Identifying a lease

Lease is present in a contract if the contract includes both:

- An identified asset
  - Is explicitly or implicitly specified
  - Supplier has no practical ability to substitute or would not economically benefit from substituting

- The right to control use of the asset during the term
  - Decision-making authority over the use of the asset
  - The ability to obtain substantially all economic benefits from the use of the asset
Embedded leases

Determining whether to apply lease accounting under the new leasing guidance is likely to be much more important since virtually all leases will be on the lessee’s balance sheet.

Leases with related parties

Lease is classified based on legally enforceable terms and conditions of the lease

No adjustments for off-market terms in sale and leaseback transactions

Classification and accounting should be the same as leases between unrelated parties in the separate financial statements of the related parties

Lessors and lessees should apply related party disclosure requirements in ASC 850 Related Party Disclosures
Separating lease and nonlease components

- A contract may contain lease and nonlease components
- Components within an arrangement are those items or activities that transfer a good or service to the customer
- Lease components provide the customer with rights to use an identified asset
- Only lease components are classified

Land is a separate lease component unless the accounting effect of treating it as a separate component would be insignificant

Examples of items that are not components:
- Property taxes
- Insurance

Examples of nonlease components:
- Maintenance
- Consumables

If a lessee pays for property taxes on behalf of the lessor, should the lessor gross up the income statement for those payments?
Yes
**Allocating contract consideration**

**Lessee**
- Allocate consideration to each component based on relative standalone selling price

- Lessee may elect, by class of underlying asset, to not separate nonlease components from the associated lease component, but treat them as a lease component

**Lessor**
- Allocate consideration to the components based on transaction price allocation guidance in the new revenue recognition standard

- FASB proposal to not separate nonlease component from related lease component in certain circumstances

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**Lease classification – Lessee**

If a lease meets any of the following 5 conditions, it is a finance lease

- **Transfer of ownership**
- **Option to purchase is reasonably certain**
- **Lease term is a “major part” of the economic life**
- **Present value of lease payments is “substantially all” of the fair value**
- **Specialized nature**

*Not applicable if commencement date falls at or near end of asset’s economic life*
**Lessee model**

<table>
<thead>
<tr>
<th></th>
<th>Operating lease</th>
<th>Finance lease</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Balance sheet</strong>*</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Right-of-use asset</td>
<td>Y</td>
<td>Y</td>
</tr>
<tr>
<td>Lease liability</td>
<td>Y</td>
<td>Y</td>
</tr>
<tr>
<td><strong>Income statement</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Interest expense</td>
<td>Not applicable</td>
<td>Y</td>
</tr>
<tr>
<td>Amortization expense</td>
<td>Not applicable</td>
<td>Y</td>
</tr>
<tr>
<td>Lease expense</td>
<td>Y</td>
<td>Not applicable</td>
</tr>
<tr>
<td><strong>Statement of cash flows (operating, investing, financing)</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Interest portion of liability</td>
<td>Not applicable</td>
<td>Operating</td>
</tr>
<tr>
<td>Principal portion of liability</td>
<td>Not applicable</td>
<td>Financing</td>
</tr>
<tr>
<td>Lease expense</td>
<td>Operating</td>
<td>Not applicable</td>
</tr>
</tbody>
</table>

*Policy election to not recognize short-term leases on balance sheet, short-term lease:
  - Lease term of 12 months or less from commencement
  - No purchase option that the lessee is reasonably certain to exercise

**Income statement comparison**

![Graph showing annual expense over lease year for ASC 842 Finance lease and ASC 842 Operating lease](image)
Measurement of the lease liability

Overview

Lease liability

Lease payments

Discount rate

Which variable lease payments are included?

Which discount rate is used?

What is the lease term?

Lease term

Lease commencement
- The date a lessor makes an underlying asset available for use to a lessee
- The date for classification and initial measurement

Lease term
- Start with non-cancellable period of the lease
- Consider all relevant factors that create an economic incentive for lessee to exercise an option to continue using the asset or terminate the lease
- Is the lessee reasonably certain to exercise its option?
**Variable lease payments**

Variable lease payments depend on:
- Rate/index
- Other variables

- Example: inflation/interest rate or market rental rates
- Example: performance based lease payments, % of sales

**Part of lease liability**

**Not part of lease liability**

---

**Discount rate to measure lease liability (lessee)**

Has this changed?

Interest rate implicit in the lease:
- If rate cannot be readily determined
  - Incremental borrowing rate at commencement date*

Matters more because almost all leases recognized on balance sheet

*Non-Public Business Entities: Accounting policy election to use a risk-free discount rate for all leases; risk-free discount rate needs to match the lease term of each lease
**Incremental borrowing rate**

- **New guidance:** The rate of interest that a lessee would have to pay to borrow on a collateralized basis over a similar term an amount equal to the lease payments in a similar economic environment
- **Old guidance:** The rate that the lessee would have incurred to borrow over a similar term the funds necessary to purchase the leased asset

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**Initial direct costs (IDC)**

**Incremental costs that would not have been incurred if the lease had not been obtained**

**Examples of initial direct costs**
- Commissions
- Payments made to an existing tenant to incentivize tenant to terminate its lease

**Examples of costs that are not initial direct costs**
- Fixed employee salaries
- General overheads e.g., depreciation, equipment costs, unsuccessful origination efforts
- Costs for advertising, soliciting potential lessees, servicing existing leases
- Costs related to activities that occur before the lease is obtained, e.g., costs of obtaining tax or legal advice, negotiating lease terms, due diligence related costs such as evaluating a prospective lessee’s financial condition

*Definition is more narrow than direct loan origination costs*
Reassessment requirements – Lessees

Under ASC 842, different triggering events could cause different consequences...

<table>
<thead>
<tr>
<th>Cause</th>
<th>Effect</th>
</tr>
</thead>
</table>
| Changes in the assessment of lessee renewal, termination, or purchase options based on triggering events within lessee’s control | • Reassess lease classification  
|                                            | • Remeasure liability using updated discount rate*  |
|                                            | • Reallocation consideration between lease & non-lease components  
|                                            | • Adjust the right-of-use asset (potential P&L impact)  |
|                                            | Change in amounts probable of being owed under a lessee provided residual value guarantee  
|                                            | • Do not reassess lease classification  
|                                            | • Remeasure liability using original discount rate & revised payments  |
|                                            | Contingency resolved such that some or all variable payments, which are not based on an index or rate, become fixed  |

*unless already reflected in existing discount rate

What are the main changes for lessors?

“The accounting applied by a lessor will largely be unchanged...”

- Alignment of lessor accounting model with the revenue recognition principle in Topic 606
- Application of sale and leaseback and build-to-suit accounting
- Conformance with certain glossary terms in lessee guidance
- Changes in classification test and accounting for sales-type and direct financing leases (some STL -> DFL)
- Leveraged lease accounting discontinued
- Initial direct costs include only costs that would not have been incurred had the lease not been obtained
- Up front profit will be deferred if control is not transferred to the lessee (DFL)
- No differentiation of leases of real estate and leases of other assets (e.g. long-term land leases)
- Enhanced qualitative & quantitative disclosures required
### Sale and leaseback transactions

**Determine whether a sale has occurred**
- Seller-lessee and buyer-lessee accounting is symmetrical
- Transaction must qualify as a sale under new revenue guidance
- No sale is recognized when the leaseback is classified as a finance lease or a sales-type lease (use 842 definition of initial direct costs for classification)
- A repurchase option may prevent sale accounting

**Account for the transaction when a sale is recognized**
- Gains are recognized in full upon sale
- The seller and buyer classify the lease in the same manner as any other lease

**Account for ‘off-market’ terms**
- If the terms of a transaction are off-market, adjustment is required (e.g., recognition of a rent prepayment or a borrowing from the buyer)

### Asset impairment

**Lessee**
- Apply long-lived assets guidance (ASC 360)
- Appropriately write down the right-of-use asset
- Following the impairment, amortize the right-of-use asset on a straight-line basis
  - For operating leases, expense will continue to be reflected as a single lease expense in the income statement, but lease expense will no longer be recognized on a straight-line basis

**Lessor**
- Sales-type and direct financing leases: Apply guidance for receivables (ASC 310 impairment, ASC 326 credit losses when adopted) to the entire net investment in lease, treating any unguaranteed residual as a terminal cash flow
  - How to consider changes in residual value under CECL?
- Operating leases: apply long-lived asset guidance (ASC 360)
  - Does CECL apply to straightline operating lease receivables?
**Effective date**

<table>
<thead>
<tr>
<th></th>
<th>Public Business Entity*</th>
<th>Non-public Entity</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Effective date</strong></td>
<td>Fiscal years and interim periods after Dec 15, 2018 (2019 calendar year)</td>
<td>Fiscal years after Dec 15, 2019 (2020 calendar year) Interim periods after Dec 15, 2020 (2021 calendar year)</td>
</tr>
<tr>
<td><strong>Early adoption permitted?</strong></td>
<td>Yes</td>
<td>Yes</td>
</tr>
</tbody>
</table>

*Also applicable to certain non-profit entities and certain employee benefit plans.

On July 20, 2017 the SEC Observer to the EITF meeting said SEC staff would not object if entities that are considered public business entities, only because their financial statements or financial information is required to be included in another entity’s SEC filing, use the effective dates for private companies when they adopt ASC 842.

**Practical Expedients**

**Individual expedients**
- May apply hindsight to existing leases to determine lease term and asset impairment
- Existing land easements not accounted for under ASC 840

**Package**
- At adoption do not reassess:
  - Whether an arrangement is, or contains, a lease
  - Lease classification
  - Whether initial direct costs would qualify for capitalization under the new standard
**Proposed optional transition method for leases**

Example using calendar year-end public company

**Current Guidance:**
- Jan 1, 2017: Earliest period presented (initial application date)
- Comparative Period
- Current Period

**Proposed: Alternative transition option**
- Jan 1, 2017: Earliest period presented (initial application date)
- Comparative Period
- Current Period

**OR**

*Cumulative-effect adjustment to retained earnings

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**Transition if package of practical expedients is elected and hindsight is not**

<table>
<thead>
<tr>
<th>Lessee</th>
<th>Lessor</th>
</tr>
</thead>
<tbody>
<tr>
<td>Capital Leases</td>
<td>All Leases</td>
</tr>
<tr>
<td>Operating Leases</td>
<td>RoU asset &amp; lease liability at PV of remaining “minimum rental payments” under ASC 840* + probable RVG</td>
</tr>
<tr>
<td>Carry over current balances</td>
<td>Carry over current balances</td>
</tr>
</tbody>
</table>

*Diversity in whether executory costs (maintenance, insurance, taxes) included in minimum lease payments under ASC 840*