284,911 | 50,000 | 16,460 | 296,873 |
| 4 | 40,702 | 244,209 | 50,000 | 14,491 | 261,364 |
| 5 | 40,702 | 203,507 | 50,000 | 12,407 | 223,772 |
| 6 | 40,702 | 162,805 | 50,000 | 10,200 | 183,972 |
| 7 | 40,702 | 122,103 | 50,000 | 7,864 | 141,836 |
| 8 | 40,702 | 81,401 | 50,000 | 5,391 | 97,227 |
| 9 | 40,702 | 40,702 | 50,000 | 2,772 | 50,000 |
| 10 | 40,702 | - | 50,000 | - | - |

### Example journal entry: Finance lease at end of year one

| Date | Account name | Debit | Credit |
|---|---|---|---|
| 12/31/20Y1 | Amortization of right-of-use asset | 40,702 | |
| | Interest expense | 20,076 | |
| | Accumulated amortization right-of-use asset | | 40,702 |
| | Lease liability | | 20,076 |
| To record year-one activity | | | |

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### Example: Initial and subsequent measurement of the right-of-use asset and the lease liability (continued)

**Lease classified as an operating lease**

The lessee determines the cost of the lease to be $515,000 (sum of the lease payments for the lease term and initial direct costs incurred by Lessee). The annual lease expense to be recognized is therefore $51,500 ($515,000 ÷ 10 years). At the end of the first year of the lease, the carrying amount of lessee's lease liability is $362,093 ($342,017 + $20,076), and the carrying amount of the right-of-use asset is $375,593 (the carrying amount of the lease liability plus the remaining initial direct costs, which equal $13,500).

| Year | Payment | Initial direct costs | Annual lease expense | Lease liability | Remaining initial direct costs | ROU |
|---|---|---|---|---|---|---|
| 0 | | | | $392,017 | $15,000 | $407,017 |
| 1 | 50,000 | 1,500 | 51,500 | 362,093 | 13,500 | 375,593 |
| 2 | 50,000 | 1,500 | 51,500 | 330,413 | 12,000 | 342,413 |
| 3 | 50,000 | 1,500 | 51,500 | 296,873 | 10,500 | 307,373 |
| 4 | 50,000 | 1,500 | 51,500 | 261,365 | 9,000 | 270,365 |
| 5 | 50,000 | 1,500 | 51,500 | 223,772 | 7,500 | 231,272 |
| 6 | 50,000 | 1,500 | 51,500 | 183,973 | 6,000 | 189,973 |
| 7 | 50,000 | 1,500 | 51,500 | 141,837 | 4,500 | 146,337 |
| 8 | 50,000 | 1,500 | 51,500 | 97,228 | 3,000 | 100,228 |
| 9 | 50,000 | 1,500 | 51,500 | 50,000 | 1,500 | 51,500 |
| 10 | 50,000 | 1,500 | 51,500 | - | - | - |

**Example journal entry: Operating lease at end of year one**

| Date | Account name | Debit | Credit |
|---|---|---|---|
| 12/31/20Y1 | Lease expense | 51,500 | |
| | Lease liability | | 20,076 |
| | Right-of-use asset | | 31,424 |
| To record year-one activity | | | |

In considering the two lease classification scenarios depicted in the example "Initial and subsequent measurement of the right-of-use asset and the lease liability," the determination between the two lease classifications would be made based on the expected remaining economic life of the leased asset. For example, in the lease classified as a finance lease, the expected remaining economic life of the leased asset may have been 12 years, but for the lease classified as an operating lease, the expected remaining economic life of the leased asset may have been 39 years. This example is meant to contrast the two approaches, not to imply that either classification could be used in the same situation.

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## Example: Recognition and initial and subsequent measurement by a lessee in an operating lease[38]

### Facts

A lessee enters into a 10-year lease for 5,000 square feet of office space. The annual lease payment is $10,000, paid in arrears, and increases 5% each year during the lease term. The lessee's incremental borrowing rate at lease commencement is 6%. The lessee incurs initial direct costs of $5,000.

At the commencement date, the lessee receives a $10,000 cash payment from the lessor and the lessee accounts for it as a lease incentive. The lessee measures the lease liability at the present value of the 10 remaining lease payments ($10,000 in year 1, increasing by 5% each year thereafter), discounted at the rate of 6%, which is $90,434.* The lessee also measures a right-of-use asset of $85,434 (the initial measurement of the lease liability + the initial direct costs of $5,000 – the lease incentive of $10,000).
*You can use the spreadsheet function "NPV" to calculate the lease liability.

| Year | Payments | Lease liability | ROU |
|---|---|---|---|
| | | 90,434 | 90,434<br>(10,000)<br>5,000<br>$85,434 |
| 1 | 10,000 | | |
| 2 | 10,500 | | |
| 3 | 11,025 | | |
| 4 | 11,576 | | |
| 5 | 12,155 | | |
| 6 | 12,763 | | |
| 7 | 13,401 | | |
| 8 | 14,071 | | |
| 9 | 14,775 | | |
| 10 | 15,513 | | |

### Example journal entry: Operating lease at commencement date

| Date | Account name | Debit | Credit |
|---|---|---|---|
| 01/01/20Y1 | Right-of-use asset | 85,434 | |
| | Cash | 10,000 | |
| | Lease liability | | 90,434 |
| | Cash | | 5,000 |
| To record right-of-use asset and related lease liability and gross cash activity | | | |

[38] FASB ASC 842-20-55-41 through FASB ASC 842-20-55-46.

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## Example: Recognition and initial and subsequent measurement by a lessee in an operating lease (continued)

### During the first year

The lessee determines the remaining cost of the lease as the sum of the following:

- The total lease payments of $115,779 (the sum of the 10 escalating payments to Lessor during the lease term of $125,779 minus the lease incentive paid to the lessee at the commencement date of $10,000)

The total initial direct costs attributable to the lease of $5,000

| Year | Payment |
|---|---|
| | |
| 1 | $10,000 |
| 2 | 10,500 |
| 3 | 11,025 |
| 4 | 11,576 |
| 5 | 12,155 |
| 6 | 12,763 |
| 7 | 13,401 |
| 8 | 14,071 |
| 9 | 14,775 |
| 10 | 15,513 |
| | 125,779 |
| | -10,000 |
| | 5,000 |
| | $120,779 |

The amount of the remaining lease cost is therefore $120,779 ($115,779 + $5,000). Consequently, the lessee determines that the single lease cost to be recognized every year throughout the lease term is $12,078 ($120,779 ÷ 10 years). This assumes that there are no remeasurements of the lease liability or modifications to the lease throughout the lease term.

### At the end of year 1

The carrying amount of the lease liability is $85,860 (nine remaining lease payments, discounted at the rate of 6%).

| Year | Interest 6% | Payment | Lease liability |
|---|---|---|---|
| Commence-ment | Plus | Minus | $90,434 |
| 1 | $5,426 | $10,000 | 85,860 |
| 2 | 5,151 | $10,500 | 80,511 |
| 3 | 4,831 | 11,025 | 74,317 |
| 4 | 4,459 | 11,576 | 67,200 |
| 5 | 4,032 | 12,155 | 59,077 |
| 6 | 3,545 | 12,763 | 49,859 |
| 7 | 2,992 | 13,401 | 39,450 |
| 8 | 2,367 | 14,071 | 27,746 |
| 9 | 1,665 | 14,775 | 14,636 |
| 10 | 877 | 15,513 | - |

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### Example: Recognition and initial and subsequent measurement by a lessee in an operating lease (continued)

The carrying amount of the right-of-use asset is the amount of the liability, adjusted for the following:

- Accrued lease payments of $2,578 (the amount of payments to Lessor to be recognized as part of the single lease cost each year during the lease of $12,578 [total payments to the lessor of $125,779 ÷ 10 years] minus the first year's lease payment of $10,000)
- Unamortized initial direct costs of $4,500 (gross initial direct costs of $5,000 minus amount recognized previously as part of the single lase cost of $500 [total initial direct costs of $5,000 ÷ 10 years])
- The remaining balance of the lease incentive of $9,000 (gross lease incentive of $10,000 minus amount recognized previously as part of the single lease cost of $1,000 [total lease incentives of $10,000 ÷ 10 years])

Therefore, at the end of year 1, the lessee measurer the right-of-use asset at the amount of $78,782 ($85,860 – $2,578 + $4,500 – $9,000).

| Year | Lease liability | Unamortized direct costs | Unamortized incentive | Accrued lease payments | ROU |
|---|---|---|---|---|---|
| 0 | 90,434 | 5,000 | (10,000) | | 85,434 |
| 1 | 85,860 | 4,500 | (9,000) | (2,578) | 78,782 |
| change | (4,574) | (500) | 1,000 | (2,578) | (6,652) |

Example journal entry: Operating lease at end of year one

| Date | Account name | Debit | Credit |
|---|---|---|---|
| 12/31/20Y1 | Lease expense | 12,078 | |
| | Lease liability | 4,574 | |
| | Right-of-use asset | | 6,652 |
| | Cash | | 10,000 |
| To record year-one activity including single lease payment and actual cash payment | | | |

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## Example: Recognition and initial and subsequent measurement by a lessee in an operating lease (continued)

### At the beginning of year 2

At the beginning of year 2, the lessee determines the remaining cost of the lease to be $108,701 (the total lease payments of $115,779 + the total initial direct costs of $5,000 – the single lease cost recognized in year 1 of $12,078). The single lease cost to be recognized in year 2 is still $12,078 ($108,701÷ 9 years). For the purposes of the example, only the first two years' determination of the single lease cost are shown. However, the single lease cost will be determined in the same way as in years 1 and 2 for the remainder of the lease and, in this example, will continue to equal $12,078 every period for the remainder of the lease term assuming that there are no remeasurements of the lease liability or modifications to the lease.

### At the end of year 2

At the end of year 2, the carrying amount of the lease liability is $80,511, and the carrying amount of the right-of-use asset is $71,855 (the carrying amount of the lease liability of $80,511 – the accrued lease payments of $4,656 + the unamortized initial direct costs of $4,000 – the remaining balance of the lease incentive received of $8,000). For the purposes of the example, the subsequent measurement of the lease liability and the subsequent measurement of the right-of-use asset are shown only for the first two years. However, the lessee will continue to measure the lease liability and the right-of-use asset for this lease in the same manner throughout the remainder of the lease term.

| Year | Lease liability | Unamortized direct costs | Unamortized incentive | Accrued lease payments | ROU |
|---|---|---|---|---|---|
| 0 | 90,434 | 5,000 | (10,000) | | 85,434 |
| 1 | 85,860 | 4,500 | (9,000) | (2,578) | 78,782 |
| 2 | 80,511 | 4,000 | (8,000) | (4,656) | 71,855 |

### Example journal entry: Operating lease at end of year two

| Date | Account name | Debit | Credit |
|---|---|---|---|
| 12/31/20Y2 | Lease expense | 12,078 | |
| | Lease liability | 5,349 | |
| | Right-of-use asset | | 6,927 |
| | Cash | | 10,500 |
| To record year two activity including single lease payment and actual escalating cash payment | | | |

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## Impairment considerations

FASB ASC 840 had no consideration of impairments as it related to operating leases because there was not an asset on a lessee's balance sheet to test for impairment. However, under FASB ASC 842, operating leases now require the recognition of a right-of-use asset, so this additional consideration comes into play.

FASB ASC 842 requires the lessee to apply FASB ASC 360 impairment guidance for long-lived assets to a lessee's right-of-use asset. Additionally, FASB noted the following with respect to this area:

> In the Board's view, it would be inappropriate to continue to recognize a right-of-use asset from which the lessee does not expect to derive future economic benefits (for example, a right to use a building that the lessee has abandoned) or to recognize that asset at an amount the lessee does not expect to recover. Furthermore, the Board noted that the Topic 360 model is the appropriate impairment model to apply to a lessee's right-of-use assets because there are substantial benefits for users of financial statements in having comparability in the accounting for all of an entity's long-lived nonfinancial assets (that is, because a right-of-use asset is a long-lived nonfinancial asset, there is no compelling reason that it should not be assessed for impairment consistent with the model for other long-lived nonfinancial assets).

If after applying the impairment guidance and recording an impairment loss, the right-of-use asset should be measured at its carrying value less any accumulated amortization and should continue to be amortized from the date of the impairment to the earlier of its useful life or the end of the lease term.[39]

An example of the application of this impairment situation is included in the example "Impairment of right-of-use asset."

[39] FASB ASC 842-20-35-10.

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## Example: Impairment of right-of-use asset[40]

### Facts

Lessee enters into a 10-year lease of a nonspecialized asset. Lease payments are $10,000 per year, payable in arrears and the lease does not transfer ownership of the underlying asset or grant Lessee an option to purchase the underlying asset.

At lease commencement, the remaining economic life of the underlying asset is 50 years, and the fair value of the underlying asset is $600,000. Lessee does not incur any initial direct costs as a result of the lease. Lessee's incremental borrowing rate is 7%, which reflects the fixed rate at which Lessee could borrow the amount of the lease payments in the same currency, for the same term, and with similar collateral as in the lease at commencement.

### Initial recognition

The lease is classified as an operating lease. At the commencement date, Lessee recognizes the lease liability of $70,236 (the present value of the 10 lease payments of $10,000, discounted at the rate of 7%). Lessee also recognizes a right-of-use asset of $70,236 (the initial measurement of the lease liability). Lessee determines the cost of the lease to be $100,000 (the total lease payments for the lease term). The annual lease expense to be recognized is therefore $10,000 ($100,000÷ 10 years).

### Impairment consideration

At the end of year 3, when the carrying amount of the lease liability and the right-of-use asset are both $53,893, Lessee determines that the right-of-use asset is impaired and recognizes an impairment loss of $35,000. The right-of-use asset is part of an asset group that Lessee tested for recoverability because of a significant adverse change in the business climate that affects Lessee's ability to derive benefit from the assets within the asset group. The portion of the total impairment loss for the asset group allocated to the right-of-use asset is $35,000.

| Year | Interest 7% | Payment | Lease liability |
|---|---|---|---|
| Commence-ment | Plus | Minus | $70,236 |
| 1 | $4,916 | $10,000 | 65,152 |
| 2 | 4,561 | 10,000 | 59,713 |
| 3 | 4,180 | 10,000 | 53,893 |
| 4 | 3,773 | 10,000 | 47,665 |
| 5 | 3,337 | 10,000 | 41,002 |
| 6 | 2,870 | 10,000 | 33,872 |
| 7 | 2,371 | 10,000 | 26,243 |
| 8 | 1,837 | 10,000 | 18,080 |
| 9 | 1,266 | 10,000 | 9,346 |
| 10 | 654 | 10,000 | - |

[40] FASB ASC 842-20-55-47 through FASB ASC 843-20-55-51.

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### Example: Impairment of right-of-use asset (continued)

After the impairment charge, the carrying amount of the right-of-use asset at the end of year 3 is $18,893 ($53,893 – $35,000).

Because of the impairment, the total expense recognized in year 3 is $45,000 ($10,000 in lease expense + the $35,000 impairment charge). Beginning in year 4, and for the remainder of the lease term, the single lease cost recognized by Lessee in accordance will equal the sum of

- amortization of the right-of-use asset remaining after the impairment ($18,893 ÷ 7 years = $2,699 per year); and
- accretion of the lease liability. For example, in year 4, the accretion is $3,773 ($53,893 × 7%) and, in year 5, the accretion is $3,337 ($47,665 × 7%).

At the end of year 4, the carrying amount of the lease liability is $47,665 (that is, calculated as either the present value of the remaining lease payments, discounted at 7%, or the previous balance of $53,893 – $10,000 year 4 lease payment + the $3,773 accretion of the lease liability). The carrying amount of the right-of-use asset is $16,194 (the previous balance of $18,893 – $2,699 amortization). Lessee measures the lease liability and the right-of-use asset in this manner throughout the remainder of the lease term.

| Year | Lease liability | Amortization of remaining ROU | Accretion of lease liability | Single lease cost | ROU |
|---|---|---|---|---|---|
| 3 | 53,893 | | | 10,000 | 18,893 |
| 4 | 47,665 | 2,699 | 3,773 | 6,472 | 16,194 |
| 5 | 41,002 | 2,699 | 3,337 | 6,036 | 13,495 |

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## Knowledge check

6. Which is an appropriate response for a lessee when a significant change in circumstances that is within the control of the lessee directly affects whether exercise of an option to terminate a lease is reasonably certain?

    a. Reassessment of the lease term.
    b. Reassessment of the lease classification.
    c. Allocation of the remaining cost of the lease over the remaining lease term on a straight-line basis (unless another systematic basis is more representative of the benefit pattern).
    d. Recognition of interest on the lease liability to reflect the present value of all remaining lease payments.

7. Lessees are required to follow which impairment guidance that relates to the right-of-use asset created as a result of a finance or operating lease?

    a. Goodwill.
    b. Long-lived assets.
    c. Financial Instruments.
    d. Indefinite-lived intangible assets.

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# Summary

Lessee accounting for leases involves the following:

- Distinguishing leases from service contracts
- Application of recognition criteria for finance leases
- Policy decisions regarding short-term leases
- Application of recognition and measurement concepts to finance and operating leases
- Impairment considerations for right-of-use assets

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# Solutions

## Lessee Accounting

### Case study solutions

1. *Case study: Lease term*

The total lease term is seven years. This is calculated as the five-year noncancelable term plus the two-year, lessor-controlled extension. Because the lessee is not reasonably certain it will exercise the contract extensions, these are not included in the lease term.

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## Knowledge check solutions

1.

a. Correct. The fact that the obligation results in a future outflow of economic benefits from the lessee, which is typically through a contractual cash payment, establishes an obligation and support for the lessee's lease payments meeting the definition of a liability.
b. Incorrect. The lessee's right-of-use permitting it to obtain substantially all of the asset's benefits is justification for the underlying asset meeting the definition of an asset, not a liability.
c. Incorrect. The lessee having control over the asset to obtain future economic benefit is justification for the underlying asset meeting the definition of an asset, not a liability.
d. Incorrect. The lessor having the contractual right to take possession of the asset at the end of the lease term does not relate to justification for why a lessee's lease payments meet the definition of a liability.

2.

a. Correct. The criteria for classification of a lease as a finance lease under FASB ASC 842 is similar to the capital lease classification under FASB ASC 840.
b. Incorrect. Per the FASB master glossary, an operating lease is any lease other than a finance lease.
c. Incorrect. An alternative-use criterion is not used as a criterion for classification of a lease. Instead, it is related to assessing whether an underlying asset has an alternative use to the lessor at lease term end.
d. Incorrect. Under FASB ASC 842-20-25-2, a lessee may elect not to apply the recognition requirements in this subtopic to short-term leases. Instead, a lessee may recognize the lease payments in profit or loss on a straight-line basis over the lease term and variable payments in the period in which the obligation for those payments is incurred. .

3.

a. Incorrect. Any options controlled by the lessee should not be included in the lease term. Only those option period that meet certain criteria should be included in the lease term.
b. Incorrect. Noncancelable periods, not cancellable periods, should be included in the lease term.
c. Correct. Any options that are controlled by lessor, not the lessee, should be included in the lease term.
d. Incorrect. Only options that a lessee is reasonably certain, not more than likely, to exercise should be included in the lease term.

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4.

a. Correct. Payments to an existing tenant to incentivize that tenant to terminate the current lease with a lessor is an example of an initial direct cost. Another example of an initial direct cost is commissions paid.
b. Incorrect. Unsuccessful origination efforts are specially identified within FASB ASC 842 as not being an initial direct cost. Another example of an excluded cost is depreciation and amortization.
c. Incorrect. Tax or legal advice is specially identified within FASB ASC 842 as not being an initial direct cost. Another example of an excluded cost is costs related to activities performed by the lessor for advertising and soliciting potential lessees.
d. Incorrect. Costs of negotiating lease terms and conditions is specially identified within FASB ASC 842 as not being an initial direct cost. Another example of an excluded costs is costs for evaluating a potential lessee's financial condition.

5.

a. Incorrect. Fixed payments should be included in lease payments relating to an underlying asset over its lease term.
b. Incorrect. In-substance fixed payments should be included in lease payments relating to an underlying asset over its lease term.
c. Incorrect. Initial direct costs incurred by the lessee, although not included in lease payments relating to an underlying asset over its lease term, should be included in the initial measurement of a right-of-use asset as an addition to the amount of the lease liability at present value.
d. Correct. Fixed payments, or in-substance fixed payments, excluding any lease incentives paid or payable to lessee, should be included in lease payments relating to an underlying asset over its lease term.

6.

a. Correct. FASB ASC 842 prescribes that a lease term should be the sum of the noncancelable period of the lease along with any periods covered by an option to extend the lease if the lessee is reasonably certain to exercise that option, as well as any periods covered by options to extend or terminate that would be controlled only by a lessor. In this example, the lessee would reassess the lease term.
b. Incorrect. Reassessment of the lease classification would occur after reassessment of the lease term and determination that there was a change.
c. Incorrect. This response applies to subsequent measurement of an operating lease. The effect of a change in lease term is not included in the calculation of the single lease cost.
d. Incorrect. This response applies to subsequent measurement of a finance lease. The effect of a change in lease term is not included in the calculation of interest on the lease liability to reflect the present value of all remaining lease payments.

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7.

a. Incorrect. Lessees are not required to follow impairment guidance with respect to goodwill for right-of-use assets. Goodwill is tested for impairment in accordance with FASB ASC 350.
b. Correct. Lessees are required to follow impairment guidance with respect to long-lived assets prescribed within FASB ASC 360 for right-of-use assets. If after applying the impairment guidance and recording an impairment loss, the right-of-use asset should be measured at its carrying value less any accumulated amortization and should continue to be amortized from the date of the impairment to the earlier of its useful life or the end of the lease term.
c. Incorrect. Lessees are not required to follow impairment guidance with respect to financial instruments for right-of-use assets. Financial Instruments are subject to impairment in accordance with FASB ASC 825.
d. Incorrect. Lessees are not required to follow impairment guidance with respect to indefinite-lived intangible assets for right-of-use assets. These intangible assets are tested for impairment in accordance with FASB ASC 350.

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# Lessor Accounting

## Learning objectives

- Identify the recognition criteria for sales-type, direct financing, and operating leases.
- Apply the recognition and measurement requirements for lessors under FASB *Accounting Standards Codification* (ASC) 842, *Leases*.

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# Overview

This is an overview of the accounting for leases from a lessor standpoint. Though the accounting guidance for lessors in FASB ASC 842 is largely unchanged from the previous lease guidance in FASB ASC 840, *Leases*, this overview provides a comprehensive review of the requirements.

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# Background

Based on feedback received from the two exposure drafts (EDs) as well as other outreach activities considered in the development of FASB ASC 842, FASB noted that the lessor accounting model did not need comprehensive improvements and changing the model would not be justified from a cost-benefit perspective.

## Exposure draft comments

The 2010 ED issued jointly by the International Accounting Standards Board (IASB) and FASB (the boards), proposed significant changes to guidance in FASB ASC 840. The ED proposed that, depending on the extent to that a lessor retains exposure to risks or benefits associated with the underlying asset, a lessor would be required to apply either a performance obligation approach or a derecognition approach. As a result of the proposed changes, the boards included several questions specifically related to the proposals for changes in lessor accounting. These questions are included in the following exhibit.



### Exhibit — Lessor accounting: Questions for respondents (2010 ED)

Do you agree that a lessor should apply (i) the performance obligation approach if the lessor retains exposure to significant risks or benefits associated with the underlying asset during or after the expected lease term and (ii) the derecognition approach otherwise? Why or why not? If not, what alternative approach would you propose and why?

Do you agree with the boards' proposals for the recognition of assets, liabilities, income, and expenses for the performance obligation and derecognition approaches to lessor accounting? Why or why not? If not, what alternative model would you propose and why?

Do you agree that there should be no separate approach for lessors with leveraged leases, as is currently provided for under U.S. GAAP (paragraph BC15)? If not, why not? What approach should be applied to those leases and why?

The boards received significant number of comments letters to the 2010 ED. Refer to the *Selected comment letters — ED 2010* exhibit for a selection of these responses to the proposed changes to the lessor accounting model.

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### Exhibit — Selected comment letters: ED 2010

**Comment sample 1 — PricewaterhouseCoopers**

Although we agree with the boards' aim to develop a consistent model for both lessees and lessors, we do not believe that the "hybrid approach" to lessor accounting achieves this aim. We believe that the performance obligation approach is not consistent conceptually with the proposals for lessee accounting. The derecognition approach is a better fit with the right-of-use approach but applying it to all leases would be inconsistent with boards' proposed accounting for leases and licenses of intangible assets as set out in their recent revenue ED. We agree with the boards' acknowledgment that lessee accounting is of greater concern to users than lessor accounting.

**Comment sample 2 — McDonalds**

We believe the current accounting standards for lessors provide decision useful information from the balance sheet and income statement perspective. McDonald's generates rental income based on a percentage of sales with minimum rent payments under our conventional franchise arrangements. These arrangements also require a royalty based on a percentage of sales and initial fees. Our investors and creditor clearly understand how our revenues are generated and have the ability to assess expected results over a long period of time. The proposal would have a significant impact on our reported income statement results.

After considering the feedback, the boards re-exposed the proposed changes, this time recommending a different accounting approach to different leases depending on the amount of benefit a lessee consumes of the underlying asset. Refer to the following exhibit for the specific questions related to the revised lessor accounting model.



### Exhibit — Lessor accounting: Questions for respondents (2013 ED)

Do you agree that a lessor should apply a different accounting approach to different leases, depending on whether the lessee is expected to consume more than an insignificant portion of the economic benefits embedded in the underlying asset? Why or why not? If not, what alternative approach would you propose and why?

The *Selected comment letters: ED 2013* exhibit provides follow up comment letters to the 2013 ED for the two companies in the preceding exhibit.

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## Exhibit — Selected comment letters: ED 2013

### Comment sample 1 — PricewaterhouseCoopers

In our response to the 2010 ED, we disagreed with the boards' proposals for lessor accounting. We did not believe that the 'hybrid approach' was a demonstrative improvement of current lessor accounting in accordance with IAS 17/ASC 840. We therefore proposed that lessor accounting should not be amended at that time but that it should be revisited in the future. Now that the boards propose that both lessor and lessees would apply a consistent dual model, one of our significant concerns from the 2010 no longer applied. The proposals for lessors are now little different from current accounting, except that the dividing line is in a different place. We therefore support the notion that lessees and lessors use symmetrical approaches, subject to our comments on lease classification, which are set out in our response to question 4.

### Comment sample 2 — McDonalds

We do not believe that there are issues with current accounting related to lessor accounting; therefore, the proposal does not represent an improvement over current guidance. In our business, we lease land and buildings to franchisees and receive rental payments. The proposed classification test and exception criteria may result in us reflecting some of these leases under Type A classification and some under Type B classification, even though all of the transactions are very similar. Having both types of leases in our financial statements for similar lease activities will create confusion and added complexity for users of our financial statements.

We do not believe there needs to be complete symmetry between lessee and lessor accounting approaches. The substance of the transaction should be the key indicator of the lease classification. The current operating lease accounting works wells for property lessors and provides decision useful information or users of the financial statements. If a lessor specifically prices and structures a lease as a financial investment, we recognize and agree that these leases should be classified as finance leases.

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## Where did it end up?

The final version of FASB Accounting Standards Update (ASU) No. 2016-02, *Leases (Topic 842)*, left accounting requirements for lessors largely unchanged. As a result, the vast majority of operating leases should remain classified as operating leases and lessors will continue to recognize lease income for those leases on a generally straight-line basis over the lease term.[1]

Fundamentally, leasing is a revenue-generating activity for lessors with much of FASB ASC 840 guidance being derived from FASB ASC 605, *Revenue Recognition*. FASB noted the following with respect to this linkage to the revenue recognition guidance:[2]

> Topic 842 retains alignment in key respects between the lessor accounting guidance and the revenue recognition guidance in Topic 606. For example, whether a lease is similar to a sale of the underlying asset depends on whether the lessee, in effect, obtains control of the underlying asset as a result of the lease (consistent with the transfer of control principle for a sale in Topic 606), and a lessor is precluded from recognizing selling profit or sales revenue at lease commencement for a lease that does not transfer control of the underlying asset to the lessee. Also consistent with the guidance in Topic 606, the lessor accounting model in Topic 842 does not differentiate between leases of real estate and leases of other assets.

[1] ASU No. 2016-02, section A, Summary.
[2] ASU No. 2016-02, section A, Summary.

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# Lease classification

The lessor accounting model and associated requirements are prescribed in FASB ASC 842-30, *Leases-Lessor*. Although FASB ASC 842-30 is a specific subtopic dedicated to accounting for leases from the lessor standpoint, it is important to note that both lessees and lessors must follow the requirements in FASB ASC 842-10.

## Lessor lease classification

As you recall, FASB introduced the new finance lease term to replace the former capital lease term from a lessee standpoint. From a lessor standpoint however, this is referred to as a sales-type lease as noted in the following exhibit.



### Exhibit — Sales-type lease

**FASB ASC master glossary**

Sales-type lease. From the perspective of a lessor, a lease that meets one or more of the criteria in paragraph 2 of FASB ASC 842-10-25.

**Recognition criteria**

A lessor is required to classify a lease as sales type when it meets any one of the following criteria:[3]

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

From the lessee standpoint, if a lease did not meet the requirements in the *Sales-type lease* exhibit to be considered a finance lease, it was considered to be an operating lease (assuming it was not considered a short-term lease). From the lessor's standpoint though, if a lease is not concluded to be a sales-type lease based on the criteria in the *Sales-type lease* exhibit, it is either classified as a direct financing lease or an operating lease.

[3] FASB ASC 842-10-25-2.

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When reviewing the FASB ASC master glossary for direct financing lease and operating lease, you will note that the definitions are not very helpful and simply direct the user to the relevant FASB ASC 842 paragraphs that provide the criteria. The main point to note here is that if, from a lessor's standpoint, a lease is not a sales-type lease or a direct financing lease, then it would be considered an operating lease. Herein lies the more fundamental question: what is a direct financing lease? Refer to the following exhibit for an overview of a direct financing lease.



### Exhibit — Direct financing lease

**FASB ASC master glossary**

Direct financing lease. From the perspective of a lessor, a lease that meets none of the criteria in paragraph 842-10-25-2 but meets the criteria in paragraph 842-10-25-3(b).

**Recognition criteria**

A lessor is required to classify a lease as a direct financing lease when both of the following conditions are met:[4]

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

FASB also provides the following expansive discussion as it relates to classification of a lease as a direct financing lease:[5]

> When a lease is not a sales-type lease but meets the criteria to be classified as a direct financing lease, the lease transaction effectively converts the lessor's risk arising from ownership of the underlying asset (that is, asset risk) into credit risk. Consequently, the most faithful representation of a lessor's involvement in a lease that transfers substantially all the risks and rewards incidental to ownership of the underlying asset to one or more third parties is to recognize the lessor's financial net investment in the lease and financial (interest) income on that net investment.

As was previously noted, if a lease does not meet the criteria prescribed in the *Direct financing lease* exhibit for a direct financing lease, it should be classified as an operating lease. FASB has noted that given the alignment of guidance in FASB ASC 842 with that in FASB ASC 840 from a lessor's standpoint, a "vast majority of operating leases should remain classified as operating leases, and lessors should

[4] FASB ASC 842-10-25-3(b).

[5] ASU No. 2016-02, section C, paragraph BC73.

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continue to recognize lease income for those leases on a generally straight-line basis over the lease term."[6]

## Knowledge check

1. Which category of lease from a lessor's perspective uses the same classification criteria as that of a finance lease for a lessee?

    a. Sales-type lease.
    b. Direct financing lease.
    c. Operating lease.
    d. Short-term lease.

[6] ASU No. 2016-02, section A, Summary.

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# Lease recognition and measurement

## Lease versus nonlease components

A lessor, like a lessee, is also required to perform the same allocation of consideration between lease and nonlease components. As a practical expedient, lessees may elect (by class of underlying asset) not to separate lease components from nonlease components but instead to account for a lease component and associated nonlease component as a single lease component. FASB ASC 842-10-15-42A also permits lessors to use a practical expedient, by class of underlying asset, to not separate nonlease components from the associated lease component. Instead, lessors may account for those components as a single component if the nonlease components otherwise would be accounted for under FASB ASC 606, *Revenue from Contracts with Customers*. Also, both of the following conditions must be met:

- The timing and pattern of transfer of the nonlease component(s) and associated lease component are the same.
- The lease component, if accounted for separately, would be classified as an operating lease.

If the associated nonlease component or components are predominant, an entity is required to account for the combination in accordance with FASB ASC 606. Note that the lessor's practical expedient is similar to that provided for lessees; however, the lessor's practical expedient is limited to the circumstances identified in the previous sentences.

FASB ASC 842-10-15-38 prescribes that, unless this accounting policy election is made to use the practical expedient, a lessor should allocate consideration in the contract to the separate lease components and nonlease components using the revenue recognition guidance in FASB ASC 606, along with any capitalized costs accounted for under FASB ASC 340, *Other Assets and Deferred Costs*.[7]

## Sales taxes and other similar taxes collected from lessees

A lessor may make an accounting policy election to exclude from consideration in the contract and from variable payments not included in consideration in the contract all taxes as assessed by a governmental authority that are both imposed on and concurrent with specific lease-revenue-producing transaction and collected by the lessor from the lessee (for example, sales, use, value added, and some excise taxes). Under the election, lessors exclude all collections from lessees of taxes within the scope of the election from the consideration in the contract and from variable payments not included in consideration in the contract.[8]

[7] FASB ASC 842-10-15-38.

[8] FASB ASC 842-10-15-39A.

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## Recognition at the commencement date

The commencement date of a lease is the date on which a lessor makes an underlying asset available for use by a lessee.[9] Depending on the type of lease (sales-type, direct financing, or operating), the accounting recognition requirements vary. The following sections address the recognition requirements at the commencement date for each of the three different types of leases.

### Sales-type lease

Because a sale-type lease is akin to a finance lease from a lessee's perspective in which the lessee would reflect the asset on its balance sheet, a lessor is required to derecognize the underlying asset at the commencement date of the lease.[10] However, the important point to note here is that this derecognition should happen only if collectibility of the lease payments is probable.

In addition to this derecognition (assuming collectibility of the lease payments is probable), a lessor is required to recognize each of the following:[11]

- A net investment in the lease.
- Selling profit or selling loss arising from the lease.
- Initial direct costs as an expense if, at the commencement date, the fair value of the underlying asset is different from its carrying amount. If it is the same, these costs are deferred.

Refer to the following exhibit for definitions of key terms in the preceding paragraphs.



#### Exhibit — Sales-type lease key terms

**Net investment in the lease**
The sum of the lease receivable and the unguaranteed residual asset.

**Selling profit or selling loss**
The fair value of the underlying asset or the sum of the (1) lease receivable and (2) any lease payments prepaid by the lessee (if lower), minus the carrying amount of the underlying asset net of any unguaranteed residual asset, minus any deferred initial direct costs of the lessor.

**Initial direct costs**
Incremental costs of a lease that would not have been incurred if the lease had not been obtained.

[9] FASB ASC Master Glossary.
[10] FASB ASC 842-30-25-1.
[11] FASB ASC 842-30-25-1.

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### Direct financing lease

Consistent with the treatment previously described for a sales-type lease, an entity is required to derecognize the underlying asset at the lease commencement date of a direct financing lease.[12] In addition, an entity is also required to recognize both of the following:

- A net investment in the lease
- A selling loss arising from the lease, if applicable

It's important to note the subtle distinction between the initial recognition requirements of the sales-type lease versus the direct financing lease. As you will note, the sales-type lease recognized both selling profit, if applicable, and any initial direct costs up front at the lease commencement date. This is not the case for the direct financing lease. In fact, both selling profit, if applicable, and initial direct costs are required to be deferred at the commencement date and included in the measurement of the net investment in the lease.[13]

### Operating lease

The final type of lease results in the least number of requirements at the lease commencement date. No underlying asset is derecognized, as compared to the sale-type and direct financing lease. In fact, the only recognition at the lease commencement date is the deferral of initial direct costs.[14]

## Knowledge check

2. Which term identifies the sum of the lease receivable and the unguaranteed residual asset?

    a. Selling profit or loss.
    b. Initial direct costs.
    c. Net investment in the lease.
    d. Nonlease component.

## Recognition after the commencement date and subsequent measurement

Once a lease has been initially recorded, there are certain accounting requirements for the subsequent measurement of the lease. The following paragraphs discuss the requirements and are presented according to the various types of lease contracts. Note that the measurement requirements within the scope of the following discussion are similar for both sales-type and direct financing leases.

[12] FASB ASC 842-30-25-7.
[13] FASB ASC 842-30-25-8.
[14] FASB ASC 842-30-25-10.

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## Sales-type lease and direct financing lease

### Recognition after the commencement date

Once a sales-type lease or a direct financing lease has been initially recorded and the underlying asset has been derecognized from the lessor's balance sheet, a lessor is required to recognize all of the following subsequent to that lease commencement date:[15]

- Interest income on the net investment in the lease
- Variable lease payments that are not included in the net investment in the lease as income in profit or loss in the period when the changes in facts and circumstances on which the variable lease payments are based occur. Note this excludes lessor costs paid directly to third parties; lessee reimbursed payments made directly by lessors are included in variable lease payments.
- Impairment of the net investment in the lease. Note that ASU No. 2016-13, *Financial Instruments — Credit Losses (Topic 326)*, amends FASB ASC 842-30-25-2 and FASB ASC 842-30-25-9 and pending content refers to credit losses on the net investment in the lease.

### Subsequent measurement

It is important to note that a lessor should increase the carrying amount to reflect the interest income on the net investment in the lease. In other words, a lessor should determine the interest income on the net investment in the lease in each period during the lease term as the amount that produces a constant periodic discount rate on the remaining balance of the net investment in the lease. On the flip side, the net investment in the lease should be reduced to reflect the lease payments collected during the period.[16] This recognition of interest income over the lease term, coupled with the reduction of the receivable through each recurring lease payment is similar in form to the interest expense incurred by a lessee. It's important to note the symmetry in the lessor's pattern of recognition over time with that of the lessee.

## Operating lease

### Recognition after the commencement date

The subsequent measurement for an operating lease is different compared to the sales-type and direct financing leases. For an operating lease, a lessor is required to recognize the following after the lease commencement date:[17]

- The lease payments as income in profit or loss over the lease term on a straight basis unless another systematic and rational basis is more representative of the pattern in which benefit is expected to be derived from the use of the asset (e.g., when collectibility is not probable).
- Variable lease payments as income in profit or loss in the period in which the changes in facts and circumstances on which the variable lease payments are based occur. Note this excludes lessor costs paid by lessee directly to third parties; lessee reimbursed payments made directly by lessors are included in these variable lease payments.

[15] "Pending Content" in FASB ASC 842-30-25-2 (Sales-Type) 25-9 (Direct Financing).

[16] FASB ASC 842-30-35-1.

[17] FASB ASC 842-30-25-11.

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- Initial direct costs as an expense over the lease term on the same basis as lease income.

### Lessor reassessment of lease term and purchase option

FASB ASC 842-10-35-3 clarifies that a lessor should account for a lessee's exercise of an option in the same manner as a lease modification unless the lessee's exercise of the option is consistent with the assumptions used by the lessor to account for the lease at the commencement date. For example, a lessee may exercise an option to extend a lease, purchase an underlying asset, or terminate a lease; the lessor should account for the lessee's exercise of the option in the same manner as a lease modification if the lessor previously determined that the lessee was not reasonably certain to exercise the option.

## Lease terminations

One final consideration is lease termination and the appropriate accounting treatment if a lessee returns the underlying asset before the end of the lease term. The following exhibit presents a summary of the boards' conclusions with respect to this topic.



### Exhibit — Return of underlying asset[18]

#### FASB conclusions

FASB decided that if a lessee returns the underlying asset before the end of the lease term (for example, because of a premature termination of the lease), the lessor should account for the returned asset as a reclassification of the net investment in the lease (that is, the lease receivable and the unguaranteed residual asset) and, therefore, measure the returned asset at the carrying amount of the net investment in the lease at that date.

In reaching that decision, FASB noted that the net investment in the lease would be required to be assessed for impairment immediately before the underlying asset is returned to the lessor, and that this approach is consistent with how that impairment assessment would be performed. FASB concluded, however, that a lessor should continue to recognize a receivable for any amounts that it expects to receive relating to the lease.

Accordingly, a lessor should initially measure the returned asset at the carrying amount of the net investment in the lease (after impairment), excluding any amounts that the lessor expects to receive, which the lessor will continue to recognize as a receivable.

FASB considered two alternatives to this treatment prior to issuing the final version of ASU No. 2016-2. One of the alternatives was to measure the return asset at fair value. However, FASB rejected his idea noting the following:[19]

[18] ASU No. 2016-02, section C, paragraph BC319.
[19] ASU No. 2016-02, section C, paragraph BC321.

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The Board rejected fair value because, in rare circumstances, it could potentially result in a lessor recognizing a gain from a repossession of the underlying asset. The Board noted that it is counterintuitive for a lessor to recognize a gain as a result of what most would view as an unfavorable circumstance (that is, the termination of a lease before the end of the lease term).

FASB also considered another alternative that would retrospectively measure the asset. In short, a lessor would calculate a revised rate implicit in the lease on the basis of fair value of the returned asset at the time the lease terminates prematurely. FASB rejected this proposal as well, noting in part that the approach would be complex, require the use of hindsight, would not be consistent with the way in which a lessor would assess the net investment in the lease for impairment immediately before recognition of the returned asset, and in rare circumstances, could result in a net gain from repossession.

## Illustrative examples

Let's reflect on the information presented up to this point and review how the guidance presented is actually applied to a real-world example. The first two examples that follow show a sales-type lease with differences in probability of collectibility; the third example presents a lease that if collectibility had been probable would have been classified and accounted for as a direct financing lease.



### Example — Sales-type lease: Collectibility is probable[20]

**Facts**

Lessor enters into a six-year lease of equipment with Lessee, receiving annual lease payments of $9,500, payable at the end of each year. Lessee provides a residual value guarantee of $13,000. Lessor concludes that it is probable it will collect the lease payments and any amount necessary to satisfy the residual value guarantee provided by Lessee. The equipment has a nine-year estimated remaining economic life, a carrying amount of $54,000, and a fair value of $62,000 at the commencement date. Lessor expects the residual value of the equipment to be $20,000 at the end of the six-year lease term. The lease does not transfer ownership of the underlying asset to Lessee or contain an option for Lessee to purchase the underlying asset. Lessor incurs $2,000 in initial direct costs in connection with obtaining the lease, and no amounts are prepaid by Lessee to Lessor. The rate implicit in the lease is 5.4839%.

[20] FASB ASC 842-30-55-19 through FASB ASC 842-30-55-24.

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## Example — Sales-type lease: Collectibility is probable (continued)

### Lease classification

Lessor classifies the lease as a sales-type lease because the sum of the present value of the lease payments and the present value of the residual value guaranteed by the lessee amounts to substantially all of the fair value of the equipment. None of the other criteria to be classified as a sales-type lease are met.

### Initial measurement

Lessor measures the net investment in the lease at $62,000 at lease commencement, which is equal to the fair value of the equipment. The net investment in the lease consists of the lease receivable (which includes the six annual payments of $9,500 and the residual value guarantee of $13,000, both discounted at the rate implicit in the lease, which equals $56,920) and the present value of the unguaranteed residual value (the present value of the difference between the expected residual value of $20,000 and the residual value guarantee of $13,000, which equals $5,080).

Lessor calculates the selling profit on the lease as $8,000, which is the difference between the lease receivable ($56,920) and the carrying amount of the equipment net of the unguaranteed residual asset ($54,000 – $5,080 = $48,920). The initial direct costs do not factor into the calculation of the selling profit in this example because they are not eligible for deferral. At the commencement date, Lessor derecognizes the equipment (carrying amount of $54,000) and recognizes the net investment in the lease of $62,000 and the selling profit of $8,000. Lessor also pays and recognizes the initial direct costs of $2,000 as an expense.

### Example journal entry: Sales-type lease — Collectibility is probable — At commencement date

| Date | Account name | Debit | Credit |
|---|---|---|---|
| 01/01/20Y1 | Lease receivable | 56,920 | |
| | Present value of unguaranteed residual | 5,080 | |
| | Machinery | | 54,000 |
| | Selling profit | | 8,000 |
| To record sales-type lease and derecognition of underlying asset | | | |

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## Example — Sales-type lease: Collectibility is probable (continued)

Subsequent measurement

At the end of year 1, Lessor recognizes the receipt of a lease payment of $9,500 and interest on the net investment in the lease (the beginning balance of the net investment in the lease of $62,000 × the rate implicit in the lease of 5.4839% = $3,400), resulting in a balance in the net investment of the lease of $55,900. For disclosure purposes, Lessor also calculates the separate components of the net investment in the lease: the lease receivable and the unguaranteed residual asset. The lease receivable equals $50,541 (the beginning balance of the lease receivable of $56,920 – the annual lease payment received of $9,500 + the amount of interest income on the lease receivable during year 1 of $3,121, which is $56,920 × 5.4839%). The unguaranteed residual asset equals $5,360 (the beginning balance of the unguaranteed residual asset of $5,081 + the interest income on the unguaranteed residual asset during year 1 of $279, which is $5,081 × 5.4839%).

Example journal entry: Sales-type lease — Collectibility is probable — At end of year 1

| Date | Account name | Debit | Credit |
|---|---|---|---|
| 12/31/20Y1 | Cash | 9,500 | |
| | Present value of unguaranteed residual | 279 | |
| | Interest income in net investment in lease | | 3,400 |
| | Lease receivable | | 6,379 |
| To record year 1 activity | | | |

At the end of year 6, Lessor reclassifies the net investment in the lease, then equal to the estimated residual value of the underlying asset of $20,000, as equipment.

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## Example — Sales-type lease: Collectibility is not probable[21]

### Facts

Assume the same facts and circumstances as in the *Sales-type lease: Collectibility is probable* example, except that it is not probable that the Lessor will collect the lease payments and any amount necessary to satisfy the residual value guarantee provided by Lessee. Recall that it was a six-year lease of equipment with a nine-year estimated remaining economic life for annual lease payments of $9,500, payable at the end of each year and a residual value guarantee of $13,000. The carrying amount and fair value of the equipment at the commencement date was $54,000 and $62,000, respectively. Additionally, Lessor expects the residual value of the equipment to be $20,000 at the end of the six-year lease term

### Initial measurement

Lessor does not derecognize the equipment and does not recognize a net investment in the lease or any selling profit or selling loss. However, consistent with the *Sales-type lease: Collectibility is probable* example, the Lessor pays and recognizes the initial direct costs of $2,000 as an expense at the commencement date.

**Example journal entry: Sales-type lease — Collectibility is not probable — At commencement**

| Date | Account name | Debit | Credit |
|---|---|---|---|
| 01/01/20Y1 | Lease-related commission expense | 2,000 | |
| | Cash | | 2,000 |
| To record initial direct costs | | | |

### Subsequent measurement

At the end of year 1, Lessor reassesses whether it is probable it will collect the lease payments and any amount necessary to satisfy the residual value guarantee provided by Lessee and concludes that it is not probable. In addition, neither of the events in paragraph 842-30-25-3(b) has occurred. The contract has not been terminated and Lessor has not repossessed the equipment because Lessee is fulfilling the terms of the contract. Consequently, Lessor accounts for the $9,500, year 1 lease payment as a deposit liability in accordance with paragraph 842-30-25-3. Lessor recognizes depreciation expense on the equipment of $7,714 ($54,000 carrying value ÷ seven-year useful life).

[21] FASB ASC 842-30-55-25 through FASB ASC 842-30-55-30.

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### Example — Sales-type lease: Collectibility is not probable (continued)

Lessor's accounting in years 2 and 3 is the same as in year 1. At the end of year 4, Lessee makes the fourth $9,500 annual lease payment such that the deposit liability equals $38,000. Lessor concludes that collectibility of the lease payments and any amount necessary to satisfy the residual value guarantee provided by Lessee is now probable on the basis of Lessee's payment history under the contract and the fact that Lessee has been successfully operating its business for four years. Lessor does not reassess the classification of the lease as a sales-type lease.

Consequently, at the end of year 4, Lessor derecognizes the equipment, which has a carrying amount of $23,143, and recognizes a net investment in the lease of $35,519. The net investment in the lease consists of the lease receivable (the sum of the two remaining annual payments of $9,500 and the residual value guarantee of $13,000, discounted at the rate implicit in the lease of 5.4839% determined at the commencement date, which equals $29,228) and the unguaranteed residual asset (the present value of the difference between the expected residual value of $20,000 and the residual value guarantee of $13,000, which equals $6,291). Lessor recognizes selling profit of $50,376, the difference between (*a*) the sum of the lease receivable and the carrying amount of the deposit liability ($29,228 lease receivable + $38,000 in lease payments already made = $67,228) and (*b*) the carrying amount of the equipment, net of the unguaranteed residual asset ($23,143 – $6,291 = $16,852).

After the end of year 4, Lessor accounts for the remaining two years of the lease in the same manner as any other sales-type lease. Consistent with the *Sales-type lease: Collectibility is probable* example, at the end of year 6, the Lessor reclassifies the net investment in the lease, then equal to the estimated residual value of the underlying asset of $20,000, as equipment.

**Example journal entry: Sales-type lease — Collectibility is not probable — At end of year 1**

| Date | Account name | Debit | Credit |
|---|---|---|---|
| 12/31/20Y1 | Cash | 9,500 | |
| | Depreciation expense machinery | 7,714 | |
| | Deposit liability | | 9,500 |
| | Accumulated depreciation machinery | | 7,714 |
| To record cash receipts relating to lease and underlying asset depreciation | | | |

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### Example — Sales-type lease: Collectibility is not probable (continued)

Example journal entry: Sales-type lease — Collectibility reassessed as probable — After receipt of year 4 lease payment

| Date | Account name | Debit | Credit |
|---|---|---|---|
| 12/31/20Y4 | Deposit liability | 38,000 | |
| | Lease receivable | 29,228 | |
| | Present value of unguaranteed residual | 6,291 | |
| | Accumulated depreciation machinery | 30,857 | |
| | Selling profit | | 50,376 |
| | Machinery | | 54,000 |
| Entry upon reassessment of lease as collectibility probable end of year 4 | | | |

### Example — Collectibility is not probable[22]

Facts

Lessor enters into a six-year lease of equipment with Lessee. Third party provides a residual value guarantee of $13,000. The equipment has a nine-year estimated remaining economic life, a carrying amount of $54,000, and a fair value of $62,000 at the commencement date. Lessor expects the residual value of the equipment to be $20,000 at the end of the six-year lease term. The lease does not transfer ownership of the underlying asset to Lessee or contain an option for Lessee to purchase the underlying asset. Lessor incurs $2,000 in initial direct costs in connection with obtaining the lease, and no amounts are prepaid by Lessee to Lessor. The rate implicit in the lease is 5.4839%. The collectibility of the lease payments and any amount necessary to satisfy the residual value guarantee provided by the third party is not probable and the lease payments escalate every year over the lease term. Specifically, the lease payment due at the end of year 1 is $7,000, and subsequent payments increase by $1,000 every year for the remainder of the lease term intended to result in a total of $57,000 of payments over the six years.

[22] FASB ASC 842-30-55-40 through FASB ASC 842-30-55-43.

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## Example — Collectibility is not probable (continued)

### Lease classification

Because it is not probable that Lessor will collect the lease payments and any amount necessary to satisfy the residual value guarantee provided by the third party, Lessor classifies and accounts for the lease as an operating lease. Note that, based on the facts provided, if collectibility would have been probable this arrangement would have been classified and accounted for as a direct-financing lease. An example of that type of direct-financing lease situation can be found at FASB ASC 842-30-55-31 through FASB ASC 842-30-55-39.

### Initial measurement

Lessor continues to measure the equipment in accordance with Topic 360 property, plant, and equipment. No journal entry is required on the commencement date.

### Subsequent measurement

Because collectibility of the lease payments is not probable, Lessor recognizes lease income only when Lessee makes the lease payments, and in the amount of those lease payments. Therefore, Lessor recognizes only lease income of $7,000 at the point in time Lessee makes the end of year 1 payment for that amount.

### Example journal entry: Collectibility is not probable — End of year 1

| Date | Account name | Debit | Credit |
|---|---|---|---|
| 12/31/20Y1 | Cash | 7,000 | |
| | Lease income | | 7,000 |
| To record lease income received | | | |

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### Example — Collectibility is not probable (continued)

At the end of year 2, Lessor concludes that collectibility of the remaining lease payments and any amount necessary to satisfy the residual value guarantee provided by the third party is probable; therefore, consistent with FASB ASC 842 guidance income recognition for operating leases by lessors, Lessor recognizes lease income of $12,000. The amount of $12,000 is the difference between lease income that would have been recognized through the end of year 2 ($57,000 in total lease payments ÷ six years = $9,500 per year × two years = $19,000) and the $7,000 in lease income previously recognized. Collectibility of the remaining lease payments remains probable throughout the remainder of the lease term; therefore, Lessor continues to recognize lease income of $9,500 each year, which represents the straight-line basis as is generally the case for lessor income recognition of operating leases.

Example journal entry: Collectibility is not probable — End of year 2

| Date | Account name | Debit | Credit |
|---|---|---|---|
| 12/31/20Y2 | Cash | 8,000 | |
| | Accrued lease payments receivable | 4,000 | |
| | Lease income | | 12,000 |
| To record lease income and related cash receipt | | | |

Example journal entry: Collectibility is not probable — End of year 3

| Date | Account name | Debit | Credit |
|---|---|---|---|
| 12/31/20Y3 | Cash | 9,000 | |
| | Accrued lease payments receivable | 500 | |
| | Lease income | | 9,500 |
| To record lease income and related cash receipt | | | |

Example journal entry: Collectibility is not probable — End of year 4

| Date | Account name | Debit | Credit |
|---|---|---|---|
| 12/31/20Y4 | Cash | 10,000 | |
| | Accrued lease payments receivable | | 500 |
| | Lease income | | 9,500 |
| To record lease income and related cash receipt | | | |

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### Example — Collectibility is not probable (continued)

Example journal entry: Collectibility is not probable — End of year 5

| Date | Account name | Debit | Credit |
|---|---|---|---|
| 12/31/20Y5 | Cash | 11,000 | |
| | Accrued lease payments receivable | | 1,500 |
| | Lease income | | 9,500 |
| To record lease income and related cash receipt | | | |

Example journal entry: Collectibility is not probable — End of year 6

| Date | Account name | Debit | Credit |
|---|---|---|---|
| 12/31/20Y6 | Cash | 12,000 | |
| | Accrued lease payments receivable | | 2,500 |
| | Lease income | | 9,500 |
| To record lease income and related cash receipt | | | |

The income recognition demonstrated by this example is consistent with guidance in FASB ASC 842-30-25-11 through FASB ASC 842-30-25-13.

## Knowledge check

3. If a lessee returns an underlying asset before the end of the lease term, which should the lessor use to account for the returned asset?

   a. Fair market value.
   b. The net investment in lease.
   c. Net carrying value.
   d. A retrospective measurement using a revised rate implicit in the lease.

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# Summary

Lessor accounting for leases under ASC 842 remains substantial unchanged from previous guidance. The three classifications of leases from a lessor's perspective are sales-type, direct financing, and operating leases. The initial recognition and subsequent measurement of each of these lease classifications is unique and is outlined in ASC 842.

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# Solutions

## Lessor Accounting

### Knowledge check solutions

1.

a. Correct. A sales-type lease for a lessor uses the same classification criteria prescribed for a finance lease for a lessee. This includes criteria such as transfer of ownership, purchase option that is reasonably certain to be exercised by the lessee, and so on.
b. Incorrect. A direct financing lease does not meet any of the classification criteria prescribed for a finance lease for a lessee.
c. Incorrect. An operating lease does not meet any of the conditions for the other type of lessor lease classifications. It is, in essence, the default classification for leases that do not meet certain prescribed criteria within the new lease accounting standards.
d. Incorrect. A short-term lease is not assessed using specific criteria, instead it is a lease classified based on its concluded lease term and is exempt from the accounting recognition requirements of FASB ASC 842.

2.

a. Incorrect. The selling profit or loss for a lease is the fair value of the underlying asset or the sum of the (1) lease receivable and (2) any lease payments prepaid by the lessee, if lower, minus the carrying amount of the underlying asset net of any unguaranteed residual asset, minus any deferred initial direct costs of the lessor.
b. Incorrect. Initial direct costs are incremental costs of a lease that would not have been incurred if the lease had not been obtained.
c. Correct. Net investment in the lease is the sum of the lease receivable and unguaranteed residual asset. For both sales-type and direct financing leases, a lessor is required to recognize a net investment in the lease at the commencement date.
d. Incorrect. An example of a nonlease component is administrative tasks to setup a contract or initiate a lease that do not transfer a good or service to a lessee. It is not included in the lease receivable unless an entity elects to not separate lease versus nonlease components as a practical expedient.

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3.

a. Incorrect. The lessor should not account for the return of the asset at fair market value. However, this type of measurement was considered by FASB but was rejected.
b. Correct. The lessor should account for the returned asset as a reclassification of the net investment in the lease (that is, the lease receivable and the unguaranteed residual asset) and, therefore, measure the returned asset at the carrying amount of the net investment in the lease at that date.
c. Incorrect. The lessor should not account for the return of the asset at its carrying value. Because the asset has been derecognized (assuming either a sales-type or direct financing lease), the carrying value is not known by the lessor as the asset is included on the lessee's books.
d. Incorrect. The lessor should not account for the return of the asset by performing a retrospective measurement. However, this was considered by FASB but was rejected based on, among other things, its complexity and the required use of hindsight.

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# Presentation and Disclosures Requirements

## Learning objectives

- Identify the presentation requirements for lease transactions for both lessees and lessors.
- Recognize both the qualitative and quantitative disclosure requirements for both lessees and lessors.
- Identify the approaches that may be used to adopt the accounting guidance relating to the two issues addressed by FASB ASU No. 2023-01.

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# Presentation of lease transactions

Note that because FASB elected to retain most aspects of the lessor accounting model from FASB *Accounting Standards Codification* (ASC) 840, the lessor presentation sections for each statement type are largely unchanged in FASB ASC 842.

## Statement of financial position

### Lessee

For lessees, FASB ASC 842 requires that both finance lease right-of-use (ROU) assets and operating lease ROU assets should be presented separately from other assets, either in the statement of financial position or in the notes.[1] The "FASB's views on lessee disclosures" exhibit, which follows, gives an overview of FASB's conclusions for this requirement.



#### Exhibit: FASB's views on lessee disclosures[2]

The board decided that it did not want to mandate separate presentation of each of those amounts. However, the board noted that there are differences between a right-of-use (lease) asset and other, owned nonfinancial assets and that users of financial statements may benefit from disclosure of the carrying amount of a lessee's right-of-use assets.

For example, ROU assets may be viewed as being (*a*) less risky than owned assets because an ROU asset may not embed residual asset risk or (*b*) more risky than owned assets because the lessee may need to replace the ROU asset at the end of the lease term but may not be able to secure a favorable rate for the replacement lease. Accordingly, FASB ASC 842 requires that a lessee provide information about the carrying amount of ROU assets separately, either in the statement of financial position or in the notes. Similarly, a lease liability is a unique class of liability that is linked to a corresponding asset and may have features, such as options and variable lease payments that differ from those in other liabilities. Therefore, presenting the carrying amount of the lessee's lease liabilities separately from other financial liabilities either in the statement of financial position or in the notes provides users of financial statements with information that is important to understanding the extent to which an entity uses lease arrangements and highlights the relationship between the lessee's lease liabilities and its ROU assets.

Two key points are worth emphasizing here. First, the entity has the option of either calling out these assets and liabilities separately in the statement of financial position or disclosing within the notes which

[1] FASB *Accounting Standards Codification* (ASC) 842-20-45-1.

[2] FASB Accounting Standards Update (ASU) No. 2016-02, Section C, paragraph BC262.

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line items in the statement of financial position include these assets and liabilities.[3] Second, an entity is prohibited from presenting finance lease and operating lease assets and liabilities within the same line items.[4] In other words, the entity must ensure that the presentation of a finance lease and an operating lease is distinct. FASB provided additional commentary in FASB Accounting Standards Update (ASU) No. 2016-02, *Leases (Topic 842) Section A—Leases: Amendments to the FASB Accounting Standards Codification,®* about the importance of the distinction between finance leases and operating leases, both from a ROU and lease liability perspective. See "FASB's views on lease type classification," which follows.



### Exhibit: FASB's views on lease type classification[5]

The board concluded that separate presentation or disclosure of ROU assets resulting from finance leases and ROU assets resulting from operating leases will be useful because those ROU assets are measured in a different way after the commencement date and arise from what are, in the board's view, economically different transactions. Similarly, the board decided to require the presentation or disclosure of lease liabilities arising from finance leases separately from lease liabilities arising from operating leases. Although all lease liabilities are measured in the same way, the board concluded that separate presentation or disclosure should help a user to understand the liability balance to which the lessee's lease costs, which differ in terms of recognition and presentation for finance and operating leases, relate.

In reaching this decision, the board concluded that presenting the assets and liabilities that result from these two different types of transactions in the same line item in the statement of financial position would be misleading; it would convey an economic similarity that, in the board's view, does not exist. For example, because of how operating lease obligations are generally treated in lessee bankruptcy, which is generally different from how finance lease obligations are treated in lessee bankruptcy, the board concluded that it would be inappropriate to present those two different types of liabilities in the same line on the statement of financial position. Although both types of lease liabilities are financial liabilities, finance lease liabilities are the equivalent of debt, and operating lease liabilities are not "debt like" but, rather, operating in nature.

[3] FASB ASC 842-20-45-2.
[4] FASB ASC 842-20-45-3.
[5] Paragraphs BC263–264 in ASU No. 2016-02, Section C.

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## Five examples of alternative financial statement presentations of lease-related information for a lessee

Next, let's consider five examples of financial statement presentation for a lessee. Note that there are many other presentation alternatives that may be appropriate, depending on the facts and circumstances. Following the examples is a discussion of alternatives for financial statement line items in which lease amounts may be presented.



### Example: All operating lease amounts presented on the face of the financial statements

#### Facts

A lessee entity has a material ROU asset and a related lease liability arising from operating leases. The lessee entity presents the amounts in three financial statement line items classified as both current and long term. This example assumes that the entity has operating leases only.

| Statement of Financial Position<br>[*Sample excerpt*] | |
|---|---|
| Long-term assets | |
| Operating lease right-of-use assets | $500,000 |
| | |
| Current liabilities | |
| Current portion of operating lease liabilities | $100,000 |
| Long-term liabilities | |
| Long-term operating lease liabilities | $400,000 |

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### Example: Operating lease ROU assets and related long-term operating lease liabilities amounts presented on face of the financial statements

Facts

A lessee entity has material ROU assets and related lease liabilities arising from operating leases. The lessee entity separately presents the amounts of the long-term operating lease ROU assets and long-term operating lease liabilities on the statement of financial position and discloses the amount of the current portion of the liability in the notes to the financial statements. This example assumes that the entity has operating leases only.

| Statement of Financial Position<br>***[Sample excerpt]*** | |
|---|---|
| | |
| Long-term assets | |
| Operating lease right-of-use assets | $500,000 |
| | |
| Current liabilities | |
| Other current liabilities | $600,000 |
| Long-term liabilities | |
| Long-term operating lease liabilities | $400,000 |

Notes to financial statements

Leases [excerpt only]

The current portion of operating lease liabilities of $100,000 is reported in the *Other current liabilities* line item in the statement of financial position.

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### Example: All operating lease amounts disclosed in the notes to the financial statements

**Facts**

A lessee entity has material operating lease ROU assets and related lease liabilities and chooses to disclose which line items in the statement of financial position include those ROU assets and lease liabilities, rather than present them on the face of the financial statements. No financial statement line item presentation of leases is made. This example assumes that the entity has operating leases only.

**Notes to financial statements [*Sample excerpt*]**

Leases

The following table presents balance sheet amounts and classification information related to operating leases:

| | |
|---|---|
| **Assets** | |
| Operating lease right-of-use assets included in *Other long-term assets* | $500,000 |
| **Liabilities** | |
| Operating lease liabilities included in *Other current liabilities* | $100,000 |
| Operating lease liabilities included in *Other long-term liabilities* | $400,000 |

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### Example: All operating lease amounts presented on the face of the financial statements and finance lease amounts disclosed in the notes to the financial statements

**Facts**

A lessee entity has material ROU assets and related lease liabilities arising from operating leases and separately presents the amounts in three financial statement line items classified as both current and long term. The entity also has material finance lease ROU assets and related lease liabilities; the amounts are included in other financial statement line items, which are disclosed in the notes to the financial statements. The specific class(es) of property, plant, and equipment, net that the finance lease ROU assets are included in would also be disclosed either in the lease or the property, plant and equipment note.

| Statement of Financial Position<br>[Sample excerpt] | |
|---|---|
| Long-term assets | |
| Operating lease right-of-use assets | $500,000 |
| Property, plant, and equipment, net | $4,000,000 |
| | |
| Current liabilities | |
| Current portion of operating lease liabilities | $100,000 |
| Current maturities of long-term debt and finance lease liabilities | $600,000 |
| Long-term liabilities | |
| Long-term operating lease liabilities | $400,000 |
| Long-term debt and finance lease liabilities | $3,000,000 |

**Notes to financial statements**

Leases [excerpts only]

The following table presents balance sheet amounts and classification information related to finance leases:

| | |
|---|---|
| **Assets** | |
| Finance lease right-of-use assets included in *Property, plant and equipment* | $1,500,000 |
| **Liabilities** | |
| Finance lease liabilities included in *Current maturities of long-term debt and finance lease liabilities* | $150,000 |
| Finance lease liabilities included in *Long-term debt and finance lease liabilities* | $1,350,000 |

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### Example: All operating lease and finance lease amounts disclosed in the notes to the financial statements

**Facts**

A lessee entity has material operating and finance lease ROU assets and related lease liabilities; the entity chooses to disclose the six required disclosure amounts in the notes to financial statements and identify which line items in the statement of financial position include those ROU assets and lease liabilities, rather than separately present them on the face of the financial statements. The specific class(es) of property, plant, and equipment, net that the finance lease ROU assets are included in would also be disclosed either in the lease or the property, plant, and equipment note. No financial statement line item disclosures of leases are made.

Notes to financial statements [*Sample excerpt*]

**Leases**

The following table presents balance sheet amounts and classification information related to operating and finance leases:

| | |
|---|---|
| **Assets** | |
| Operating lease right-of-use assets included in *Other long-term assets* | $500,000 |
| Finance lease right-of-use assets included in *Property, plant, and equipment, net* | $1,200,000 |
| **Liabilities** | |
| Current liabilities | |
| Operating lease liabilities included in *Other current liabilities* | $100,000 |
| Finance lease liabilities included in *Current maturities of long-term debt* | $120,000 |
| Operating lease liabilities included in *Other long-term liabilities* | $400,000 |
| Finance lease liabilities included in *Long-term debt* | $1,080,000 |

Be aware that when comparative statements of financial position are presented, these presentation alternatives would be comparative, as well.

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## Alternative financial statement line item names

There is considerable diversity in practice regarding the captions used by lessees to present the six line items required by FASB ASC 842. This conclusion is based on observation of publicly available financial statements in SEC filings and certain published studies and surveys of such filings.

The following table provides some examples of line item names (in addition to the line item names used in the preceding examples) that may be used.

### Table: Examples of line item captions

| Assets |
|---|
| Operating lease ROU assets |
| Operating lease assets |
| ROU assets — operating leases |
| Operating lease ROU assets |
| Other assets [*line item will likely include other assets as well*] |
| Other noncurrent assets [*line item will likely include other assets as well*] |
| Deferred charges and other assets [*line item will likely include other assets as well*] |
| Finance lease ROU assets |
| Finance lease assets |
| Finance lease ROU assets |
| ROU assets — finance leases |
| |
| **Liabilities** |
| Current portion of operating lease liabilities |
| Current operating lease liabilities |
| Current maturities of operating leases |
| Accrued expenses and other current liabilities [*line item will likely include other amounts as well*] |
| Other accrued expenses [*line item will likely include other items as well*] |
| Accrued and other current liabilities [*line item will likely include other items as well*] |
| Current portion of finance lease liabilities |
| Current portion of long-term debt including obligations under finance leases |
| Current installments of long-term debt [*line item will likely include other debt as well*] |
| Current portion of notes payable and other borrowings [*line item will likely include other notes payable amounts as well*] |
| Long-term debt due within one year [*line item will likely include other debt as well*] |

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| Table: Examples of line item captions (continued) |
|---|
| Long-term operating lease liabilities |
| Long-term portion of operating lease liabilities |
| Operating lease liabilities |
| Noncurrent operating leases |
| Noncurrent operating lease liabilities |
| Other liabilities [*line item will likely include other liabilities as well*] |
| Other noncurrent liabilities [*line item will likely include other liabilities as well*] |
| Other noncurrent obligations [*line item will likely include other items as well*] |
| Long-term portion of finance lease liabilities |
| Long-term debt and finance leases |
| Long-term debt including obligations under finance leases |
| Noncurrent finance lease liabilities |
| Long-term debt, excluding current installments [*line item will likely include other debt as well*] |
| Other liabilities [*line item will likely include other liability amounts as well*] |
| Other long-term liabilities [*line item will likely include other liability amounts as well*] |
| Long-term notes payable and other borrowings [*line item will likely include other notes payable amounts as well*] |

To provide a point of reference to what others are doing regarding the presentation of this information, Connor Group conducted a lease disclosure study of public company SEC filings made by companies with market caps between $500 million and $1 billion (199 companies) and identified the following trends:[6]

- 79% of entities separately presented operating lease ROU asset amounts in its own financial statement line item
- 79% of entities separately presented operating lease long-term lease liabilities amounts in its own financial statement line item
- 57% of entities separately presented operating lease short-term lease liabilities amounts in its own financial statement line item
- Less than 10% of entities presented any of the three possible finance lease related amounts in its own individual financial statement line item

[6] Connor Group, "ASC 842 | Disclosure Study, Companies with Market Cap of $500 Million to $1 Billion," August 2019. https://www.connorgp.com/resources

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## Knowledge check

1. Which amount is least likely to be reported separately on its own financial statement line item based on trends observed from SEC filings made by companies with market caps between $500 million and $1 billion?

    a. Operating leases right-of-use (ROU) assets.
    b. Operating lease long-term lease liabilities.
    c. Short-term operating lease liabilities.
    d. Finance lease ROU assets.

### Lessor

The lessor accounting presentation requirements have remained substantially the same in FASB ASC 842 as they were in FASB ASC 840. Specifically, for the statement of financial position, a lessor is required to present lease assets (sales-type leases and direct financing leases only) separately from other assets, subject to the same current versus noncurrent classification.[7]

Additionally, the lessor should present a single net investment in both sales-type and direct financing leases instead of separately presenting the respective components (for example, lease receivable, unguaranteed residual asset, and so on). See the "FASB's views on lessor lease classification" exhibit for an overview of FASB's reasoning for requiring this single net asset presentation.



#### Exhibit: FASB's views on lessor lease classification[8]

**Reason #1**

In the vast majority of sales-type and direct financing leases, the estimated residual value (whether guaranteed or unguaranteed) is realized by a sale or re-lease of the asset, and, for that reason, the residual value should be looked at as a last payment, similar to the lease payments.

[7] Paragraphs 1–2 of FASB ASC 842-30-45.
[8] ASU No. 2016-02, Section C, paragraph BC330.

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Exhibit: FASB's views on lessor lease classification (continued)

Reason #2
Combined presentation of a net investment in the lease helps to explain the rationale for discounting, and then accreting, the unguaranteed residual asset. Although the unguaranteed residual asset is defined in generally accepted accounting principes (GAAP) as a nonfinancial asset, it is, in substance, a final cash flow at the end of sales-type and direct financing leases and, therefore, is reasonably accounted for like a financial asset when part of the lessor's net investment in the lease. Conversely, it would generally not be appropriate to present the nonfinancial unguaranteed residual asset with other nonfinancial assets (for example, with property, plant, and equipment), when they are not accounted for in a similar way (that is, unless the unguaranteed residual asset is no longer accreted, which is what occurs after a sale of the lease receivable) and do not share the same economic characteristics (for example, a lessor cannot use or sell — without the lease being attached — an asset while it is the subject of a lease).

Reason #3
This presentation is consistent with the board's decision to assess impairment of the unguaranteed residual asset in a lease together with impairment of the lease receivable.

## Statement of comprehensive income

### Lessee

Under FASB ASC 842, operating leases should be included in income from continuing operations as a single lease cost.[9] This is consistent with prior guidance in FASB ASC 840.

In contrast though, an entity should present the components of a finance lease (amortization of the ROU asset and interest on the lease liability) in a manner consistent with how the entity presents depreciation and amortization of similar assets and other interest expense.[10] This type of presentation on the statement of comprehensive income is directly linked to FASB's rationale for the lessee accounting model.

### Lessor

A lessor has the option of presenting lease income (for all three different types of lease) separately or disclosing in the notes which line items in the statement include lease income.[11] The guidance in FASB ASC 842 is that a lessor should present profit or loss from leases in a manner that best reflects the

[9] FASB ASC 842-20-45-4.
[10] See footnote 9.
[11] FASB ASC 842-30-45-3.

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lessor's business model. FASB provided additional clarification on this topic in its Basis for Conclusions (BCs):[12]

> Business models vary among lessors with sales-type and direct financing leases. For example, many financial institution lessors use leasing solely as a means of providing financing to lessees. Other lessors, for example, manufacturer or dealer lessors, use leasing as an alternative means of realizing value from assets that they would otherwise sell, and also provide financing to lessees. Topic 842 permits a lessor to present profit recognized at the commencement date either gross or net to reflect its business model(s) (if the lessor has different leasing businesses). That would enable a lessor to present the effects of leases in a way that is consistent with how the lessor generates its income.

Because lessors have options for presentation, FASB provided examples for different situations in which the presentation of this profit or loss can be presented. See the following exhibit, "Lessor presentation examples."



### Exhibit: Lessor presentation examples[13]

**Example #1**
If a lessor uses leases as an alternative means of realizing value from the goods that it would otherwise sell, the lessor should present revenue and cost of goods sold relating to its leasing activities in separate line items so that income and expenses from sold and leased items are presented consistently. Revenue recognized is the lesser of the fair value of the underlying asset at the commencement date and the sum of the lease receivable and any lease payments prepaid by the lessee. Cost of goods sold is the carrying amount of the underlying asset at the commencement date minus the unguaranteed residual asset.

**Example #2**
If a lessor uses leases for the purposes of providing financing, the lessor should present the profit or loss in a single line item.

## Knowledge check

2. Under FASB ASC 842, operating leases should be included in income from continuing operations

   a. As a single lease cost.
   b. Consistent with how the entity presents depreciation and amortization of similar assets and other interest expense.
   c. In a manner that best reflects the business model.
   d. With the respective components separately presented.

[12] ASU No. 2016-02, Section C, paragraph BC334.
[13] See footnote 2.

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# Statement of cash flows

## Lessee

In general, the presentation requirements for cash outflows in the statement of cash flows are aligned to the presentation of expenses arising from a lease in the statement of comprehensive income discussed previously. The FASB BCs note that "it would be inconsistent to present payments in one manner in the statement of comprehensive income and in another manner in the statement of cash flows."[14]

The following table presents a summary of the classification guidance of cash outflows in FASB ASC 842.

Table: Presentation of lessee cash outflows[15]

| Type of cash outflow | Operating | Investing | Financing |
|---|---|---|---|
| Payments arising from operating leases | ✓ | | |
| Repayment of the principal portion of finance lease liabilities | | | ✓ |
| Interest paid on finance lease liabilities | ✓ | | |
| Payments to bring another asset to the condition and location necessary for its intended use | | ✓ | |
| Variable lease payments and short-term lease payments not included in the lease liability | ✓ | | |

## Lessor

Although the presentation of cash outflows for a lessee makes a distinction between several different transactions, the presentation requirements for cash inflows for a lessor is very simple. Whether it is a sale-type lease, a direct financing lease, or an operating lease, all cash receipts from a lease should be classified as operating activities.[16] This single presentation format for the statement of cash flows for a lessor results from the fact that leasing is generally part of the lessor's revenue-generating activities.

[14] ASU No. 2016-02, Section C, paragraph BC269.
[15] FASB ASC 842-20-45-5.
[16] Paragraphs 5–7 of FASB ASC 842-30-45.

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### Lessors within the scope of FASB ASC 942, *Financial Services — Depository and Lending*

Although FASB ASC 842 requires lessors to present cash receipts from leases within operating activities, guidance provided in FASB ASC 842-30-45-5, which refers to FASB ASC 942-230-45-4, clarifies that lessors that are depository and lending institutions within the scope of FASB ASC 942 will present all "principal payments received under leases" within investing activities. This presentation is consistent with the presentation of principal payments received on loans more generally and aligns with an illustrative example in FASB ASC 942 that predates the FASB ASC 842 leases standard.

## Knowledge check

3. Which type of cash outflows from a lessee's perspective should be classified within financing activities?

    a. Payments arising from operating leases.
    a. Payments to bring another asset to a location necessary for its intended use.
    a. Variable lease payments.
    b. Repayments of the principal portion of a finance lease liability.

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## Contrasting GAAP and IFRS 16 for Lessees

*"IFRS 16 is effective for annual reporting periods beginning on or after 1 January 2019, with earlier application permitted (as long as IFRS 15 is also applied).*

The objective of IFRS 16 is to report information that (a) faithfully represents lease transactions and (b) provides a basis for users of financial statements to assess the amount, timing and uncertainty of cash flows arising from leases. To meet that objective, a lessee should recognise assets and liabilities arising from a lease.

IFRS 16 introduces a single lessee accounting model and requires a lessee to recognise assets and liabilities for all leases with a term of more than 12 months, unless the underlying asset is of low value. A lessee is required to recognise a right-of-use asset representing its right to use the underlying leased asset and a lease liability representing its obligation to make lease payments."[17]

Before moving on to disclosures for both lessees and lessors, the following is a brief summary contrasting differences in accounting treatments by lessees between GAAP and IFRS 16, *Leases*:

- Under GAAP, lessee finance leases flow through the statement of operations as amortization of the right-of-use assets and interest expense on lease liabilities. Under IFRS 16, all leases are accounted for this way by lessees.
- Under GAAP, operating leases flow through the statement of operations as single lease costs for lessees. There is no equivalent to single lease costs under IFRS 16 for lessees.
- Statement of cash flows presentation under IFRS 16 is similar to finance lease presentation under GAAP for all leases.

[17] https://www.ifrs.org/issued-standards/list-of-standards/ifrs-16-leases/

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# Disclosure

When determining the disclosure requirements for both lessees and lessors, FASB considered the requirements of FASB ASC 840 and decisions from FASB's disclosure framework project. Under FASB ASC 842, entities should consider the level of detail necessary to satisfy the disclosure objective as well as how much emphasis to place on various requirements.[18] The objective of the disclosure requirements for both lessees and lessors is to enable users of financial statements to assess the amount, timing, and uncertainty of cash flows arising from leases.[19]

## Disclosures for both lessees and lessors

Both lessees and lessors are required to present both qualitative and quantitative information about their leases, the significant judgments made, as well as the amounts recognized in the financial statements relating to those leases.[20] In addition, both lessees and lessors should consider the level of detail necessary to satisfy disclosure objectives and appropriately aggregate and disaggregate disclosures in order to ensure the information is useful to investors.

Required disclosures that are applicable to both lessees and lessors include the following: [21]

- Information about the nature of the entity's leases to include
  - a general description of those leases;
  - the basis and terms and conditions on which variable lease payments are determined; and
  - the existence and terms and conditions of options to extend or terminate the lease
- Information about significant assumptions and judgments to include
  - the determination of whether a contract contains a lease and
  - the allocation of consideration in a contract between lease and nonlease components
- Any lease transactions between related parties[22]

## Lessee disclosures

In addition to the qualitative disclosures applicable to both lessees and lessors, the following qualitative disclosures specific to lessees, if applicable, are also required:[23]

- Narrative disclosures about the options recognized and not recognized as part of its ROU assets and lease liabilities
- Existence of any residual value guarantees along with the related terms and conditions
- Restrictions or covenants imposed by leases
- Significant leases that have not yet commenced to include any construction or design involvement

[18] ASU No. 2016-02, Section C, paragraph BC274.
[19] FASB ASC 842-20-50-1 and 842-30-50-1.
[20] See footnote 18.
[21] FASB ASC 842-20-50-3 and 842-30-50-3.
[22] FASB ASC 842-20-50-7 and 842-30-50-4.
[23] FASB ASC 842-20-50-3 and FASB ASC 842-20-50-9.

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- Determination of the discount rate
- Election of the practical expedient for not separating lease components from nonlease components

In addition to the qualitative disclosures discussed previously, FASB ASC 842 requires lessees to present the following quantitative disclosures, if applicable:[24]

- Finance lease cost, segregated between amortization of the ROU assets and interest on the lease liabilities
- Operating lease cost
- Short-term lease cost, excluding expenses relating to leases with a lease term of one month or less
- Variable lease cost
- Sublease income, disclosed on a gross basis, separate from finance or operating lease expense
- Net gain or loss recognized on sale and leaseback transactions
- The following amounts segregated between each type of lease:
  - Cash paid for amounts included in the measurement of lease liabilities
  - Supplemental noncash information on lease liabilities arising from obtaining ROU assets
  - Weighted-average remaining lease term and discount rate
- Maturity analysis separately for both finance and operating leases

The following exhibit, "Sample lessee disclosure," is a reproduction of a sample disclosure from FASB ASC 842 that lessees can use to satisfy the quantitative disclosure requirements.[25]

[24] FASB ASC 842-20-50-4 and FASB ASC 842-20-50-6.

[25] FASB ASC 842-20-55-53.

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## Exhibit: Sample lessee disclosure

| | Year Ending December 31, | |
|---|---|---|
| | 20X2 | 20X1 |
| Lease cost | | |
| Finance lease cost: | $XXX | $XXX |
| Amortization of right-of-use assets | XXX | XXX |
| Interest on lease liabilities | XXX | XXX |
| Operating lease cost | XXX | XXX |
| Short-term lease cost | XXX | XXX |
| Variable lease cost | XXX | XXX |
| Sublease income | (XXX) | (XXX) |
| Total lease cost | $XXX | SXXX |
| | | |
| Other information | | |
| (Gains) and losses on sale and leaseback transactions, net | $(XXX) | $XXX |
| Cash paid for amounts included in the measurement of lease liabilities | XXX | XXX |
| Operating cash flows from finance leases | XXX | XXX |
| Operating cash flows from operating leases | XXX | XXX |
| Financing cash flows from finance leases | XXX | XXX |
| Right-of-use assets obtained in exchange for new finance lease liabilities | XXX | XXX |
| Right-of-use assets obtained in exchange for new operating lease liabilities | XXX | XXX |
| Weighted-average remaining lease term—finance leases | X.X years | X.X years |
| Weighted-average remaining lease term—operating leases | X.X years | X.X years |
| Weighted-average discount rate—finance leases | X.X% | X.X% |
| Weighted-average discount rate—operating leases | X.X% | X.X% |

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One of the primary issues FASB considered when developing these quantitative disclosure requirements for FASB ASC 842 was understanding how users of financial statements evaluated an entity's leasing activities. In short, a single user may conduct multiple analyses of an entity for varying purposes. As a result, FASB conducted extensive user outreach to best assess the principal information needs of users. Refer to the following exhibit, "User needs for quantitative disclosures," for an overview of these needs along with how these were adequately addressed within the disclosure requirements.



### Exhibit: User needs for quantitative disclosures[26]

**User need: Information about interest**

Many users treat all leases as finance leases in their analyses because they want to compare an entity that leases its assets with one that purchases those same assets (for example, an airline that leases its airplanes and an airline that purchases its airplanes). Presently, users make imprecise adjustments in their analyses.

**How FASB addressed this need**

The disclosure requirements will provide those users with significantly improved information for their analyses by providing separate interest and amortization information for finance leases, the beginning (end of prior reporting period) and ending balances of the lessee's operating lease liabilities, and the weighted-average discount rate for the entity's operating leases as of the beginning and the end of the reporting period.

**User need: Information about cash paid for leases**

Users have communicated that they want information about a lessee's cash payments during a period for leases but that this information is often not presented or disclosed separately in the financial statements.

**How FASB addressed this need**

The disclosures required will provide users with information about cash paid for leases during each reporting period presented. Specific cash flow information is provided for cash payments to settle amounts included in the lessee's lease liability, broken out between financing and operating activities. This cash flow information, together with the required disclosures of short-term lease costs and variable lease costs (for which cash flows should approximate those costs), will provide improved information to users from what they received under previous GAAP.

**User need: Information about alternative measurement information**

Some users will continue to adjust the reported ROU assets and lease liabilities (for example, to produce a "whole asset" view of the entity). In previous GAAP, users often made adjustments on the basis of the reported operating lease expense, capitalizing a multiple of that operating lease expense.

[26] See footnote 2.

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Exhibit: User needs for quantitative disclosures (continued)

How FASB addressed this need

The disclosure requirements include more detailed lease cost information (which, unlike operating lease expense information disclosed in previous GAAP, will include lease costs capitalized as part of the cost of other assets) for those users that may still make adjustments on the basis of lease cost, as well as information on the weighted-average remaining lease term for the lessee's finance and operating leases. The board decided to include weighted-average remaining lease term information to provide users with a better understanding of both (1) the period of time the lessee's capitalized lease obligations would allow the lessee to continue its current operations and (2) the lessee's renewal risk.

User need: Information about new leasing activity during the reporting period

The requirements in previous GAAP included only disclosure requirements regarding the ROU assets obtained during the period in exchange for lease liabilities for capital leases.

How FASB addressed this need

The FASB ASC 842 lease accounting standards will address all leases (other than short-term leases for which the lessee elects the recognition and measurement exemption).

## Lessor disclosures

In addition to the qualitative disclosures that are applicable to both lessees and lessors, the following qualitative disclosures specific to lessors, if applicable, are also required:[27]

- Options for a lessee to purchase the leased asset including terms and conditions
- Determination of the amount the entity expects to derive from the leased asset following the end of the lease term
- Information about how it manages its risk associated with the residual value of its leased assets including the following:
  - Risk management strategy
  - Carrying amount of residual assets covered by residual value guarantees
  - Other means by which it reduces its residual asset risk
- For sales-type leases and direct financing leases only
  - Significant changes in the balance of its unguaranteed residual assets and deferred selling profit on direct financing leases
  - Maturity analysis of its lease receivables
- For operating leases only maturity analysis of lease payments

Although the basic qualitative disclosure requirements for lessors are substantially similar as those required by lessees, one additional point is worth mentioning with respect to residual asset risk. Refer to the following exhibit, "Residual asset risk disclosures," which addresses previous FASB ASC 840 lease

[27] Paragraphs 3, 7, 9–10, and 12 of FASB ASC 842-30-50.

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accounting requirements, user concerns with respect to these requirements, and how FASB ASC 842 addresses these.



### Exhibit: Residual asset risk disclosures[28]

A primary concern of users on the disclosure requirements in previous GAAP is the lack of transparency about how the lessor manages its exposure to residual value risk. Although users generally said that the lessor accounting model in previous GAAP provided them with the financial information they needed, many users indicated that additional information was needed about the lessor's residual assets and exposure to residual risk. Uncertainty about the residual value of the underlying asset at the end of the lease is a lessor's primary risk, particularly for a lessor of equipment and vehicles. This is because a decline in the market value of leased equipment and vehicles at a rate greater than the rate the lessor projected (on the basis of its policy on residual value measurement) would adversely affect the profitability of the lease.

Consequently, the board decided that a lessor should disclose how it manages its residual value risk to enable users to assess the uncertainty of cash flows arising from a lessor's leases and from its leased assets. The board considered that producing residual risk disclosures will carry an incremental cost to preparers, but it decided to require the disclosures on the basis that this is an area in which users have consistently requested additional information and told the board that the financial reporting for lessors in previous GAAP was inadequate for their information needs in many cases.

In addition to the qualitative disclosures discussed previously, the following quantitative disclosures, if applicable, are also required to be presented by a lessor:[29]

- Lease income recognized in each annual and interim period, in a tabular format, to include the following:
  - Sales-type leases and direct financing leases, including the following:
    - Profit or loss recognized at the commencement date
    - Interest income either in aggregate or separated by components of the net investment in the lease
  - Operating lease, including lease income relating lease payments as well as variable lease payments not included in the measurement of the lease receivable
- Components of its aggregate net investment in sales-type and direct financing leases

[28] ASU No. 2016-02, Section C, paragraph BC275.

[29] Paragraphs 5–6 of FASB ASC 842-30-50.

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# Knowledge check

4. Which disclosure is applicable only to lessees under FASB ASC 842?

    a. Information about the nature of the entity's leases.
    b. Determination of the discount rate.
    c. Significant assumptions and judgments.
    d. Existence of options to extend or terminate.

## Nonlease componentsPractical expedient for lessors

FASB ASC 842-10-15-42A allows that as a practical expedient, a lessor may not, as an accounting policy election, by class of underlying asset, separate nonlease components from the associated lease component and, instead, account for those components as a single component if the nonlease components otherwise would be accounted for under FASB ASC 606 and both of the following conditions are met: 1) The timing and pattern of transfer of the nonlease component(s) and associated lease component are the same, and 2) the lease component, if accounted for separately, would be classified as an operating lease.

. Disclosure of the use of this practical expedient and related accounting policy should be made.

## Subsequent developments: Common control arrangements

In March 2023, FASB issued ASU No. 2023-01, *Leases (Topic 842): Common Control Arrangements*. This ASU amends FASB ASC 842 to address two matters related to arrangements between entities under common control, as follows:

- Issue 1:  Terms and conditions to be considered (private entities)
- Issue 2:  Accounting for leasehold improvements (all entities)

For Issue 1, ASU No. 2023-01 provides entities that are not public business entities, not-for-profit bond obligors, or employee benefit plans that file or furnish financial statements with or to the U.S. Securities and Exchange Commission with a practical expedient to use written terms and conditions for (1) determining whether a lease exists and, if so, (2) the classification and accounting for that lease.

The practical expedient may be applied on an arrangement-by-arrangement basis. If the practical expedient is applied, the private entity is not required to determine whether those written terms and conditions are legally enforceable. If there are no written terms and conditions exist, an entity is required to apply FASB ASC 842 based on the legally enforceable terms of the arrangement.

Entities may document any previously unwritten terms and conditions of an arrangement between entities under common control before they adopt the ASU.

For Issue 2, leasehold improvements related to common control leases must be

- amortized by the lessee over the useful life of the leasehold improvements to the common control group for as long as the lessee controls the use of the underlying asset through a lease. If the underlying asset was obtained by the lessor through a lease with another entity not under common

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control, the amortization period cannot exceed the lease term associated with the lessor's lease with the other entity.
- accounted for as a transfer between entities under common control through an adjustment to equity (net assets for not-for-profit entities) when and if the lessee ceases to control the use of the underlying asset.
- applied to the leasehold improvements, considering the useful life to the control group, and disclosure is required if the useful life of the leasehold improvements to the common control group exceeds the lease term.

ASU No. 2023-01 is effective for all entities for fiscal years beginning after December 15, 2023, including interim periods within those fiscal periods. Early adoption is permitted.

Under ASU No. 2023-01, Issue 1, the practical expedient is to use written terms and conditions to determine whether a lease exists and, if so, its classification may be applied

- prospectively.
- retrospectively.

Issue 2 leasehold improvements and related amortization may be applied

- prospectively.
- prospectively, with any remaining unamortized balance of existing leasehold improvements amortized over remaining useful life to the control group.
- retrospectively.

The following examples demonstrate how these ASU No. 2023-01 application methods may be applied:

Example: Common control arrangement

Facts:

An informal month-to-month arrangement regarding the use of a building exists between related parties under common control and has been for several years. The building has a remaining expected life of 39 years.

FABS ASC 842 has already been adopted effective January 1, 20X2. Since FASB ASC 842 was adopted, the informal month-to-month arrangement has been treated as a short-term lease under FASB ASC 842 for financial reporting purposes by this calendar year-end entity.

During the current year 20X3, the related parties become aware of ASU No. 2023-01.

The related parties decide that they would like to adopt the practical expedient for common control arrangements effective January 1, 20X3.

Requirements:

Describe how ASU No. 2023-01 would be applied prospectively.

Describe how ASU No. 2023-01 would be applied retrospectively.

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### Prospective application

Application of the practical expedient may be elected on an arrangement-by-arrangement basis.

The terms and conditions of the existing informal arrangement continue to not be documented in writing.

The existing informal arrangement continues to be accounted for as a short-term lease under FASB ASC 842 during 20X3.

If any common control arrangements commence, or are modified, during the 2023 calendar year, for which the terms and conditions are documented in writing by the related parties, such arrangements on an arrangement-by-arrangement basis may be considered regarding whether the practical expedient will be elected and used to determine

- whether a lease exists and, if so,
- the classification and accounting for the lease.

### Retrospective application

The existing informal arrangement is documented in writing by both related entities on March 20, 20X4, after year-end but prior to the date the calendar 20X3 comparative financial statements are available to be issued. The written common control arrangement documents the terms and conditions for the period January 1, 20X2 through December 31, 20X5.

Choosing to apply the practical expedient for common control arrangements to this arrangement, management determines that a lease exists and that because of the term of the arrangement (4 years versus the remaining expected life of the building, which is 39 years) the lease will be classified and accounted for as an operating lease.

The lease liability and right-of-use asset would be determined and recorded as of January 1, 20X2 by discounting the payments remaining under the arrangement from January 1, 20X2 through December 31, 20X5.

Retrospective application is to the beginning of the period in which the entity first applied FASB ASC 842 (in this case, January 1, 20X2) for arrangements that exist at the date of adoption for the practical expedient (in this case, January 1, 20X3).

The common control arrangement would be accounted for as an operating lease under FASB ASC 842 during 20X3 and 20X2.

As a result of retrospective application, the right-of-use asset-operating lease and related lease liability — operating lease for this common control arrangement — will need to be reflected in the statements of financial position as of both December 31, 20X2 and 20X3.

There will be financial statement disclosure of the impact of adoption of the practical expedient retrospectively and as otherwise required for leases under FASB ASC 842.

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### Example: Leasehold improvements associated with common control leases

#### Facts:

Widget Co., a calendar year-end company, adopted FASB ASC 842 effective January 1, 20X2 using the optional (and additional) transition method.

Widget Co. has common control leases A and B with its related entity Alpha Inc.

Lease A has a lease term of January 1, 20X2 through December 31, 20X5 (4 years).

A leasehold improvement with a cost of $100,000 is made by Widget Co. to the right-of-use asset associated with lease A effective January 1, 20X2.

Lease B has a lease term of January 1, 20X3 through December 31, 20X7 (5 years).

A leasehold improvement with a cost of $400,000 is made by Widget Co. to the right-of-use asset associated with lease B effective January 1, 20X3.

The leasehold improvement made to the right-of-use asset associated with lease A has a useful life to the common control group of 10 years.

The leasehold improvement made to the right-of-use asset associated with lease B has a useful life to the common control group of 20 years.

No impairment under FASB ASC 360 is evident with respect to either of these leasehold improvements.

Related parties decide they would like to adopt ASU No. 2023-01 relating to Issue 2: Accounting for leasehold improvements effective January 1, 20X3.

#### Requirements:

Describe how ASU No. 2023-01 would be applied prospectively.

Describe how ASU No. 2023-01 would be applied prospectively, with any remaining unamortized balance of existing leasehold improvements amortized over the remaining useful life to the common control group at that date.

Describe how ASU No. 2023-01 would be applied retrospectively.

#### Prospective application

Leasehold improvement made to the right of use asset associated with lease A would continue to be amortized over 4 years (the shorter of the remaining lease term and the useful life of the improvements to the common control group). The amortization for 20X3 would be $100,000 divided by 4, or $25,000 per year, with accumulated amortization totaling $50,000 ($25,000 current year plus $25,000 prior year) as of December 31, 20X3.

The leasehold improvement made to the right-of-use asset associated with lease B would be amortized over 20 years (the useful life of the improvements to the common control group). The amortization for 20X3 and accumulated amortization as of December 31, 20X3 would be $400,000 divided by 20 or $20,000 per year .

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If lease B is not renewed, the unamortized leasehold improvement of $300,000 as of December 31, 20X7, the end of the lease term, would be transferred to Alpha Inc. and accounted for as a transfer between entities under common control through an adjustment to equity, if and when, the lessee Widget Co. no longer controls the underlying asset.

### Prospective application with existing leasehold improvement amortized over remaining useful life to the common control group

Leasehold improvement made to right-of-use asset associated with lease A, an existing leasehold improvement, beginning January 1, 20X3 would be amortized over 9 years (the remaining useful life of the improvement to the common control group). The amortization for 20X3 would be $75,000 (the remaining unamortized amount upon adoption) divided by 9 or $8,333 per year, with accumulated amortization totaling $33,333 ($25,000 of 20X2 plus $8,333 for 20X3) as of December 31, 20X3.

The leasehold improvement made to the right-of-use asset associated with lease B would be amortized over 20 years (the useful life of the improvements to the common control group). The amortization for 20X3 and accumulated amortization as of December 31, 20X3 would be $400,000 divided by 20 or $20,000 per year .

If either lease is not renewed, the unamortized leasehold improvement of $50,000 for lease A or $300,000 for lease B as of December 31, 20X5 or 20X7, the end of the respective lease terms, would be transferred to Alpha Inc. and accounted for as a transfer between entities under common control through an adjustment to equity, if and when, the lessee Widget Co. no longer controls the underlying assets.

### Retrospective application

The leasehold improvement made to the right-of-use asset associated with lease A would be amortized over 10 years (the useful life of the improvements to the common control group). The retroactively stated amortization for 20X2 and 20X3 would be $100,000 divided by 10 or $10,000 per year, with accumulated amortization totaling $20,000 ($10,000 for 20X2 and $10,000 for 20X3) as of December 31, 20X3.

Because prior to the adoption of ASU No. 2023-01, effective January 1, 20X3, the unamortized leasehold improvement balance was $75,000 as of December 31, 20X2 instead of $90,000 (as it would have been had the 10-year useful life of the asset to the common control group been used rather than the 4-year lease term). A $15,000 cumulative-effect adjustment to retained earnings at the beginning of the earliest year presented (in this case, January 1, 20X2) with the other side of the entry to accumulated amortization of leasehold improvement is necessary to retrospectively adopt the ASU.

The leasehold improvement made to the right-of-use asset associated with lease B would be amortized over 20 years (the useful life of the improvements to the common control group). The amortization for 20X3 and accumulated amortization as of December 31, 20X3 would be $400,000 divided by 20 or $20,000 per year.

If either lease is not renewed, the unamortized leasehold improvement of $60,000 or $300,000 as of December 31, 20X5 or 20X7, the end of the respective lease terms, would be transferred to Alpha Inc. and accounted for as a transfer between entities under common control through an adjustment to equity, if and when, the lessee Widget Co. no longer controls the underlying assets.

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Under ASU No. 2023-01, Issue 2, regardless of the application method chosen, when the useful life of the leasehold improvements to the common control group exceeds the lease term, the lessee shall disclose the following:

- The unamortized balance of the leasehold improvements at the balance sheet date
- The remaining useful life of the leasehold improvements to the common control group
- The remaining lease term

## Knowledge check

5. Which statement is correct regarding the available practical expedient for adoption of ASU No. 2023-1?

   a. It relates to the manner in which the common control group can be determined.
   b. It is available to all entities.
   c. It relates to how the terms and conditions of a common control arrangement are documented and used.
   d. It allows the determination of useful life to be consistent with useful life for income tax purposes.



### Example: Comprehensive lessee lease disclosures

To wrap up and help demonstrate how the topics we have discussed might be applied in practice, let's observe the following example of a lessee's disclosures, with excerpts of financial statements and related note disclosures for both finance and operating leases in a year subsequent to having transitioned to FASB ASC 842.

Background facts:

- The entity has chosen to apply the short-term lease practical expedient for all asset classes.
- The entity has chosen to apply the practical expedient not to separate lease and nonlease components of arrangements involving office space, warehouses, and vehicles.
- Disclosures highlighted with a (***) designation are required to be made on a comparative basis for all periods presented.

Note this is merely an example of excerpts of possible disclosures that might be made for training purposes. If certain facts and circumstances were to exist in an actual situation, additional disclosures may be required under FASB ASC 842. Refer to a current and appropriate GAAP disclosure checklist in making that type of determination and judgment.

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Example: Comprehensive lessee lease disclosures (continued)

| Statements of Financial Position<br>[*Sample excerpt*] | | |
|---|---|---|
| | (*Amounts in millions*)<br>December 31, | |
| | 20X2 | 20X1 |
| Long-term assets | | |
| Operating lease right of use assets | $10,900 | $9,500 |
| Property, plant, and equipment, net | $30,000 | $25,000 |
| Current liabilities | | |
| Current portion of operating lease liabilities | $ 2,050 | $2,050 |
| Current maturities of long-term debt | $ 4,000 | $ 3,000 |
| Long-term liabilities | | |
| Long-term operating lease liabilities | $ 8,850 | $ 7,450 |
| Long-term debt | $14,000 | $17,000 |

| Statements of operations/income statements<br>[*Sample excerpt*] | | |
|---|---|---|
| | (*Amounts in millions*)<br>Year ended December 31, | |
| | 20X2 | 20X1 |
| [No lease-specific line items are presented; disclosures are made in the notes to the financial statements.] | | |

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Example: Comprehensive lessee lease disclosures (continued)

| Cash flow statements<br>[*Sample excerpt*] | | |
|---|---|---|
| | (*Amounts in millions*)<br>Year ended December 31, | |
| | 20X2 | 20X1 |
| [*No lease-specific line items are presented; disclosures are made in the notes to the financial statements*] | | |
| | | |

Notes to the financial statements [*Sample excerpt*]

(Amounts in millions)

Significant accounting policies

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Example: Comprehensive lessee lease disclosures (continued)

Leases

The Company accounts for leases in accordance with FASB ASC 842. The Company is a lessee in several noncancellable operating leases for office space, warehouses, and vehicles. Leases for other equipment are evaluated using the criteria outlined in FASB ASC 842 to determine whether they will be classified as operating leases or finance leases. The Company determines if an arrangement is a lease, or contains a lease, at inception of a contract and when terms of an existing contract are changed. The Company determines if an arrangement conveys the right to use an identified asset and whether the Company obtains substantially all of the economic benefits from and has the ability to direct the use of the asset. The Company recognizes a lease liability and ROU asset at the commencement date of the lease.

*Lease liabilities*. A lease liability is measured based on the present value of its future lease payments. Variable payments are included in the future lease payments when those variable payments depend on an index or rate and are measured using the index or rate at the commencement date. Lease payments, including variable payments made based on an index rate, are remeasured when any of the following occur: (1) the lease is modified (and the modification is not accounted for as a separate contract), (2) certain contingencies related to variable lease payments are resolved, or (3) there is a reassessment of any of the following: the lease term, purchase options, or amounts that are probable of being owed under a residual value guarantee. The discount rate is the rate implicit in the lease if it is readily determinable; otherwise, the Company uses its incremental borrowing rate. The implicit rates of the Company's leases are not readily determinable; accordingly, the Company uses its incremental borrowing rate based on the information available at the commencement date for each lease. The Company's incremental borrowing rate for a lease is the rate of interest it would have to pay on a collateralized basis to borrow an amount equal to the lease payments under similar terms and in a similar economic environment and geographic location. The Company determines its incremental borrowing rates by starting with the interest rates on recent borrowings and other observable market rates and adjusting those rates to reflect differences in the amount of collateral and the payment terms of the leases.

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Example: Comprehensive lessee lease disclosures (continued)

*ROU assets.* A ROU asset is measured at the commencement date at the amount of the initially measured liability plus any lease payments made to the lessor before or after commencement date, minus any lease incentives received, plus any initial direct costs. Unless impaired, the ROU asset is subsequently measured throughout the lease term at the amount of the lease liability (that is the present value of the remaining lease payments), plus unamortized initial direct costs, plus (minus) any prepaid (accrued lease payments, less the unamortized balance of lease incentives received. Lease cost for lease payments is recognized on a straight-line basis over the lease term. Finance lease ROU assets are amortized on a straight-line basis over the shorter of the lease term or the remaining useful life of the asset.

*Accounting policy election for short-term leases*. The Company has elected the practical expedient for all underlying classes of assets, to not recognize ROU assets and lease liabilities for short-term leases that have a lease term of 12 months or less, at lease commencement, and do not include an option to purchase the underlying asset that the Company is reasonably certain to exercise. The Company recognizes lease cost associated with its short-term leases on a straight-line basis over the lease term.

Depreciation

Leasehold improvements are amortized over the lesser of the economic useful life of the improvement or the term of the lease.

Property, plant, and equipment

As of December 31, 20X2 and 20X1, other equipment assets under finance leases with a cost of $5,500 and $4,500 and accumulated amortization of $1,400 and $800, respectively, were included in property, plant, and equipment, net.

Leases

The Company has obligations as a lessee for office space, warehouses, vehicles, and other equipment with initial noncancelable terms in excess of one year. Generally, the office space and warehouse leases have an initial term of 5 years and the vehicle leases have a 3-year term. Other equipment leases range from 1 to 10 years. The Company classifies these leases as operating leases, except for any equipment leases that meet the FASB ASC 842 criteria to be classified as a finance lease. Because the Company is not reasonably certain to exercise these

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Example: Comprehensive lessee lease disclosures (continued)

renewal options, the optional periods are not included in determining the lease term, and associated payments under these renewal options are excluded from lease payments used to determine the lease liabilities. The Company's leases do not include termination options for either party to the lease, guaranteed residual values or restrictive financial or other covenants.

Payments due under lease contracts include fixed payments and, for many leases, variable payments. These leases generally contain renewal options for periods ranging from 2 to 5 years. The Company's office space and warehouse leases require it to make variable payments for the Company's proportionate share of the buildings' property taxes and insurance. These variable lease payments are not included in lease payments used to determine lease liabilities and are recognized as variable lease costs when incurred.

Beginning in 20X1, the Company had elected the practical expedient not to separate nonlease components from lease components in leases for office space, warehouses, and vehicles.

The components of lease cost and income statement caption allocation for the year ended December 31, 20X2, are as follows***:

| | Income statement caption(s) | Year ended December 31, 20X2 |
|---|---|---|
| Operating lease cost: | Selling, general and administrative expenses | $1,400 |
| | Research and development | $ 750 |
| Total operating lease cost | | $2,150 |
| | | |
| Finance lease cost: | | |
| Amortization of ROU assets | Depreciation and amortization | $ 600 |
| Interest on lease liabilities | Interest expense | $ 345 |
| Short-term lease cost | Selling, general and administrative expenses | $ 160 |
| Variable lease cost | Selling, general and administrative expenses | $ 300 |
| | Research and development | $ 100 |
| Total variable lease cost | | $ 400 |
| Total lease cost | | $3,655 |

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### Example: Comprehensive lessee lease disclosures (continued)

The following table represents supplemental balance sheet classification information related to finance leases (in millions) as of December 31, 20X2***:

| | As of December 31, 20X2 |
|---|---|
| **Assets** | |
| Finance lease right-of-use assets included in *Property, plant, and equipment, net* | $5,500 |
| (classified as other equipment at cost, which has $1,400 of accumulated amortization) | |
| **Liabilities** | |
| Finance lease liabilities included in *Current maturities of long-term debt* | $785 |
| Finance lease liabilities included in *Long-term debt* | $4,010 |

Other information related to leases as of or for the year ended December 31, 20X2 are as follows***:

| | |
|---|---|
| Weighted-average remaining lease term (years): | |
| Operating leases | 6 years |
| Finance leases | 8 years |
| Weighted-average discount rate: | |
| Operating leases | 5.0% |
| Finance leases | 8.5% |

Supplemental cash flow information (in millions) for the year ended December 31, 20X2***:

| | |
|---|---|
| Cash paid for amounts included in the measurement of lease liabilities: | |
| Operating cash flows—operating leases | $2,150 |
| Operating cash flows—finance leases | $ 345 |
| Finance cash flows—finance leases | $ 505 |
| Right-of-use assets obtained in exchange for lease liabilities: | |
| Operating leases | $3,450 |
| Finance leases | $1,000 |
| | |
| | |

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Example: Comprehensive lessee lease disclosures (continued)

Maturities of operating and finance lease liabilities (in millions) as of December 31, 20X2, were as follows:

| | Operating leases | Finance leases |
|---|---|---|
| 20X3 | $ 2,150 | $ 850 |
| 20X4 | 2,150 | 850 |
| 20X5 | 2,150 | 850 |
| 20X6 | 2,150 | 850 |
| 20X7 | 2,150 | 850 |
| Thereafter | 2,150 | 2,550 |
| Total lease payments | 12,900 | 6,800 |
| Less: present value adjustment | 2,000 | 2,005 |
| Present value of lease liabilities | $ 10,900 | $4,795 |

As of December 31, 20X2, the Company has a rental commitment of approximately $5 million for equipment that has not yet commenced. This finance lease is expected to commence in the second quarter of 20X3 with a noncancellable lease term of 10 years.

The Company leases certain office space from XYZ Company, a related party***. The lease is for an initial 5-year term expiring in 20X4, with annual renewals unless cancelled by either party thereafter. Only the initial 5-year term has been considered in determining the lease term and related lease payments for this lease. This lease has been classified as an operating lease and is included in the preceding data, as a $60 operating lease ROU asset and has an associated current portion of operating lease liability of $18 and $32 long-term operating lease liability. The total lease cost associated with this lease for the year ended December 31, 20X2 was $20 and it is included in the selling, general and administrative expense line item on the income statement

Having walked through this comprehensive lessee lease presentation and disclosure example, hopefully you will be better able to visualize what the concepts we have discussed will look like in practice and how you might choose to apply them. Consider the capabilities of your, or your client's, current accounting systems and processes and what efforts will be necessary to have the kind of information available to make financial statement disclosures like this. It should be noted that comparative FASB ASC 842 disclosures for previous periods presented are also required in the related notes to the financial statements as designated by (***) and like the ones shown earlier in the "Sample lessee disclosure" exhibit.

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# Summary

FASB ASC 842 has significantly expanded the qualitative and quantitative disclosures required to be made by lessees regarding their leasing activities. Separate presentation of finance lease and operating lease ROU assets and related lease liabilities is required. Although there is flexibility concerning where the information is presented or disclosed, whether that be on the face of the financial statements or in the related notes, the amounts must be segregated. The FASB ASC 842 standard provides guidance for reporting lease-related amounts in the statement of cash flows. Sample quantitative disclosures that could be made by lessees were presented. Lessor disclosure requirements were considered along with those of lessees. Approaches used to adopt Issue numbers 1 and 2 of ASU No. 2023-01 were described. An example comprehensive lessee lease disclosure was reviewed and correlated to related disclosure requirements.

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# Solutions

## Presentation and Disclosures Requirements

### Knowledge check solutions

1.

a. Incorrect. The majority of entities separately presented operating lease right-of-use asset amounts in their own financial statement line item.
b. Incorrect. Seventy-nine percent of entities separately presented operating lease long-term lease liabilities amounts in their own financial statement line item.
c. Incorrect. Fifty-seven percent of entities separately presented operating lease short-term lease liabilities amounts in their own financial statement line item.
d. Correct. Less than 10% of entities presented any of the three possible finance lease-related amounts in their own individual financial statement line item.

2.

a. Correct. Under FASB ASC 842, operating leases should be included in income from continuing operations as a single lease cost. This is consistent with guidance in FASB ASC 840.
b. Incorrect. An entity should present the components of a finance lease in a manner consistent with how the entity presents depreciation and amortization of similar assets and other interest expenses.
c. Incorrect. The guidance in FASB ASC 842 is that a lessor should present profit or loss from leases in a manner that best reflects the lessor's business model.
d. Incorrect. A lessor should present a single net investment in both sales-type and direct financing leases instead of separately presenting the respective components.

3.

a. Incorrect. This cash outflow should be reported in operating activities.
b. Incorrect. This cash outflow should be reported in investing activities.
c. Incorrect. This cash outflow should be reported in operating activities. In addition, short-term lease payment should also be included in operating activities.
d. Correct. This cash outflow should be reported in financing activities of the statement of cash flows.

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4.

a. Incorrect. Both lessees and lessors are required to disclose information about the nature of the entity's leases.
b. Correct. The determination of the discount rate is a disclosure that is applicable only to lessees, not lessors.
c. Incorrect. Both lessees and lessors are required to disclose significant assumptions and judgments about whether a contract contains a lease.
d. Incorrect. Both lessees and lessors are required to disclose the existence of options to extend or terminate a lease.

5.

a. Incorrect. The practical expedient under FASB ASU No. 2023-01 does not relate to the manner in which the common control group can be determined.
b. Incorrect. This practical expedient is not available to all entities. It is not available to public business entities, not-for-profit bond obligors, or employee benefit plans that file or furnish financial statements with or to the SEC.
c. Correct. The practical expedient relates to how the terms and conditions of a common control arrangement are documented and used.
d. Incorrect. The practical expedient under ASU No. 2023-01 does not allow the determination of useful life to be consistent with useful life for income tax purposes.

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# Accounting and Auditing Glossary

**account.** Formal record that represents, in words, money or other unit of measurement, certain resources, claims to such resources, transactions or other events that result in changes to those resources and claims.

**account payable.** Amount owed to a creditor for delivered goods or completed services.

**account receivable.** Claim against a debtor for an uncollected amount, generally from a completed transaction of sales or services rendered.

**accountants' report.** Formal document that communicates an independent accountant's (1) expression of limited assurance on financial statements as a result of performing inquiry and analytic procedures (Review Report); (2) results of procedures performed (type of Attestation Report); (3) non-expression of opinion or any form of assurance on a presentation in the form of financial statements information that is the representation of management (Compilation Report); or (4) an opinion on an assertion made by management in accordance with the Statements on Standards for Attestation Engagements (Attestation Report). An accountant's report does not result from the performance of an audit.

**accounting.** Recording and reporting of financial transactions, including the origination of the transaction, its recognition, processing, and summarization in the financial statements.

**accounting change.** Change in (1) an accounting principle; (2) an accounting estimate; or (3) the reporting entity. The correction of an error in previously issued financial statements is not an accounting change.

**accounting estimate.** A monetary amount for which the measurement, in accordance with the requirements of the applicable financial reporting framework, is subject to estimation uncertainty.

**accrual basis.** Method of accounting that recognizes revenue when earned, rather than when collected. Expenses are recognized when incurred rather than when paid.

**accrued expense.** An expense incurred during an accounting period for which payment is not due until a later accounting period. This results from the purchase of services which at the time of accounting have only been partly performed, are not yet billable, or have not been paid for.

**accumulated depreciation.** Total depreciation pertaining to an asset or group of assets from the time the assets were placed in service until the date of the financial statement or tax return. This total is the contra account to the related asset account.

**additional paid in capital.** Amounts paid for stock in excess of its par value or stated value. Also, other amounts paid by stockholders and charged to equity accounts other than capital stock.

**adjusting entries.** Accounting entries made at the end of an accounting period to allocate items between accounting periods.

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**amortization.** The process of reducing a recognized liability systematically by recognizing revenues or by reducing a recognized asset systematically by recognizing expenses or costs. In accounting for postretirement benefits, amortization also means the systematic recognition in net periodic postretirement benefit cost over several periods of amounts previously recognized in other comprehensive income, that is, gains or losses, prior service cost or credits, and any transition obligation or asset.

**analytical procedures.** Substantive tests of financial information which examine relationships among data as a means of obtaining evidence. Such procedures include (1) comparison of financial information with information of comparable prior periods; (2) comparison of financial information with anticipated results (e.g., forecasts); (3) study of relationships between elements of financial information that should conform to predictable patterns based on the entity's experience; and (4) comparison of financial information with industry norms.

**annual report.** The annual report to shareholders is the principal document used by most public companies to disclose corporate information to their shareholders. It is usually a state-of-the-company report, including an opening letter from the Chief Executive Officer, financial data, results of continuing operations, market segment information, new product plans, subsidiary activities, and research and development activities on future programs. The Form 10-K, which must be filed with the SEC, typically contains more detailed information about the company's financial condition than the annual report.

**appropriateness (of audit evidence).** The measure of the quality of audit evidence, that is, its relevance and reliability in providing support for the conclusions on which the auditor's opinion is based.

**assertions.** Representations, explicit or otherwise, with respect to the recognition, measurement, presentation, and disclosure of information in the financial statements, which are inherent in management, representing that the financial statements are prepared in accordance with the applicable financial reporting framework. Assertions are used by the auditor to consider the different types of potential misstatements that may occur when identifying, assessing, and responding to the risks of material misstatement..

**audit evidence.** Information used by the auditor in arriving at the conclusions on which the auditor's opinion is based. Audit evidence is information to which audit procedures have been applied and consists of information that corroborates or contradicts assertions in the financial statements.

**audit risk.** The risk that the auditor may unknowingly fail to modify appropriately his/her opinion on financial statements that are materially misstated.

**audit sampling.** Application of an audit procedure to less than 100% of the items within an account balance or class of transactions for the purpose of evaluating some characteristic of the balance or class.

**auditors' report.** Written communication issued by an independent certified public accountant (CPA) describing the character of his/her work and the degree of responsibility taken. An auditor's report includes a statement that the audit was conducted in accordance with

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generally accepted auditing standards (GAAS), which require that the auditor plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, as well as a statement that the auditor believes the audit provides a reasonable basis for his/her opinion.

**bad debt.** All or portion of an account, loan, or note receivable considered to be uncollectible.

**balance sheet.** Basic financial statement, usually accompanied by appropriate disclosures that describe the basis of accounting used in its preparation and presentation of a specified date the entity's assets, liabilities, and the equity of its owners. Also known as a statement of financial condition.

**bond.** One type of long-term promissory note, frequently issued to the public as a security regulated under federal securities laws or state blue sky laws. Bonds can either be registered in the owner's name or are issued as bearer instruments.

**book value.** Amount, net or contra account balances, that an asset or liability shows on the balance sheet of a company. Also known as carrying value.

**business combinations.** Combining of two entities. Under the purchase method of accounting, one entity is deemed to acquire another and there is a new basis of accounting for the assets and liabilities of the acquired company.

**business risk.** A risk resulting from significant conditions, events, circumstances, actions, or inactions that could adversely affect an entity's ability to achieve its objectives and execute its strategies, or from the setting of inappropriate objectives and strategies.

**business segment.** Any division of an organization authorized to operate, within prescribed or otherwise established limitations, under substantial control by its own management.

**capital stock.** Ownership shares of a corporation authorized by its articles of incorporation. The money value assigned to a corporation's issued shares. The balance sheet account with the aggregate amount of the par value or stated value of all stock issued by a corporation.

**capitalized cost.** Expenditure identified with goods or services acquired and measured by the amount of cash paid or the market value of other property, capital stock, or services surrendered. Expenditures that are written off during two or more accounting periods.

**carrying value.** Amount, net or contra account balances, that an asset or liability shows on the balance sheet of a company. Also known as book value.

**cash basis.** A special purpose framework in which revenues and expenditures are recorded when they are received and paid.

**cash equivalents.** Short-term (generally less than three months), highly liquid investments that are convertible to known amounts of cash.

**cash flows.** Net of cash receipts and cash disbursements relating to a particular activity during a specified accounting period.

**casualty loss.** Sudden property loss caused by theft, accident, or natural causes.

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**change in engagement.** A request, before the completion of the audit (review), to change the engagement to a review or compilation (compilation) of financial statements.

**class actions.** A federal securities class action is a court action filed on behalf of a group of shareholders under Rule 23 of the Federal Rules of Civil Procedure. Instead of each shareholder bringing an individual lawsuit, one or more shareholders bring a class action for the entire class of shareholders.

**common stock.** Capital stock having no preferences generally in terms of dividends, voting rights, or distributions.

**companies, going public.** Companies become public entities for different reasons, but usually to raise additional capital. The SEC has prepared a guide for companies – Q&A: Small Business and the SEC – that provides a basic understanding about the various ways companies can become public and what securities laws apply. The SEC also has a list of some of the registration and reporting forms and related regulations that pertain to small and large companies.

**comparative financial statement.** Financial statement presentation in which the current amounts and the corresponding amounts for previous periods or dates also are shown.

**compilation.** Presentation in the form of financial statements information that is the representation of management (owners) without the accountant's assurance as to conformity with generally accepted accounting principles (GAAP).

**comprehensive income.** Change in equity of a business entity during a period from transactions and other events and circumstances from nonowner sources. The period includes all changes in equity except those resulting from investments by owners and distributions to owners.

**confirmation.** Auditor's receipt of a written or oral response from an independent third party verifying the accuracy of information requested.

**consolidated financial statements.** Combined financial statements of a parent company and one or more of its subsidiaries as one economic unit.

**consolidation.** The presentation of a single set of amounts for an entire reporting entity. Consolidation requires elimination of intra-entity transactions and balances.

**contingent liability.** Potential liability arising from a past transaction or a subsequent event.

**continuing accountant.** An accountant who has been engaged to audit, review, or compile and report on the financial statements of the current period and one or more consecutive periods immediately prior to the current period.

**controls**. Policies or procedures that an entity establishes to achieve the control objectives of management or those charged with governance. In this context, (1) policies are statements of what should, or should not, be done within the entity to effect control. Such statements may be documented, explicitly stated in communications, or implied through actions and decisions; 2) procedures are actions to implement policies.

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**control risk.** Measure of risk that errors exceeding a tolerable amount will not be prevented or detected by an entity's internal controls.

**controls tests.** Tests directed toward the design or operation of an internal control structure policy or procedure to assess its effectiveness in preventing or detecting material misstatements in a financial report.

**current asset.** Asset that one can reasonably expect to convert into cash, sell, or consume in operations within a single operating cycle, or within a year if more than one cycle is completed each year.

**current liability.** Obligation whose liquidation is expected to require the use of existing resources classified as current assets, or the creation of other current liabilities.

**current value.** (1) Value of an asset at the present time as compared with the asset's historical cost. (2) In finance, the amount determined by discounting the future revenue stream of an asset using compound interest principles.

**debt.** General name for money, notes, bonds, goods, or services which represent amounts owed.

**definite criteria.** A special purpose framework using a definite set of criteria having substantial support that is applied to all material items appearing in financial statements, such as the price-level basis of accounting.

**depreciation.** Expense allowance made for wear and tear on an asset over its estimated useful life.

**derivatives.** Derivatives are financial instruments whose performance is derived, at least in part, from the performance of an underlying asset, security or index. For example, a stock option is a derivative because its value changes in relation to the price movement of the underlying stock.

**detection risk.** Risk that the auditor will not detect a material misstatement.

**disclosure.** Process of divulging accounting information so that the content of financial statements is understood.

**discount.** Reduction from the full amount of a price or debt.

**dividends.** Distribution of earnings to owners of a corporation in cash, other assets of the corporation, or the corporation's capital stock.

**earnings per share (EPS).** The amount of earnings attributable to each share of common stock. For convenience, the term is used to refer to either earnings or loss per share.

**employee stock options plans.** An employee stock ownership plan is an employee benefit plan that is described by the Employee Retirement Income Security Act of 1974 and the Internal Revenue Code of 1986 as a stock bonus plan, or combination stock bonus and money purchase pension plan, designed to invest primarily in employer stock. Also called an

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employee share ownership plan. Employee Stock Options Plans should not be confused with the term "ESOPs," or Employee Stock Ownership Plans, which are retirement plans.

**employee stock ownership plans (ESOPs).** An employee stock ownership plan (ESOP) is a retirement plan in which the company contributes its stock to the plan for the benefit of the company's employees. With an ESOP, you never buy or hold the stock directly. This type of plan should not be confused with employee stock options plans, which are not retirement plans. Instead, employee stock options plans give the employee the right to buy their company's stock at a set price within a certain period of time.

**engagement partner.** The partner or other individual appointed by the firm who is responsible for the audit engagement and its performance, and for the auditor's report that is issued on behalf of the firm, and who, when required, has the appropriate authority from a professional, legal, or regulatory body.

**engagement quality review.** An objective evaluation of the significant judgments made by the engagement team and the conclusions reached thereon, performed by the engagement quality reviewer and completed before the engagement report is released.

**engagement quality reviewer.** A partner, other individual in the firm, or an external individual appointed by the firm to perform the engagement quality review.

**engagement team.** All partners and staff performing the audit engagement and any other individuals who perform audit procedures on the engagement, excluding an auditor's external specialist5 and internal auditors who provide direct assistance on an engagement.

**equity.** Residual interest in the assets of an entity that remains after deducting its liabilities. Also, the amount of a business' total assets, less total liabilities. Also, the third section of a balance sheet, the other two being assets and liabilities.

**equity security.** Any security representing an ownership interest in an entity (for example, common, preferred, or other capital stock) or the right to acquire (for example, warrants, rights, and call options) or dispose of (for example, put options) an ownership interest in an entity at fixed or determinable prices. However, the term does not include convertible debt or preferred stock that by its terms either must be redeemed by the issuing entity or is redeemable at the option of the investor.

**error.** Act that departs from what should be done; imprudent deviation, unintentional mistake or omission.

**executive compensation: Where to find in SEC reports.** The federal securities laws require clear, concise and understandable disclosure about compensation paid to CEOs and certain other high-ranking executive officers of public companies. You can locate information about executive pay in (1) the company's annual proxy statement; (2) the company's annual report on Form 10-K; and (3) registration statements filed by the company to register securities for sale to the public.

**expenditures.** Expenditures to which capitalization rates are to be applied are capitalized expenditures (net of progress payment collections) for the qualifying asset that have required the payment of cash, the transfer of other assets, or the incurring of a liability on

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which interest is recognized (in contrast to liabilities, such as trade payables, accruals, and retainages on which interest is not recognized).

**external information source.** An external individual or organization that provides information that is used by the entity in preparing the financial statements or that has been obtained by the auditor as audit evidence, when such information is suitable for use by a broad range of users. When information has been provided by an individual or organization acting in the capacity of management's specialist, service organization, or auditor's specialist, the individual or organization is not considered an external information source with respect to that particular information.

**extraordinary items.** Events and transactions distinguished by their unusual nature and by the infrequency of their occurrence. Extraordinary items are reported separately, less applicable income taxes, in the entity's statement of income or operations.

**Fair Disclosure, Regulation FD.** On August 15, 2000, the SEC adopted Regulation FD to address the selective disclosure of information by companies and other issuers. Regulation FD provides that when an issuer discloses material nonpublic information to certain individuals or entities – generally, securities market professionals, such as stock analysts, or holders of the issuer's securities who may well trade on the basis of the information – the issuer must make public disclosure of that information. In this way, the new rule aims to promote the full and fair disclosure.

**fair market value.** Price at which property would change hands between a buyer and a seller without any compulsion to buy or sell.

**federal securities laws.** The laws that govern the securities industry, include the Securities Act of 1933; Securities Exchange Act of 1934; Investment Company Act of 1940; Investment Advisers Act of 1940; and Public Utility Holding Company Act of 1935.

**financial statements.** Presentation of financial data including balance sheets, income statements and statements of cash flow, or any supporting statement that is intended to communicate an entity's financial position at a point in time and its results of operations for a period then ended.

**Firm.** A form of organization permitted by law or regulation whose characteristics conform to resolutions of the Council of the AICPA and that is engaged in public practice.

**first in, first out (FIFO).** Accounting method of valuing inventory under which the costs of the first goods acquired are the first costs charged to expense. Commonly known as FIFO.

**fiscal year.** Period of 12 consecutive months chosen by an entity as its accounting period which may or may not be a calendar year.

**fixed asset.** Any tangible asset with a life of more than one year used in an entity's operations.

**foreign currency translation.** Restating foreign currency in equivalent dollars; unrealized gains or losses are postponed and carried in Stockholder's Equity until the foreign operation is substantially liquidated.

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**Form 10-K.** This is the report that most publicly traded companies file with the SEC on an annual basis. It provides a comprehensive overview of the company's business and financial condition. Some companies choose to send their Form 10-K to their shareholders instead of sending a separate annual report. Currently, Form 10-K must be filed with the SEC within 90 days after the end of the company's fiscal year.

**Form 10-Q.** The Form 10-Q is a report filed quarterly by most reporting companies. It includes unaudited financial statements and provides a continuing view of the company's financial position during the year. The report must be filed for each of the first three fiscal quarters of the company's fiscal year and is currently due within 45 days of the close of the quarter. In addition to Form 10-Q, companies provide annual reports to their shareholders and file Form 10-K on an annual basis with the SEC.

**Form 8-K.** This is the "current report" used to report material events or corporate changes that have previously not been reported by the company in a quarterly report (Form 10-Q) or annual report (Form 10-K).

**Forms 3, 4, 5.** Corporate insiders-meaning a company's officers and directors, and any beneficial owners of more than 10% of a class of the company's equity securities registered under Section 12 of the Securities Exchange Act of 1934 – must file with the SEC a statement of ownership regarding those securities. The initial filing is on Form 3. Changes in ownership are reported on Form 4. Insiders must file a Form 5 to report any transactions that should have been reported earlier on a Form 4 or were eligible for deferred reporting.

**fraud.** Willful misrepresentation by one person of a fact inflicting damage on another person.

**gain.** Excess of revenues received over costs relating to a specific transaction.

**general information technology (IT) controls.** Controls over the entity's IT processes that support the continued proper operation of the IT environment, including the continued effective functioning of information-processing controls and the integrity of information in the entity's information system. Also see **IT environment**.

**general ledger.** Collection of all assets, liability, owners' equity, revenue, and expense accounts.

**generally accepted accounting principles (GAAP).** Conventions, rules, and procedures necessary to define accepted accounting practice at a particular time. The highest level of such principles is set by the Financial Accounting Standards Board (FASB).

**generally accepted auditing standards (GAAS).** Standards set by the American Institute of Certified Public Accountants (AICPA) which concern the auditor's professional qualities and judgment in the performance of his/her audit and in the actual report.

**going concern.** Assumption that a business can remain in operation long enough for all of its current plans to be carried out.

**going private.** A company "goes private" when it reduces the number of its shareholders to fewer than 300 and is no longer required to file reports with the SEC.

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**goodwill.** An asset representing the future economic benefits arising from other assets acquired in a business combination or an acquisition by a not for profit entity that are not individually identified and separately recognized.

**gross income.** A tax term meaning all income from whatever source derived, except as otherwise provided in the income tax code.

**guaranty.** Legal arrangement involving a promise by one person to perform the obligations of a second person to a third person, in the event the second person fails to perform.

**hedges.** Protect an entity against the risk of adverse price or interest-rate movements on its assets, liabilities, or anticipated transactions. A hedge is used to avoid or reduce risks by creating a relationship by which losses on positions are counterbalanced by gains on separate positions in another market.

**historical cost.** The generally accepted method of accounting used in the primary financial statements that is based on measures of historical prices without restatement into units, each of which has the same general purchasing power.

**income.** Inflow of revenue during a period of time.

**income statement.** Summary of the effect of revenues and expenses over a period of time.

**income tax basis.** A special purpose framework that the reporting entity uses or expects to use to file its income tax return for the period covered by the financial statements.

**initial public offerings (IPO).** IPO stands for initial public offering and occurs when a company first sells its shares to the public.

**initial public offerings, lockup agreements.** Lockup agreements prohibit company insiders – including employees, their friends and family, and venture capitalists – from selling their shares for a set period of time. In other words, the shares are "locked up." Before a company goes public, the company and its underwriter typically enter into a lockup agreement to ensure that shares owned by these insiders do not enter the public market too soon after the offering.

**insider trading.** "Insider trading" actually includes both legal and illegal conduct. The legal version is when corporate insiders – officers, directors, and employees – buy and sell stock in their own companies. Illegal insider trading refers generally to buying or selling a security, in breach of a fiduciary duty or other relationship of trust and confidence, while in possession of material, nonpublic information about the security. Insider trading violations may also include "tipping" such information, securities trading by the person "tipped," and securities trading by those who misappropriate such information.

**intangible asset.** Asset having no physical existence such as trademarks and patents.

**interest.** Payment for the use or forbearance of money.

**interim financial statements.** Financial statements that report the operations of an entity for less than one year.

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**information-processing controls**. Controls relating to the processing of information in IT applications or manual information processes in the entity's information system that directly address risks to the integrity of information.

**inherent risk factors.** Characteristics of events or conditions that affect the susceptibility to misstatement, whether due to fraud or error, of an assertion about a class of transactions, account balance, or disclosure, before consideration of controls. Such factors may be qualitative or quantitative and include complexity, subjectivity, change, uncertainty, or susceptibility to misstatement due to management bias or other fraud risk factors insofar as they affect inherent risk. Depending on the degree to which the inherent risk factors affect the susceptibility of an assertion to misstatement, the level of inherent risk varies on a scale that is referred to as *the spectrum of inherent risk*.

**Inspection.** Inspection is an evaluation of the adequacy of aspects of the firm's quality management policies and procedures, its personnel's understanding of those policies and procedures, and the extent of the firm's compliance with them.

**internal control.** Process designed to provide reasonable assurance regarding achievement of various management objectives such as the reliability of financial reports.

**inventory.** Tangible property held for sale, or materials used in a production process to make a product.

**investment.** Expenditure used to purchase goods or services that could produce a return to the investor.

**IT environment.** The IT applications and supporting IT infrastructure, as well as the IT processes and personnel involved in those processes, that an entity uses to support business operations and achieve business strategies. For the purposes of this definition, (1) an *IT application* is a program or a set of programs that is used in the initiation, processing, recording, and reporting of transactions or information. IT applications include data warehouses and report writers; (2) the IT infrastructure comprises the network, operating systems, and databases and their related hardware and software; and (3) the IT processes are the entity's processes to manage access to the IT environment, manage program changes or changes to the IT environment, and manage IT operations.

**journal.** Any book containing original entries of daily financial transactions.

**last in, first out (LIFO).** Accounting method of valuing inventory under which the costs of the last goods acquired are the first costs charged to expense. Commonly known as LIFO.

**lease.** Conveyance of land, buildings, equipment, or other assets from one person (Lessor) to another (Lessee) for a specific period of time for monetary or other consideration, usually in the form of rent.

**leasehold.** Property interest a lessee owns in the leased property.

**ledger.** Any book of accounts containing the summaries of debit and credit entries.

**lessee.** Person or entity that has the right to use property under the terms of a lease.

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**lessor.** Owner of property, the temporary use of which is transferred to another (lessee) under the terms of a lease.

**liability.** Debts or obligations owed by one entity (Debtor) to another entity (Creditor) payable in money, goods, or services.

**listing and delisting requirements.** Before a company can begin trading on an exchange or the Nasdaq Stock Market, it must meet certain initial requirements or "listing standards." The exchanges and the Nasdaq Stock Market set their own standards for listing and continuing to trade. The SEC does not set listing standards. The initial listing requirements mandate that a company meet specified minimum thresholds for the number of publicly traded shares, total market value, stock price, and number of shareholders. After a company starts trading, it must continue to meet different standards set by the exchanges or the Nasdaq Stock Market. Otherwise, the company can be delisted. These continuing standards usually are less stringent than the initial listing requirements.

**long-term debt.** Debt with a maturity of more than one year from the current date.

**loss.** Excess of expenditures over revenue for a period or activity. Also, for tax purposes, an excess of basis over the amount realized in a transaction.

**lower of cost or market.** Valuing assets for financial reporting purposes. Ordinarily, "cost" is the purchase price of the asset and "market" refers to its current replacement cost. Generally accepted accounting principles (GAAP) requires that certain assets (e.g., inventories) be carried at the lower of cost or market.

**management discussion and analysis (MD&A).** SEC requirement in financial reporting for an explanation by management of significant changes in operations, assets, and liquidity.

**management's specialist.** An individual or organization possessing expertise in a field other than accounting or auditing, whose work in that field is used by the entity to assist the entity in preparing the financial statements.

**manipulation.** Manipulation is intentional conduct designed to deceive investors by controlling or artificially affecting the market for a security. Manipulation can involve a number of techniques to affect the supply of, or demand for, a stock. They include spreading false or misleading information about a company; improperly limiting the number of publicly-available shares; or rigging quotes, prices, or trades to create a false or deceptive picture of the demand for a security.

**marketable securities.** Stocks and other negotiable instruments which can be easily bought and sold on either listed exchanges or over-the-counter markets.

**mark-to-market.** Method of valuing assets that results in adjustment of an asset's carrying amount to its market value.

**matching principle.** The concept that all costs and expenses incurred in generating revenues must be recognized in the same reporting period as the related revenues.

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**materiality.** Magnitude of an omission or misstatements of accounting information that, in the light of surrounding circumstances, makes it probable that the judgment of a reasonable person relying on the information would change or be influenced.

**mergers.** Mergers are business transactions involving the combination of two or more companies into a single entity. Most state laws require that mergers be approved by at least a majority of the company's shareholders if the merger will have a significant impact on the company.

**modified cash basis.** A special purpose framework that begins with the cash basis method (see Cash basis) and applies modifications having substantial support, such as recording depreciation on fixed assets or accruing income taxes.

**NASDAQ.** Nasdaq stands for the National Association of Securities Dealers Automated Quotation System. Unlike the New York Stock Exchange where trades take place on an exchange, Nasdaq is an electronic stock market that uses a computerized system to provide brokers and dealers with price quotes. The National Association of Securities Dealers, Inc. owns and operates The Nasdaq Stock Market.

**net assets.** Excess of the value of securities owned, cash, receivables, and other assets over the liabilities of the company.

**net income.** Excess or deficit of total revenues and gains compared with total expenses and losses for an accounting period.

**net sales.** Sales at gross invoice amounts less any adjustments for returns, allowances, or discounts taken.

**net worth.** Similar to equity, the excess of assets over liabilities.

**network.** An association of entities that includes one or more firms.

**network firm.** Another firm or entity that belongs to the same network as the firm.

**nonpublic entity.** Any entity other than (a) one whose securities trade in a public market either on a stock exchange (domestic or foreign) or in the over-the-counter market, including securities quoted only locally or regionally; (b) one that makes a filing with a regulatory agency in preparation for the sale of any class of its securities in a public market; or (c) a subsidiary, corporate joint venture, or other entity controlled by an entity covered by (a) or (b).

**no-par stock.** Stock authorized to be issued but for which no par value is set in the articles of incorporation. A stated value is set by the board of directors on the issuance of this type of stock.

**no-par value.** Stock or bond that does not have a specific value indicated.

**notional.** Value assigned to assets or liabilities that is not based on cost or market (e.g., the value of a service not yet rendered).

**objectivity.** Emphasizing or expressing the nature of reality as it is apart from personal reflection or feelings; independence of mind.

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**paid in capital.** Portion of the stockholders' equity which was paid in by the stockholders, as opposed to capital arising from profitable operations.

**par value.** Amount per share set in the articles of incorporation of a corporation to be entered in the capital stocks account where it is left permanently and signifies a cushion of equity capital for the protection of creditors.

**parent company.** Company that has a controlling interest in the common stock of another.

**partner.** Any individual with authority to bind the firm with respect to the performance of a professional services engagement. For purposes of this definition, *partner* may include an employee with this authority who has not assumed the risks and benefits of ownership. Firms might use different titles to refer to individuals with this authority.

**personnel.** Partners and staff in the firm.

**predecessor accountant.** An accountant who (a) has reported on the most recent compiled or reviewed financial statements or was engaged to perform but did not complete a compilation or review of the financial statements, and (b) has resigned, declined to stand for reappointment, or been notified that his or her services have been or may be terminated.

**preferred stock.** Type of capital stock that carries certain preferences over common stock, such as a prior claim on dividends and assets.

**premium.** (1) Excess amount paid for a bond over its face amount. (2) In insurance, the cost of specified coverage for a designated period of time.

**prepaid expense.** Cost incurred to acquire economically useful goods or services that are expected to be consumed in the revenue-earning process within the operating cycle.

**prescribed form.** Any standard preprinted form designed or adopted by the body to which it is to be submitted, for example, forms used by industry trade associations, credit agencies, banks, and governmental and regulatory bodies other than those concerned with the sale or trading of securities. A form designed or adopted by the entity whose financial statements are to be compiled is not considered to be a prescribed form.

**present value.** Current value of a given future cash flow stream, discounted at a given rate.

**principal.** Face amount of a security, exclusive of any premium or interest. The basis for interest computations.

**professional standards.** Standards promulgated by the AICPA Auditing Standards Board or the AICPA Accounting and Review Services Committee under the "General Standards Rule" (ET sec. 1.300.001) or the "Compliance With Standards Rule" (ET sec. 1.310.001) of the AICPA code, or by other standard-setting bodies that set auditing and attest standards applicable to the engagement being performed and relevant ethical requirements.

**proxy statement.** The SEC requires that shareholders of a company whose securities are registered under Section 12 of the Securities Exchange Act of 1934 receive a proxy statement prior to a shareholder meeting, whether an annual or special meeting. The information contained in the statement must be filed with the SEC before soliciting a

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shareholder vote on the election of directors and the approval of other corporate action. Solicitations, whether by management or shareholders, must disclose all important facts about the issues on which shareholders are asked to vote.

**purchase method of accounting.** Accounting for a merger by adding the acquired company's assets at the price paid for them to the acquiring company's assets.

**quiet period.** The term "quiet period," also referred to as the "waiting period," is not defined under the federal securities laws. The quiet period extends from the time a company files a registration statement with the SEC until SEC staff declares the registration statement "effective." During this period, the federal securities laws limit what information a company and related parties can release to the public. Rule 134 of the Securities Act of 1933 discusses these limitations.

**ratio analysis.** Comparison of actual or projected data for a particular company to other data for that company or industry in order to analyze trends or relationships.

**real property.** Land and improvements, including buildings and personal property that is permanently attached to the land or customarily transferred with the land.

**receivables.** Amounts of money due from customers or other debtors.

**reconciliation.** Comparison of two numbers to demonstrate the basis for the difference between them.

**Registration Under the Securities Act of 1933.** Often referred to as the "truth in securities" law, the Securities Act of 1933 has two basic objectives: (1) To require that investors receive financial and other significant information concerning securities being offered for public sale; and (2) To prohibit deceit, misrepresentations, and other fraud in the sale of securities. The SEC accomplishes these goals primarily by requiring that companies disclose important financial information through the registration of securities. This information enables investors, not the government, to make informed judgments about whether to purchase a company's securities.

**Regulation D offerings.** Under the Securities Act of 1933, any offer to sell securities must either be registered with the SEC or meet an exemption. Regulation D (or Reg D) provides three exemptions from the registration requirements, allowing some smaller companies to offer and sell their securities without having to register the securities with the SEC.

**regulatory basis.** A special purpose framework that the reporting entity uses to comply with the requirements or financial reporting provisions of a governmental regulatory agency to whose jurisdiction the entity is subject. An example is a basis of accounting insurance companies use pursuant to the rules of a state insurance commission.

**reissued report.** A report issued subsequent to the date of the original report that bears the same date as the original report. A reissued report may need to be revised for the effects of specific events; in these circumstances, the report should be dual-dated with the original date and a separate date that applies to the effects of such events.

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**related party transaction.** Business or other transaction between persons who do not have an arm's-length relationship (e.g., a relationship with independent, competing interests). The most common is between family members or controlled entities. For tax purposes, these types of transactions are generally subject to a greater level of scrutiny.

**relevant assertions.** An assertion about a class of transactions, account balance, or disclosure is relevant when it has an identified risk of material misstatement. A risk of material misstatement exists when (*a*) there is a reasonable possibility of a misstatement occurring (that is, its likelihood), and (*b*) if it were to occur, there is a reasonable possibility of the misstatement being material (that is, its magnitude). The determination of whether an assertion is a relevant assertion is made before consideration of any related controls (that is, the determination is based on inherent risk).

**Relevant ethical requirements.** Principles of professional ethics and ethical requirements to which the engagement team and engagement quality reviewer are subject, which consist of the AICPA code together with rules of applicable state boards of accountancy and applicable regulatory agencies that are more restrictive.

**research and development (R&D).** Research is a planned activity aimed at discovery of new knowledge with the hope of developing new or improved products and services. Development is the translation of research findings into a plan or design of new or improved products and services.

**response (in relation to a system of quality management).** Policies or procedures designed and implemented by the firm to address one or more quality risks. Policies are statements of what should, or should not, be done to address a quality risk or risks. Such statements may be documented, explicitly stated in communications, or implied through actions and decisions. Procedures are actions to implement policies.

**retained earnings.** Accumulated undistributed earnings of a company retained for future needs or for future distribution to its owners.

**revenue recognition.** Method of determining whether or not income has met the conditions of being earned and realized or is realizable.

**revenues.** Sales of products, merchandise, and services; and earnings from interest, dividend, rents.

**review.** Accounting service that provides some assurance as to the reliability of financial information. In a review, a certified public accountant (CPA) does not conduct an examination under generally accepted auditing standards (GAAS). Instead, the accountant performs inquiry and analytical procedures that provide the accountant with a reasonable basis for expressing limited assurance that there are no material modifications that should be made to the statements for them to be in conformity with GAAP or, if applicable, with a special purpose framework.

**risks arising from the use of IT.** Susceptibility of information-processing controls to ineffective design or operation, or risks to the integrity of information in the entity's information system,

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due to ineffective design or operation of controls in the entity's IT processes. See **IT environment**.

**risk assessment procedures.** The audit procedures designed and performed to identify and assess the risks of material misstatement, whether due to fraud or error, at the financial statement and assertion levels.

**risk management.** Process of identifying and monitoring business risks in a manner that offers a risk/return relationship that is acceptable to an entity's operating philosophy.

**security.** Any kind of transferable certificate of ownership including equity securities and debt securities.

**significant class of transactions, account balance, or disclosure.** A class of transactions, account balance, or disclosure for which there is one or more relevant assertions.

**significant risk.** An identified risk of material misstatement, (1) for which the assessment of inherent risk is close to the upper end of the spectrum of inherent risk due to the degree to which inherent risk factors affect the combination of the likelihood of a misstatement occurring and the magnitude of the potential misstatement should that misstatement occur, or, (2) that is to be treated as a significant risk in accordance with the requirements of other AU-C sections.

**short-term.** Current; ordinarily due within one year.

**SSARS.** Statements on Standards for Accounting And Review Services issued by the AICPA Accounting and Review Services Committee (ARSC).

**start-up costs.** (1) Costs, excluding acquisition costs, incurred to bring a new unit into production. (2) Costs incurred to begin a business.

**statement of cash flows.** A statement of cash flows is one of the basic financial statements that is required as part of a complete set of financial statements prepared in conformity with generally accepted accounting principles. It categorizes net cash provided or used during a period as operating, investing and financing activities, and reconciles beginning and ending cash and cash equivalents.

**statement of financial condition.** Basic financial statement, usually accompanied by appropriate disclosures that describe the basis of accounting used in its preparation and presentation as of a specified date, the entity's assets, liabilities, and the equity of its owners. Also known as *balance sheet*.

**statutory basis.** See Regulatory basis.

**straight-line depreciation.** Accounting method that reflects an equal amount of wear and tear during each period of an asset's useful life. For instance, the annual straight-line depreciation of a $10,000 asset expected to last ten years is $1,000.

**strike price.** Price of a financial instrument at which conversion or exercise occurs.

**submission of financial statements.** Presenting to a client or third party's financial statements that the accountant has prepared either manually or through the use of computer software.

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**subsequent event.** Material event that occurs after the end of the accounting period and before the publication of an entity's financial statements. Such events are disclosed in the notes to the financial statements.

**successor accountant.** An accountant who has been invited to make a proposal for an engagement to compile or review financial statements and is considering accepting the engagement or an accountant who has accepted such an engagement.

**sufficiency (of audit evidence).** The measure of the quantity of audit evidence. The quantity of audit evidence necessary is affected by the auditor's assessment of the risks of material misstatement and the quality of the audit evidence obtained (that is, its appropriateness).

**system of internal control.** The system designed, implemented, and maintained by those charged with governance, management, and other personnel to provide reasonable assurance about the achievement of an entity's objectives with regard to reliability of financial reporting, effectiveness and efficiency of operations, and compliance with applicable laws and regulations. For purposes of GAAS, the system of internal control consists of five interrelated components: (1) Control environment, (2) the entity's risk assessment process, (3) the entity's process to monitor the system of internal control, (4) the information system and communication, and (5) control activities.

**tangible asset.** Assets having a physical existence, such as cash, land, buildings, machinery, or claims on property, investments or goods in process.

**tax.** Charge levied by a governmental unit on income, consumption, wealth, or other basis.

**third party.** All parties except for members of management who are knowledgeable about the nature of the procedures applied and the basis of accounting and assumptions used in the preparation of the financial statements.

**trade date.** Date when a security transaction is entered into, to be settled on at a later date. Transactions involving financial instruments are generally accounted for on the trade date.

**treasury bill.** Short-term obligation that bears no interest and is sold at a discount.

**treasury bond.** Long-term obligation that matures more than five years from issuance and bears interest.

**treasury note.** Intermediate-term obligation that matures one to five years from issuance and bears interest.

**treasury stock.** Stock reacquired by the issuing company. It may be held indefinitely, retired, issued upon exercise of stock options, or resold.

**trial balance.** A trial balance consists of a listing of all of the general ledger accounts and their corresponding debit or credit balances. Also, in a trial balance, no attempt is made to establish a mathematical relationship among the assets, liabilities, equity, revenues, and expenses except that total debits equal total credits.

**unearned income.** Payments received for services which have not yet been performed.

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**updated report.** A report issued by a continuing accountant that takes into consideration information that he/she becomes aware of during his/her current engagement and that re-expresses his/her previous conclusions or, depending on the circumstances, expresses different conclusions on the financial statements of a prior period as of the date of his/her current report.

**valuation allowance.** Method of lowering or raising an object's current value by adjusting its acquisition cost to reflect its market value by use of a contra account.

**variance.** Deviation or difference between an estimated value and the actual value.

**work in progress.** Inventory account consisting of partially completed goods awaiting completion and transfer to finished inventory.

**working capital.** Excess of current assets over current liabilities.

**working papers.** (1) Records kept by the auditor of the procedures applied, the tests performed, the information obtained, and the pertinent conclusions reached in the course of the audit. (2) Any records developed by a certified public accountant (CPA) during an audit.

**yield.** Return on an investment an investor receives from dividends or interest expressed as a percentage of the cost of the security.

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