FINANCIAL ACCOUNTING SERIES

FASB ACCOUNTING STANDARDS UPDATE

No. 2016-02
February 2016

Leases (Topic 842)

An Amendment of the *FASB Accounting Standards Codification*®

Financial Accounting Standards Board

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Summary

Why Is the FASB Issuing This Accounting Standards Update (Update)?

The FASB is issuing this Update to increase transparency and comparability among organizations by recognizing lease assets and lease liabilities on the balance sheet and disclosing key information about leasing arrangements. To meet that objective, the FASB is amending the *FASB Accounting Standards Codification*® and creating Topic 842, Leases. This Update, along with IFRS 16, *Leases,* are the results of the FASB's and the International Accounting Standards Board's (IASB's) efforts to meet that objective and improve financial reporting.

Leasing is utilized by many entities. It is a means of gaining access to assets, of obtaining financing, and/or of reducing an entity's exposure to the full risks of asset ownership. The prevalence of leasing, therefore, means that it is important that users of financial statements have a complete and understandable picture of an entity's leasing activities. Previous leases accounting was criticized for failing to meet the needs of users of financial statements because it did not always provide a faithful representation of leasing transactions. In particular, it did not require lessees to recognize assets and liabilities arising from operating leases on the balance sheet. As a result, there had been long-standing requests from many users of financial statements and others to change the accounting requirements so that lessees would be required to recognize the rights and obligations resulting from leases as assets and liabilities.

Many of the criticisms associated with previous leases guidance related to the accounting for operating leases in the financial statements of lessees, and addressing those concerns with lessee accounting was the main focus of the Boards. As such, the Boards decided to not fundamentally change lessor accounting with the amendments in this Update. However, some changes have been made to lessor accounting to conform and align that guidance with the lessee guidance and other areas within generally accepted accounting principles (GAAP), such as Topic 606, Revenue from Contracts with Customers.

Who Is Affected by the Amendments in This Update?

Topic 842 affects any entity that enters into a lease (as that term is defined in this Update), with some specified scope exemptions. The guidance in this Update supersedes Topic 840, Leases.

How Do the Main Provisions Differ from Current Generally Accepted Accounting Principles (GAAP) and Why Are They an Improvement?

The main difference between previous GAAP and Topic 842 is the recognition of lease assets and lease liabilities by lessees for those leases classified as operating leases under previous GAAP. During redeliberations, the Board considered the feedback received throughout the project and in response to the different models proposed in the FASB Discussion Paper, *Leases: Preliminary Views*, the 2010 proposed Accounting Standards Update, *Leases (Topic 840)*, and the 2013 proposed Accounting Standards Update, *Leases (Topic 842)*. The Board decided that, consistent with all three proposals, lessees should be required to recognize the assets and liabilities arising from leases on the balance sheet. Throughout the project, the Board consulted extensively on the approach to lease expense recognition and considered a number of alternatives. The feedback received indicated that stakeholders had various views about the economics of lease transactions. The Board ultimately reached the conclusion that the economics of leases can vary for a lessee and that those economics should be reflected in the financial statements; therefore, Topic 842 retains a distinction between finance leases and operating leases. The classification criteria for distinguishing between finance leases and operating leases are substantially similar to the classification criteria for distinguishing between capital leases and operating leases in the previous leases guidance. The result of retaining a distinction between finance leases and operating leases is that under the lessee accounting model in Topic 842, the effect of leases in the statement of comprehensive income and the statement of cash flows is largely unchanged from previous GAAP.

Other differences between the previous leases guidance and Topic 842 are described below. Throughout redeliberations, the Board introduced a number of simplifications from what were previously proposed; some of those simplifications were to keep the requirements in Topic 842 similar to those in the previous leases guidance in order to reduce the cost and complexity of transition to the new guidance. In addition to simplifications from the previous leases proposals, certain aspects of lease accounting have been simplified in Topic 842 as compared with the previous leases guidance in Topic 840.

Lessee Accounting

The core principle of Topic 842 is that a lessee should recognize the assets and liabilities that arise from leases. All leases create an asset and a liability for the lessee in accordance with FASB Concepts Statement No. 6, *Elements of Financial Statements*, and, therefore, recognition of those lease assets and lease liabilities represents an improvement over previous GAAP, which did not require lease assets and lease liabilities to be recognized for most leases.

A lessee should recognize in the statement of financial position a liability to make lease payments (the lease liability) and a right-of-use asset representing its right to use the underlying asset for the lease term. When measuring assets and liabilities arising from a lease, a lessee (and a lessor) should include payments to be made in optional periods only if the lessee is reasonably certain to exercise an option to extend the lease or not to exercise an option to terminate the lease. Similarly, optional payments to purchase the underlying asset should be included in the measurement of lease assets and lease liabilities only if the lessee is reasonably certain to exercise that purchase option. *Reasonably certain* is a high threshold that is consistent with and intended to be applied in the same way as the *reasonably assured* threshold in the previous leases guidance. In addition, also consistent with the previous leases guidance, a lessee (and a lessor) should exclude most variable lease payments in measuring lease assets and lease liabilities, other than those that depend on an index or a rate or are in substance fixed payments.

For leases with a term of 12 months or less, a lessee is permitted to make an accounting policy election by class of underlying asset not to recognize lease assets and lease liabilities. If a lessee makes this election, it should recognize lease expense for such leases generally on a straight-line basis over the lease term.

The recognition, measurement, and presentation of expenses and cash flows arising from a lease by a lessee have not significantly changed from previous GAAP. There continues to be a differentiation between finance leases and operating leases. However, the principal difference from previous guidance is that the lease assets and lease liabilities arising from operating leases should be recognized in the statement of financial position.

For finance leases, a lessee is required to do the following:

1. Recognize a right-of-use asset and a lease liability, initially measured at the present value of the lease payments, in the statement of financial position
2. Recognize interest on the lease liability separately from amortization of the right-of-use asset in the statement of comprehensive income
3. Classify repayments of the principal portion of the lease liability within financing activities and payments of interest on the lease liability and variable lease payments within operating activities in the statement of cash flows.

For operating leases, a lessee is required to do the following:

1. Recognize a right-of-use asset and a lease liability, initially measured at the present value of the lease payments, in the statement of financial position
2. Recognize a single lease cost, calculated so that the cost of the lease is allocated over the lease term on a generally straight-line basis

3. Classify all cash payments within operating activities in the statement of cash flows.

Lessor Accounting

The accounting applied by a lessor is largely unchanged from that applied under previous GAAP. For example, the vast majority of operating leases should remain classified as operating leases, and lessors should continue to recognize lease income for those leases on a generally straight-line basis over the lease term. However, some changes to the lessor accounting guidance were made to align both of the following:

1. The lessor accounting guidance with specific changes made to the lessee accounting guidance. For example, certain glossary terms that are applied by lessees and lessors and that will affect a lessee applying the lessor guidance as a sublessor were updated so that lessees and lessors apply the same terms.
2. Key aspects of the lessor accounting model with the revenue recognition guidance in Topic 606. Leasing is fundamentally a revenue-generating activity for lessors, and many aspects of the previous lessor accounting guidance aligned with, or were derived from, the revenue recognition guidance that preceded Topic 606 (for example, specific aspects of the lessor accounting guidance for real estate assets were designed to conform with the revenue recognition guidance specific to sales of real estate, and both the previous leasing and certain revenue recognition guidance in GAAP utilized a risk-and-rewards principle for determining when the sale of an asset occurred). 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.

Leveraged Leases

In addition to the changes outlined above, the previous accounting model for leveraged leases continues to apply only to those leveraged leases that commenced before the effective date of the guidance in this Update. The accounting model for leveraged leases in Topic 840 is not retained for leases that commence after the effective date of the guidance in this Update.

Definition of a Lease

At inception of a contract, an entity should determine whether the contract is or contains a lease. Topic 842 defines a lease as 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. Control over the use of the identified asset means that the customer has both (1) the right to obtain substantially all of the economic benefits from the use of the asset and (2) the right to direct the use of the asset.

Under the lessee accounting model in previous GAAP, the critical determination was whether a lease was a capital lease or an operating lease because lease assets and lease liabilities were recognized only for capital leases. Under Topic 842, the critical determination is whether a contract is or contains a lease because lessees are required to recognize lease assets and lease liabilities for all leases—finance and operating—other than short-term leases (that is, if the entity elects the short-term lease recognition and measurement exemption). Topic 842 provides detailed guidance and several examples to illustrate the application of the definition of a lease to assist entities in making this critical determination.

Components

Topic 842 requires an entity to separate the lease components from the nonlease components (for example, maintenance services or other activities that transfer a good or service to the customer) in a contract. Although this was a requirement in previous GAAP, Topic 842 provides more guidance on how to identify and separate components than previous GAAP. Only the lease components must be accounted for in accordance with Topic 842. The consideration in the contract is allocated to the lease and nonlease components on a relative standalone price basis (for lessees) or in accordance with the allocation guidance in Topic 606 (for lessors). Consideration attributable to nonlease components is not a lease payment and, therefore, is not included in the measurement of lease assets or lease liabilities. Entities should account for nonlease components in accordance with other applicable Topics. Activities that do not transfer a good or service to the lessee or amounts paid solely to reimburse costs of the lessor are not components in a contract and are not allocated any of the consideration in the contract.

The above notwithstanding, Topic 842 provides a practical expedient for lessees as it relates to separating lease components from nonlease components. Lessees may make an accounting policy election by class of underlying asset not to separate lease components from nonlease components. If an entity makes that accounting policy election, it is required to account for the nonlease components together with the related lease components as a single lease component.

Sale and Leaseback Transactions

For a sale to occur in the context of a sale and leaseback transaction, the transfer of the asset must meet the requirements for a sale in Topic 606. If there is no sale for the seller-lessee, the buyer-lessor also does not account for a purchase. Any consideration paid for the asset is accounted for as a financing transaction by both the seller-lessee and the buyer-lessor. There could be circumstances in which a transaction would have qualified for a sale under the previous leases guidance but will not qualify for a sale under Topic 606, or vice versa. In particular, many sale and leaseback transactions involving real estate will qualify for sale and leaseback accounting that would not have qualified for sale and leaseback accounting under the previous leases guidance. In contrast, some sale and leaseback transactions involving assets other than real estate that previously would have qualified for sale and leaseback accounting will not qualify for sale and leaseback accounting under Topic 842. Topic 842 includes implementation guidance to assist entities in determining whether the transfer of an asset in the context of a sale and leaseback transaction is a sale. In particular, Topic 842 specifies that if the leaseback is classified as a finance/sales-type lease, no sale has occurred. Topic 842 also specifies that a repurchase option (that is, for the seller-lessee to repurchase the asset from the buyer-lessor) precludes sale accounting unless (1) the asset is nonspecialized and (2) the exercise price of the option is the fair value of the asset on the date the option is exercised.

For transactions previously accounted for as a sale and a leaseback under previous GAAP, the transition guidance in Topic 842 does not require an entity to reassess whether the transaction would have qualified as a sale and a leaseback in accordance with Topic 842.

Disclosures

Disclosures are required by lessees and lessors to meet the objective of enabling users of financial statements to assess the amount, timing, and uncertainty of cash flows arising from leases. To meet that objective, the Board decided to require qualitative disclosures along with specific quantitative disclosures. The Board's intention is to require enough information to supplement the amounts recorded in the financial statements so that users can understand more about the nature of an entity's leasing activities.

Transition

In transition, lessees and lessors are required to recognize and measure leases at the beginning of the earliest period presented using a modified retrospective approach. The modified retrospective approach includes a number of optional practical expedients that entities may elect to apply. These practical expedients relate to the identification and classification of leases that commenced before the effective date, initial direct costs for leases that commenced before the effective date, and the ability to use hindsight in evaluating lessee options to extend or terminate a lease or to purchase the underlying asset.

An entity that elects to apply the practical expedients will, in effect, continue to account for leases that commence before the effective date in accordance with previous GAAP unless the lease is modified, except that lessees are required to recognize a right-of-use asset and a lease liability for all operating leases at each reporting date based on the present value of the remaining minimum rental payments that were tracked and disclosed under previous GAAP.

The transition guidance in Topic 842 also provides specific guidance for sale and leaseback transactions, build-to-suit leases, leveraged leases, and amounts previously recognized in accordance with the business combinations guidance for leases.

When Will the Amendments Be Effective?

The amendments in this Update are effective for fiscal years beginning after December 15, 2018, including interim periods within those fiscal years, for any of the following:

1. A public business entity
2. A not-for-profit entity that has issued, or is a conduit bond obligor for, securities that are traded, listed, or quoted on an exchange or an over-the-counter market
3. An employee benefit plan that files financial statements with the U.S. Securities and Exchange Commission (SEC).

For all other entities, the amendments in this Update are effective for fiscal years beginning after December 15, 2019, and interim periods within fiscal years beginning after December 15, 2020.

Early application of the amendments in this Update is permitted for all entities.

How Do the Provisions Compare with International Financial Reporting Standards (IFRS)?

The leases project began as a joint project with the IASB, and many of the requirements in Topic 842 are the same as the requirements in IFRS 16. The main differences between Topic 842 and IFRS 16 are in relation to certain aspects of the lessee accounting model. In contrast to the lessee accounting model in Topic 842, which distinguishes between finance leases and operating leases in the financial statements, the lessee accounting model in IFRS 16 requires all leases to be accounted for consistent with the Topic 842 approach for finance leases. Consequently, leases classified as operating leases under Topic 842 will be accounted for differently under GAAP than under IFRS and will have a different effect on the statement of comprehensive income and the statement of cash flows under IFRS 16 than under previous IFRSs. The following are the other notable requirements of IFRS 16 that are not consistent with the requirements in Topic 842:

1. Lessee accounting model

   a. IFRS 16 has a lessee recognition and measurement exemption for leases of assets with values of less than $5,000.
2. Lessor accounting model
   a. IFRS 16 does not distinguish between sales-type and direct financing leases; therefore, IFRS 16 permits recognition of selling profit on direct financing leases at lease commencement.
   b. IFRS 16 does not include any explicit guidance on collectibility of the lease payments and amounts necessary to satisfy a residual value guarantee.
   c. IFRS 16 applies a model to modifications of sales-type and direct financing leases that is predicated on IFRS financial instruments guidance.
3. Measurement of the right-of-use asset
   a. IFRS 16 allows alternative measurement bases for the right-of-use asset (for example, the fair value model under IAS 40, *Investment Property*, or at a revalued amount in accordance with IAS 16, *Property, Plant and Equipment*).
4. Variable lease payments
   a. IFRS 16 requires reassessment of variable lease payments that depend on an index or a rate when there is a change in the cash flows resulting from a change in the reference index or rate (that is, when an adjustment to the lease payments takes effect).
5. Subleases
   a. When classifying a sublease, IFRS 16 requires an intermediate lessor to determine the classification of the sublease with reference to the right-of-use asset arising from the head lease.
6. Sale and leaseback transactions
   a. IFRS 16 does not include application guidance on whether the transfer of an asset in a sale and leaseback transaction is a sale, other than to state that if the seller-lessee has a substantive repurchase option regarding the underlying asset, then no sale has occurred.
   b. IFRS 16 restricts the gain recognized by a seller-lessee in a sale and leaseback transaction to the amount of the gain that relates to the buyer-lessor's residual interest in the underlying asset at the end of the leaseback.
7. Private companies
   a. IFRS 16 does not have guidance specifically for private companies; however, Topic 842 permits an accounting policy election for private companies to use a risk-free rate to discount the lease liability for each lease.
8. Statement of cash flows
   a. IFRS 16 accounts for payments of interest in accordance with IAS 7, *Statement of Cash Flows*. IAS 7 allows interest to be classified within operating, investing, or financing activities.

9. Disclosure
    a. IFRS 16 has similar but not identical qualitative and quantitative disclosure requirements to Topic 842.
10. Transition
    a. IFRS 16 has different transition provisions than Topic 842 as a result of the differences in the lessee and lessor accounting provisions.
11. Existing differences in other areas of GAAP and IFRS that affect the accounting for leases
    a. The key areas of difference are the existing requirements for impairment (of financial instruments and long-lived assets other than goodwill) and the accounting for investment properties.

Amendments to the *FASB Accounting Standards Codification®*

Introduction

1. This Update is organized into two sections:

   a. Leases—Amendments in this section codify the Board's decision in the leases project and create a new Topic 842. For those amendments, see Section A.
   b. Conforming Amendments—Amendments in this section conform guidance throughout the Accounting Standards Codification as a result of the Board's decisions in the leases project. For those amendments, see Section B.

2. The Accounting Standards Codification is amended as described in paragraphs 3–185. In some cases, to put the change in context, not only are the amended paragraphs shown but also the preceding and following paragraphs. Terms from the Master Glossary are linked (in **bold** type) the first time they appear in each Section and the first time they appear after a “>” symbol and a “>>” symbol heading. In the Implementation Guidance part of Section 55, Glossary terms are linked the first time they appear after a “>>” symbol heading and a “>>>” symbol heading. Added text is underlined, and deleted text is ~~struck out~~.

Section A—Leases: Amendments to the Accounting Standards Codification

Addition of Topic 842

3. Add Subtopic 842-10, with a link to transition paragraph 842-10-65-1, as follows.

[For ease of readability, the new Subtopic is not underlined.]

Leases—Overall

Overview and Background

General

842-10-05-1 The **Leases** Topic includes the following Subtopics:

a. Overall
b. **Lessee**
c. **Lessor**
d. Sale and Leaseback Transactions
e. **Leveraged Lease** Arrangements.

842-10-05-2 The Subtopics listed in paragraph 842-10-05-1 establish the requirements of financial accounting and reporting for lessees and lessors.

Objectives

General

842-10-10-1 This Topic specifies the accounting for **leases**. An entity should consider the terms and conditions of the **contract** and all relevant facts and circumstances when applying this Topic. An entity should apply this Topic consistently to leases with similar characteristics and in similar circumstances.

842-10-10-2 The objective of this Topic is to establish the principles that **lessees** and **lessors** shall apply to report useful information to users of financial statements about the amount, timing, and uncertainty of cash flows arising from a lease.

Scope and Scope Exceptions

General

842-10-15-1 An entity shall apply this Topic to all **leases**, including **subleases**. Because a lease is defined as 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, this Topic does not apply to any of the following:

a. Leases of intangible assets (see Topic 350, Intangibles—Goodwill and Other).
b. Leases to explore for or use minerals, oil, natural gas, and similar nonregenerative resources (see Topics 930, Extractive Activities—Mining, and 932, Extractive Activities—Oil and Gas). This includes the intangible right to explore for those natural resources and rights to use the land in which those natural resources are contained (that is, unless those rights of use include more than the right to explore for natural resources), but not equipment used to explore for the natural resources.
c. Leases of biological assets, including timber (see Topic 905, Agriculture).
d. Leases of **inventory** (see Topic 330, Inventory).
e. Leases of assets under construction (see Topic 360, Property, Plant, and Equipment).

> Identifying a Lease

842-10-15-2 At inception of a **contract**, an entity shall determine whether that contract is or contains a **lease**.

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

842-10-15-4 To determine whether a contract conveys the right to control the use of an identified asset (see paragraphs 842-10-15-17 through 15-26) for a period of time, an entity shall assess whether, throughout the **period of use**, the customer has both of the following:

a. The right to obtain substantially all of the economic benefits from use of the identified asset (see paragraphs 842-10-15-17 through 15-19)
b. The right to direct the use of the identified asset (see paragraphs 842-10-15-20 through 15-26).

If the customer in the contract is a joint operation or a joint arrangement, an entity shall consider whether the joint operation or joint arrangement has the right to control the use of an identified asset throughout the period of use.

842-10-15-5 If the customer has the right to control the use of an identified asset for only a portion of the term of the contract, the contract contains a lease for that portion of the term.

842-10-15-6 An entity shall reassess whether a contract is or contains a lease only if the terms and conditions of the contract are changed.

842-10-15-7 In making the determination about whether a contract is or contains a lease, an entity shall consider all relevant facts and circumstances.

842-10-15-8 Paragraph 842-10-55-1 includes a flowchart that depicts the decision process for evaluating whether a contract is or contains a lease.

> > Identified Asset

842-10-15-9 An asset typically is identified by being explicitly specified in a **contract**. However, an asset also can be identified by being implicitly specified at the time that the asset is made available for use by the customer.

> > > Substantive Substitution Rights

842-10-15-10 Even if an asset is specified, a customer does not have the right to use an identified asset if the supplier has the substantive right to substitute the asset throughout the period of use. A supplier's right to substitute an asset is substantive only if both of the following conditions exist:

a. The supplier has the practical ability to substitute alternative assets throughout the period of use (for example, the customer cannot prevent the supplier from substituting an asset, and alternative assets are readily available to the supplier or could be sourced by the supplier within a reasonable period of time).
b. The supplier would benefit economically from the exercise of its right to substitute the asset (that is, the economic benefits associated with substituting the asset are expected to exceed the costs associated with substituting the asset).

842-10-15-11 An entity's evaluation of whether a supplier's substitution right is substantive is based on facts and circumstances at inception of the contract and shall exclude consideration of future events that, at inception, are not considered likely to occur. Examples of future events that, at inception of the contract, would not be considered likely to occur and, thus, should be excluded from the evaluation include, but are not limited to, the following:

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

842-10-15-12 If the asset is located at the customer's premises or elsewhere, the costs associated with substitution are generally higher than when located at the supplier's premises and, therefore, are more likely to exceed the benefits associated with substituting the asset.

842-10-15-13 If the supplier has a right or an obligation to substitute the asset only on or after either a particular date or the occurrence of a specified event, the supplier does not have the practical ability to substitute alternative assets throughout the period of use.

842-10-15-14 The supplier's right or obligation to substitute an asset for repairs or maintenance, if the asset is not operating properly, or if a technical upgrade becomes available, does not preclude the customer from having the right to use an identified asset.

842-10-15-15 If the customer cannot readily determine whether the supplier has a substantive substitution right, the customer shall presume that any substitution right is not substantive.

> > > Portions of Assets

842-10-15-16 A capacity portion of an asset is an identified asset if it is physically distinct (for example, a floor of a building or a segment of a pipeline that connects a single customer to the larger pipeline). A capacity or other portion of an asset that is not physically distinct (for example, a capacity portion of a fiber optic cable) is not an identified asset, unless it represents substantially all of the capacity of the asset and thereby provides the customer with the right to obtain substantially all of the economic benefits from use of the asset.

> > Right to Control the Use of the Identified Asset

> > > Right to Obtain the Economic Benefits from the Use of the Identified Asset

842-10-15-17 To control the use of an identified asset, a customer is required to have the right to obtain substantially all of the economic benefits from use of the asset throughout the period of use (for example, by having exclusive use of the asset throughout that period). A customer can obtain economic benefits from use of an asset directly or indirectly in many ways, such as by using, holding, or subleasing the asset. The economic benefits from use of an asset include its primary output and by-products (including potential cash flows derived from these items) and other economic benefits from using the asset that could be realized from a commercial transaction with a third party.

842-10-15-18 When assessing the right to obtain substantially all of the economic benefits from use of an asset, an entity shall consider the economic benefits that result from use of the asset within the defined scope of a customer's right to use the asset in the contract (see paragraph 842-10-15-23). For example:

a. If a contract limits the use of a motor vehicle to only one particular territory during the period of use, an entity shall consider only the economic benefits from use of the motor vehicle within that territory and not beyond.
b. If a contract specifies that a customer can drive a motor vehicle only up to a particular number of miles during the period of use, an entity shall consider only the economic benefits from use of the motor vehicle for the permitted mileage and not beyond.

842-10-15-19 If a contract requires a customer to pay the supplier or another party a portion of the cash flows derived from use of an asset as consideration, those cash flows paid as consideration shall be considered to be part of the economic benefits that the customer obtains from use of the asset. For example, if a customer is required to pay the supplier a percentage of sales from use of retail space as consideration for that use, that requirement does not prevent the customer from having the right to obtain substantially all of the economic benefits from use of the retail space. That is because the cash flows arising from those sales are considered to be economic benefits that the customer obtains from use of the retail space, a portion of which it then pays to the supplier as consideration for the right to use that space.

> > > Right to Direct the Use of the Identified Asset

842-10-15-20 A customer has the right to direct the use of an identified asset throughout the period of use in either of the following situations:

a. The customer has the right to direct how and for what purpose the asset is used throughout the period of use (as described in paragraphs 842-10-15-24 through 15-26).
b. The relevant decisions about how and for what purpose the asset is used are predetermined (see paragraph 842-10-15-21) and at least one of the following conditions exists:
    1. The customer has the right to operate the asset (or to direct others to operate the asset in a manner that it determines) throughout the period of use without the supplier having the right to change those operating instructions.
    2. The customer designed the asset (or specific aspects of the asset) in a way that predetermines how and for what purpose the asset will be used throughout the period of use.

842-10-15-21 The relevant decisions about how and for what purpose an asset is used can be predetermined in a number of ways. For example, the relevant decisions can be predetermined by the design of the asset or by contractual restrictions on the use of the asset.

842-10-15-22 In assessing whether a customer has the right to direct the use of an asset, an entity shall consider only rights to make decisions about the use of the asset during the period of use unless the customer designed the asset (or specific aspects of the asset) in accordance with paragraph 842-10-15-20(b)(2).

Consequently, unless that condition exists, an entity shall not consider decisions that are predetermined before the period of use. For example, if a customer is able only to specify the output of an asset before the period of use, the customer does not have the right to direct the use of that asset. The ability to specify the output in a contract before the period of use, without any other decision-making rights relating to the use of the asset, gives a customer the same rights as any customer that purchases goods or services.

> > > > Protective Rights

842-10-15-23 A contract may include terms and conditions designed to protect the supplier's interest in the asset or other assets, to protect its personnel, or to ensure the supplier's compliance with laws or regulations. These are examples of protective rights. For example, a contract may specify the maximum amount of use of an asset or limit where or when the customer can use the asset, may require a customer to follow particular operating practices, or may require a customer to inform the supplier of changes in how an asset will be used. Protective rights typically define the scope of the customer's right of use but do not, in isolation, prevent the customer from having the right to direct the use of an asset.

> > > > How and for What Purpose an Asset Is Used

842-10-15-24 A customer has the right to direct how and for what purpose an asset is used throughout the period of use if, within the scope of its right of use defined in the contract, it can change how and for what purpose the asset is used throughout that period. In making this assessment, an entity considers the decision-making rights that are most relevant to changing how and for what purpose an asset is used throughout the period of use. Decision-making rights are relevant when they affect the economic benefits to be derived from use. The decision-making rights that are most relevant are likely to be different for different contracts, depending on the nature of the asset and the terms and conditions of the contract.

842-10-15-25 Examples of decision-making rights that, depending on the circumstances, grant the right to direct how and for what purpose an asset is used, within the defined scope of the customer's right of use, include the following:

a. The right to change the type of output that is produced by the asset (for example, deciding whether to use a shipping container to transport goods or for storage, or deciding on the mix of products sold from a retail unit)
b. The right to change when the output is produced (for example, deciding when an item of machinery or a power plant will be used)
c. The right to change where the output is produced (for example, deciding on the destination of a truck or a ship or deciding where a piece of equipment is used or deployed)
d. The right to change whether the output is produced and the quantity of that output (for example, deciding whether to produce energy from a power plant and how much energy to produce from that power plant).

842-10-15-26 Examples of decision-making rights that do not grant the right to direct how and for what purpose an asset is used include rights that are limited to operating or maintaining the asset. Although rights such as those 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. Such rights (that is, to operate or maintain the asset) can be held by the customer or the supplier. The supplier often holds those rights to protect its investment in the asset. However, rights to operate an asset may grant the customer the right to direct the use of the asset if the relevant decisions about how and for what purpose the asset is used are predetermined (see paragraph 842-10-15-20(b)(1)).

842-10-15-27 See Examples 1 through 10 (paragraphs 842-10-55-41 through 55-130) for illustrations of the requirements for identifying a lease.

> Separating Components of a Contract

842-10-15-28 After determining that a **contract** contains a **lease** in accordance with paragraphs 842-10-15-2 through 15-27, an entity shall identify the separate lease components within the contract. An entity shall consider the right to use an **underlying asset** to be a separate lease component (that is, separate from any other lease components of the contract) if both of the following criteria are met:

a. 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. Readily available resources are goods or services that are sold or leased separately (by the **lessor** or other suppliers) or resources that the lessee already has obtained (from the lessor or from other transactions or events).
b. The right of use is neither highly dependent on nor highly interrelated with the other right(s) to use underlying assets in the contract. A lessee's right to use an underlying asset is highly dependent on or highly interrelated with another right to use an underlying asset if each right of use significantly affects the other.

842-10-15-29 The guidance in paragraph 842-10-15-28 notwithstanding, to classify and account for a lease of land and other assets, an entity shall account for the right to use land as a separate lease component unless the accounting effect of doing so would be insignificant (for example, separating the land element would have no effect on lease classification of any lease component or the amount recognized for the land lease component would be insignificant).

842-10-15-30 The **consideration in the contract** shall be allocated to each separate lease component and nonlease component of the contract (see paragraphs 842-10-15-33 through 15-37 for lessee allocation guidance and paragraphs 842-10-15-38 through 15-42 for lessor allocation guidance). Components of a contract include only those items or activities that transfer a good or service to the lessee. Consequently, the following are not components of a contract and do not receive an allocation of the consideration in the contract:

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

842-10-15-31 An entity shall account for each separate lease component separately from the nonlease components of the contract (that is, unless a lessee makes the accounting policy election described in paragraph 842-10-15-37). Nonlease components are not within the scope of this Topic and shall be accounted for in accordance with other Topics.

842-10-15-32 See Examples 11 through 14 (paragraphs 842-10-55-131 through 55-158) for illustrations of the requirements for allocating consideration to components of a contract.

> > Lessee

842-10-15-33 A **lessee** shall allocate (that is, unless the lessee makes the accounting policy election described in paragraph 842-10-15-37) the **consideration in the contract** to the separate **lease** components determined in accordance with paragraphs 842-10-15-28 through 15-31 and the nonlease components as follows:

a. The lessee shall determine the relative **standalone price** of the separate lease components and the nonlease components on the basis of their observable standalone prices. If observable standalone prices are not readily available, the lessee shall estimate the standalone prices, maximizing the use of observable information. A residual estimation approach may be appropriate if the standalone price for a component is highly variable or uncertain.
b. The lessee shall allocate the consideration in the contract on a relative standalone price basis to the separate lease components and the nonlease components of the **contract**.

Initial direct costs should be allocated to the separate lease components on the same basis as the **lease payments**.

842-10-15-34 A price is observable if it is the price that either the **lessor** or similar suppliers sell similar lease or nonlease components on a standalone basis.

842-10-15-35 The consideration in the contract for a lessee includes all of the payments described in paragraph 842-10-30-5, as well as all of the following payments that will be made during the **lease term**:

a. Any fixed payments (for example, monthly service charges) or in substance fixed payments, less any incentives paid or payable to the lessee, other than those included in paragraph 842-10-30-5
b. Any other variable payments that depend on an index or a rate, initially measured using the index or rate at the **commencement date**.

842-10-15-36 A lessee shall remeasure and reallocate the consideration in the contract upon either of the following:

a. A remeasurement of the **lease liability** (for example, a remeasurement resulting from a change in the lease term or a change in the assessment of whether a lessee is or is not reasonably certain to exercise an option to purchase the **underlying asset**) (see paragraph 842-20-35-4)
b. The effective date of a contract modification that is not accounted for as a separate contract (see paragraph 842-10-25-8).

842-10-15-37 As a practical expedient, a lessee may, as an accounting policy election by class of underlying asset, choose not to separate nonlease components from lease components and instead to account for each separate lease component and the nonlease components associated with that lease component as a single lease component.

> > Lessor

842-10-15-38 A **lessor** shall allocate the **consideration in the contract** to the separate **lease** components and the nonlease components using the requirements in paragraphs 606-10-32-28 through 32-41. A lessor also shall allocate any capitalized costs (for example, **initial direct costs** or **contract** costs capitalized in accordance with Subtopic 340-40 on other assets and deferred costs—contracts with customers) to the separate lease components or nonlease components to which those costs relate.

842-10-15-39 The consideration in the contract for a lessor includes all of the amounts described in paragraph 842-10-15-35 and any other variable payment amounts that would be included in the transaction price in accordance with the guidance on variable consideration in Topic 606 on revenue from contracts with customers that specifically relates to either of the following:

a. The lessor's efforts to transfer one or more goods or services that are not leases
b. An outcome from transferring one or more goods or services that are not leases.

Any variable payment amounts accounted for as consideration in the contract shall be allocated entirely to the nonlease component(s) to which the variable payment specifically relates if doing so would be consistent with the transaction price allocation objective in paragraph 606-10-32-28.

842-10-15-40 If the terms of a variable payment amount other than those in paragraph 842-10-15-35 relate to a lease component, even partially, the lessor shall recognize those payments as income in profit or loss in the period when the changes in facts and circumstances on which the variable payment is based occur (for example, when the **lessee's** sales on which the amount of the variable payment depends occur).

842-10-15-41 A lessor shall remeasure and reallocate the remaining consideration in the contract when there is a contract modification that is not accounted for as a separate contract in accordance with paragraph 842-10-25-8.

842-10-15-42 If the consideration in the contract changes, a lessor shall allocate those changes in accordance with the requirements in paragraphs 606-10-32-42 through 32-45.

> Other Considerations

842-10-15-43 Paragraph 815-10-15-79 explains that **leases** that are within the scope of this Topic are not derivative instruments subject to Subtopic 815-10 on derivatives and hedging although a derivative instrument embedded in a lease may be subject to the requirements of Section 815-15-25. Paragraph 815-10-15-80 explains that **residual value guarantees** that are subject to the guidance in this Topic are not subject to the guidance in Subtopic 815-10. Paragraph 815-10-15-81 requires that a third-party residual value guarantor consider the guidance in Subtopic 815-10 for all residual value guarantees that it provides to determine whether they are derivative instruments and whether they qualify for any of the scope exceptions in that Subtopic.

Glossary

Acquiree

The **business** or **businesses** that the **acquirer** obtains control of in a **business combination**. This term also includes a nonprofit activity or business that a not-for-profit acquirer obtains control of in an **acquisition by a not-for-profit entity**.

Acquirer

The entity that obtains control of the **acquiree**. However, in a **business combination** in which a **variable interest entity** (VIE) is acquired, the primary beneficiary of that entity always is the acquirer.

Acquisition by a Not-for-Profit Entity

A transaction or other event in which a not-for-profit acquirer obtains control of one or more nonprofit activities or businesses and initially recognizes their assets and liabilities in the acquirer's financial statements. When applicable guidance in Topic 805 is applied by a **not-for-profit entity**, the term **business combination** has the same meaning as this term has for a for-profit entity. Likewise, a reference to business combinations in guidance that links to Topic 805 has the same meaning as a reference to acquisitions by not-for-profit entities.

Advance Refunding

A transaction involving the issuance of new debt to replace existing debt with the proceeds from the new debt placed in trust or otherwise restricted to retire the existing debt at a determinable future date or dates.

Business

An integrated set of activities and assets that is capable of being conducted and managed for the purpose of providing a return in the form of dividends, lower costs, or other economic benefits directly to investors or other owners, members, or participants. Additional guidance on what a business consists of is presented in paragraphs 805-10-55-4 through 55-9.

Business Combination

A transaction or other event in which an **acquirer** obtains control of one or more **businesses.** Transactions sometimes referred to as true mergers or mergers of equals also are business combinations. See also **Acquisition by a Not-for-Profit Entity**.

Commencement Date of the Lease (Commencement Date)

The date on which a **lessor** makes an **underlying asset** available for use by a **lessee**. See paragraphs 842-10-55-19 through 55-21 for implementation guidance on the commencement date.

Consideration in the Contract

See paragraph 842-10-15-35 for what constitutes the consideration in the **contract** for **lessees** and paragraph 842-10-15-39 for what constitutes consideration in the contract for **lessors**.

Contract

An agreement between two or more parties that creates enforceable rights and obligations.

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).

Discount Rate for the Lease

For a **lessee**, the discount rate for the **lease** is the **rate implicit in the lease** unless that rate cannot be readily determined. In that case, the lessee is required to use its **incremental borrowing rate**.

For a **lessor**, the discount rate for the lease is the rate implicit in the lease.

Economic Life

Either the period over which an asset is expected to be economically usable by one or more users or the number of production or similar units expected to be obtained from an asset by one or more users.

Effective Date of the Modification

The date that a **lease modification** is approved by both the **lessee** and the **lessor**.

Fair Value (second definition)

The price that would be received to sell an asset or paid to transfer a liability in an **orderly transaction** between **market participants** at the measurement date.

Finance Lease

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

Fiscal Funding Clause

A provision by which the lease is cancellable if the legislature or other funding authority does not appropriate the funds necessary for the governmental unit to fulfill its obligations under the lease agreement.

Incremental Borrowing Rate

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.

Initial Direct Costs

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

Inventory

The aggregate of those items of tangible personal property that have any of the following characteristics:

a. Held for sale in the ordinary course of business
b. In process of production for such sale
c. To be currently consumed in the production of goods or services to be available for sale.

The term inventory embraces goods awaiting sale (the merchandise of a trading concern and the finished goods of a manufacturer), goods in the course of production (work in process), and goods to be consumed directly or indirectly in production (raw materials and supplies). This definition of inventories excludes long-term assets subject to depreciation accounting, or goods which, when put into use, will be so classified. The fact that a depreciable asset is retired from regular use and held for sale does not indicate that the item should be classified as part of the inventory. Raw materials and supplies purchased for production may be used or consumed for the construction of long-term assets or other purposes not related to production, but the fact that inventory items representing a small portion of the total may not be absorbed ultimately in the production process does not require separate classification. By trade practice, operating materials and supplies of certain types of entities such as oil producers are usually treated as inventory.

Lease

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.

Lease Liability

A **lessee's** obligation to make the **lease payments** arising from a **lease**, measured on a discounted basis.

Lease Modification

A change to the terms and conditions of a **contract** that results in a change in the scope of or the consideration for a **lease** (for example, a change to the terms and conditions of the contract that adds or terminates the right to use one or more underlying assets or extends or shortens the contractual lease term).

Lease Payments

See paragraph 842-10-30-5 for what constitutes lease payments from the perspective of a **lessee** and a **lessor**.

Lease Receivable

A **lessor's** right to receive **lease payments** arising from a **sales-type lease** or a **direct financing lease** plus any amount that a lessor expects to derive from the underlying asset following the end of the **lease term** to the extent that it is guaranteed by the **lessee** or any other third party unrelated to the lessor, measured on a discounted basis.

Lease Term

The noncancellable period for which a **lessee** has the right to use an **underlying asset**, together with all of the following:

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

Legal Entity

Any legal structure used to conduct activities or to hold assets. Some examples of such structures are corporations, partnerships, limited liability companies, grantor trusts, and other trusts.

Lessee

An entity that enters into a **contract** to obtain the right to use an **underlying asset** for a period of time in exchange for consideration.

Lessor

An entity that enters into a **contract** to provide the right to use an **underlying asset** for a period of time in exchange for consideration.

Leveraged Lease

From the perspective of a **lessor**, a **lease** that was classified as a leveraged lease in accordance with the leases guidance in effect before the effective date and for which the **commencement date** is before the effective date.

Market Participants

Buyers and sellers in the principal (or most advantageous) market for the asset or liability that have all of the following characteristics:

a. They are independent of each other, that is, they are not **related parties**, although the price in a related-party transaction may be used as an input to a fair value measurement if the reporting entity has evidence that the transaction was entered into at market terms
b. They are knowledgeable, having a reasonable understanding about the asset or liability and the transaction using all available information, including information that might be obtained through due diligence efforts that are usual and customary
c. They are able to enter into a transaction for the asset or liability
d. They are willing to enter into a transaction for the asset or liability, that is, they are motivated but not forced or otherwise compelled to do so.

Net Investment in the Lease

For a **sales-type lease**, the sum of the **lease receivable** and the **unguaranteed residual asset**.

For a **direct financing lease**, the sum of the lease receivable and the unguaranteed residual asset, net of any deferred selling profit.

Not-for-Profit Entity

An entity that possesses the following characteristics, in varying degrees, that distinguish it from a business entity:

a. Contributions of significant amounts of resources from resource providers who do not expect commensurate or proportionate pecuniary return
b. Operating purposes other than to provide goods or services at a profit
c. Absence of ownership interests like those of business entities.

Entities that clearly fall outside this definition include the following:

a. All investor-owned entities
b. Entities that provide dividends, lower costs, or other economic benefits directly and proportionately to their owners, members, or participants, such as mutual insurance entities, credit unions, farm and rural electric cooperatives, and employee benefit plans.

Operating Lease

From the perspective of a **lessee**, any **lease** other than a **finance lease**.

From the perspective of a **lessor**, any lease other than a **sales-type lease** or a **direct financing lease**.

Orderly Transaction

A transaction that assumes exposure to the market for a period before the measurement date to allow for marketing activities that are usual and customary for transactions involving such assets or liabilities; it is not a forced transaction (for example, a forced liquidation or distress sale).

Penalty

Any requirement that is imposed or can be imposed on the **lessee** by the **lease** agreement or by factors outside the lease agreement to do any of the following:

a. Disburse cash
b. Incur or assume a liability
c. Perform services
d. Surrender or transfer an asset or rights to an asset or otherwise forego an economic benefit, or suffer an economic detriment. Factors to consider in determining whether an economic detriment may be incurred include, but are not limited to, all of the following:

1. The uniqueness of purpose or location of the **underlying asset**
2. The availability of a comparable replacement asset
3. The relative importance or significance of the underlying asset to the continuation of the lessee's line of business or service to its customers
4. The existence of leasehold improvements or other assets whose value would be impaired by the lessee vacating or discontinuing use of the underlying asset
5. Adverse tax consequences
6. The ability or willingness of the lessee to bear the cost associated with relocation or replacement of the underlying asset at market rental rates or to tolerate other parties using the underlying asset.

Period of Use

The total period of time that an asset is used to fulfill a **contract** with a customer (including the sum of any nonconsecutive periods of time).

Probable (second definition)

The future event or events are likely to occur.

Public Business Entity

A public business entity is a business entity meeting any one of the criteria below. Neither a **not-for-profit entity** nor an employee benefit plan is a business entity.

a. It is required by the U.S. Securities and Exchange Commission (SEC) to file or furnish financial statements, or does file or furnish financial statements (including voluntary filers), with the SEC (including other entities whose financial statements or financial information are required to be or are included in a filing).
b. It is required by the Securities Exchange Act of 1934 (the Act), as amended, or rules or regulations promulgated under the Act, to file or furnish financial statements with a regulatory agency other than the SEC.
c. It is required to file or furnish financial statements with a foreign or domestic regulatory agency in preparation for the sale of or for purposes of issuing securities that are not subject to contractual restrictions on transfer.
d. It has issued, or is a conduit bond obligor for, securities that are traded, listed, or quoted on an exchange or an over-the-counter market.
e. It has one or more securities that are not subject to contractual restrictions on transfer, and it is required by law, contract, or regulation to prepare U.S. GAAP financial statements (including footnotes) and make them publicly available on a periodic basis (for example, interim or annual periods). An entity must meet both of these conditions to meet this criterion.

An entity may meet the definition of a public business entity solely because its financial statements or financial information is included in another entity's filing with the SEC. In that case, the entity is only a public business entity for purposes of financial statements that are filed or furnished with the SEC.

Rate Implicit in the Lease

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

Related Parties

Related parties include:

a. Affiliates of the entity
b. Entities for which investments in their equity securities would be required, absent the election of the fair value option under the Fair Value Option Subsection of Section 825-10-15, to be accounted for by the equity method by the investing entity
c. Trusts for the benefit of employees, such as pension and profit-sharing trusts that are managed by or under the trusteeship of management
d. Principal owners of the entity and members of their immediate families
e. Management of the entity and members of their immediate families
f. Other parties with which the entity may deal if one party controls or can significantly influence the management or operating policies of the other to an extent that one of the transacting parties might be prevented from fully pursuing its own separate interests
g. Other parties that can significantly influence the management or operating policies of the transacting parties or that have an ownership interest in one of the transacting parties and can significantly influence the other to an extent that one or more of the transacting parties might be prevented from fully pursuing its own separate interests.

Remote

The chance of the future event or events occurring is slight.

Residual Value Guarantee

A guarantee made to a **lessor** that the value of an **underlying asset** returned to the lessor at the end of a **lease** will be at least a specified amount.

Right-of-Use Asset

An asset that represents a **lessee's** right to use an **underlying asset** for the **lease term**.

Sales-Type Lease

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

Selling Profit or Selling Loss

At the **commencement date**, selling profit or selling loss equals:

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

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.

Standalone Price

The price at which a customer would purchase a component of a **contract** separately.

Sublease

A transaction in which an **underlying asset** is re-leased by the **lessee** (or intermediate **lessor**) to a third party (the sublessee) and the original (or head) **lease** between the lessor and the lessee remains in effect.

Underlying Asset

An asset that is the subject of a **lease** for which a right to use that asset has been conveyed to a **lessee**. The underlying asset could be a physically distinct portion of a single asset.

Unguaranteed Residual Asset

The amount that a **lessor** expects to derive from the **underlying asset** following the end of the **lease term** that is not guaranteed by the **lessee** or any other third party unrelated to the lessor, measured on a discounted basis.

Variable Interest Entity

A **legal entity** subject to consolidation according to the provisions of the Variable Interest Entities Subsections of Subtopic 810-10.

Variable Lease Payments

Payments made by a **lessee** to a **lessor** for the right to use an **underlying asset** that vary because of changes in facts or circumstances occurring after the **commencement date**, other than the passage of time.

Warranty

A guarantee for which the underlying is related to the performance (regarding function, not price) of nonfinancial assets that are owned by the guaranteed party. The obligation may be incurred in connection with the sale of goods or services; if so, it may require further performance by the seller after the sale has taken place.

Recognition

General

> Lease Classification

842-10-25-1 An entity shall classify each separate **lease** component at the **commencement date**. An entity shall not reassess the lease classification after the commencement date unless the **contract** is modified and the modification is not accounted for as a separate contract in accordance with paragraph 842-10-25-8. In addition, a **lessee** also shall reassess the lease classification after the commencement date if there is a change in the **lease term** or the assessment of whether the lessee is reasonably certain to exercise an option to purchase the **underlying asset**.

842-10-25-2 A lessee shall classify a lease as a **finance lease** and a **lessor** shall classify a lease as a **sales-type lease** when the lease meets any of the following criteria at lease commencement:

a. The lease transfers ownership of the underlying asset to the lessee by the end of the lease term.
b. The lease grants the lessee an option to purchase the underlying asset that the lessee is reasonably certain to exercise.
c. The lease term is for the major part of the remaining **economic life** of the underlying asset. However, if the commencement date falls at or near the end of the economic life of the underlying asset, this criterion shall not be used for purposes of classifying the lease.
d. 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 in accordance with paragraph 842-10-30-5(f) equals or exceeds substantially all of the **fair value** of the underlying asset.

e. 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.

842-10-25-3 When none of the criteria in paragraph 842-10-25-2 are met:

a. A lessee shall classify the lease as an **operating lease**.
b. A lessor shall classify the lease as either a **direct financing lease** or an operating lease. A lessor shall classify the lease as an operating lease unless both of the following criteria are met, in which case the lessor shall classify the lease as a direct financing lease:
    1. 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 in accordance with paragraph 842-10-30-5(f) and/or any other third party unrelated to the lessor equals or exceeds substantially all of the fair value of the underlying asset.
    2. It is **probable** that the lessor will collect the lease payments plus any amount necessary to satisfy a **residual value guarantee**.

842-10-25-4 A lessor shall assess the criteria in paragraphs 842-10-25-2(d) and 842-10-25-3(b)(1) using the **rate implicit in the lease**. For purposes of assessing the criterion in paragraph 842-10-25-2(d), a lessor shall assume that no **initial direct costs** will be deferred if, at the commencement date, the fair value of the underlying asset is different from its carrying amount.

842-10-25-5 If a single lease component contains the right to use more than one underlying asset (see paragraphs 842-10-15-28 through 15-29), an entity shall consider the remaining economic life of the predominant asset in the lease component for purposes of applying the criterion in paragraph 842-10-25-2(c).

842-10-25-6 When classifying a **sublease**, an entity shall classify the sublease with reference to the underlying asset (for example, the item of property, plant, or equipment that is the subject of the lease) rather than with reference to the **right-of-use asset**.

842-10-25-7 See paragraphs 842-10-55-2 through 55-15 for implementation guidance on lease classification.

> Lease Modifications

842-10-25-8 An entity shall account for a modification to a **contract** as a separate contract (that is, separate from the original contract) when both of the following conditions are present:

a. The modification grants the **lessee** an additional right of use not included in the original **lease** (for example, the right to use an additional asset).
b. The **lease payments** increase commensurate with the **standalone price** for the additional right of use, adjusted for the circumstances of the particular contract. For example, the standalone price for the lease of one floor of an office building in which the lessee already leases other floors

in that building may be different from the standalone price of a similar floor in a different office building, because it was not necessary for a **lessor** to incur costs that it would have incurred for a new lessee.

842-10-25-9 If a lease is modified and that modification is not accounted for as a separate contract in accordance with paragraph 842-10-25-8, the entity shall reassess the classification of the lease as of the **effective date of the modification** based on its modified terms and conditions and the facts and circumstances as of that date (for example, the **fair value** and remaining **economic life** of the **underlying asset** as of that date).

842-10-25-10 An entity shall account for **initial direct costs**, lease incentives, and any other payments made to or by the entity in connection with a modification to a lease in the same manner as those items would be accounted for in connection with a new lease.

> > Lessee

842-10-25-11 A **lessee** shall reallocate the remaining **consideration in the contract** and remeasure the **lease liability** using a **discount rate for the lease** determined at the **effective date of the modification** if a contract modification does any of the following:

a. Grants the lessee an additional right of use not included in the original contract (and that modification is not accounted for as a separate contract in accordance with paragraph 842-10-25-8)
b. Extends or reduces the term of an existing **lease** (for example, changes the **lease term** from five to eight years or vice versa), other than through the exercise of a contractual option to extend or terminate the lease (as described in paragraph 842-20-35-5)
c. Fully or partially terminates an existing lease (for example, reduces the assets subject to the lease)
d. Changes the consideration in the contract only.

842-10-25-12 In the case of (a), (b), or (d) in paragraph 842-10-25-11, the lessee shall recognize the amount of the remeasurement of the lease liability for the modified lease as an adjustment to the corresponding **right-of-use asset**.

842-10-25-13 In the case of (c) in paragraph 842-10-25-11, the lessee shall decrease the carrying amount of the right-of-use asset on a basis proportionate to the full or partial termination of the existing lease. Any difference between the reduction in the lease liability and the proportionate reduction in the right-of-use asset shall be recognized as a gain or a loss at the effective date of the modification.

842-10-25-14 If a **finance lease** is modified and the modified lease is classified as an **operating lease**, any difference between the carrying amount of the right-of-use asset after recording the adjustment required by paragraph 842-10-25-12 or 842-10-25-13 and the carrying amount of the right-of-use asset that would result from applying the initial operating right-of-use asset measurement guidance in paragraph 842-20-30-5 to the modified lease shall be accounted for in the same manner as a rent prepayment or a lease incentive.

> > Lessor

842-10-25-15 If an **operating lease** is modified and the modification is not accounted for as a separate **contract** in accordance with paragraph 842-10-25-8, the **lessor** shall account for the modification as if it were a termination of the existing **lease** and the creation of a new lease that commences on the **effective date of the modification** as follows:

a. If the modified lease is classified as an operating lease, the lessor shall consider any prepaid or accrued lease rentals relating to the original lease as a part of the **lease payments** for the modified lease.
b. If the modified lease is classified as a **direct financing lease** or a **sales-type lease**, the lessor shall derecognize any deferred rent liability or accrued rent asset and adjust the **selling profit or selling loss** accordingly.

842-10-25-16 If a direct financing lease is modified and the modification is not accounted for as a separate contract in accordance with paragraph 842-10-25-8, the lessor shall account for the modified lease as follows:

a. If the modified lease is classified as a direct financing lease, the lessor shall adjust the discount rate for the modified lease so that the initial net investment in the modified lease equals the carrying amount of the net investment in the original lease immediately before the effective date of the modification.
b. If the modified lease is classified as a sales-type lease, the lessor shall account for the modified lease in accordance with the guidance applicable to sales-type leases in Subtopic 842-30, with the **commencement date** of the modified lease being the effective date of the modification. In calculating the selling profit or selling loss on the lease, the **fair value** of the **underlying asset** is its fair value at the effective date of the modification and its carrying amount is the carrying amount of the net investment in the original lease immediately before the effective date of the modification.
c. If the modified lease is classified as an operating lease, the carrying amount of the underlying asset equals the net investment in the original lease immediately before the effective date of the modification.

842-10-25-17 If a sales-type lease is modified and the modification is not accounted for as a separate contract in accordance with paragraph 842-10-25-8, the lessor shall account for the modified lease as follows:

a. If the modified lease is classified as a sales-type or a direct financing lease, in the same manner as described in paragraph 842-10-25-16(a)

b. If the modified lease is classified as an operating lease, in the same manner as described in paragraph 842-10-25-16(c).

842-10-25-18 See Examples 15 through 22 (paragraphs 842-10-55-159 through 55-209) for illustrations of the requirements on **lease modifications**.

> Contract Combinations

842-10-25-19 An entity shall combine two or more **contracts**, at least one of which is or contains a **lease**, entered into at or near the same time with the same counterparty (or related parties) and consider the contracts as a single transaction if any of the following criteria are met:

a. The contracts are negotiated as a package with the same commercial objective(s).
b. The amount of consideration to be paid in one contract depends on the price or performance of the other contract.
c. The rights to use **underlying assets** conveyed in the contracts (or some of the rights of use conveyed in the contracts) are a single lease component in accordance with paragraph 842-10-15-28.

Initial Measurement

General

> Lease Term and Purchase Options

842-10-30-1 An entity shall determine the **lease term** as the noncancellable period of the **lease**, together with all of the following:

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

842-10-30-2 At the **commencement date**, an entity shall include the periods described in paragraph 842-10-30-1 in the lease term having considered all relevant factors that create an economic incentive for the lessee (that is, **contract**-based, asset-based, entity-based, and market-based factors). Those factors shall be considered together, and the existence of any one factor does not necessarily signify that a lessee is reasonably certain to exercise or not to exercise an option.

842-10-30-3 At the commencement date, an entity shall assess an option to purchase the **underlying asset** on the same basis as an option to extend or not to terminate a lease, as described in paragraph 842-10-30-2.

842-10-30-4 See paragraphs 842-10-55-19 through 55-21 for implementation guidance on commencement date and paragraphs 842-10-55-23 through 55-27 for implementation guidance on lease term and purchase options. See Examples 23 through 24 (paragraphs 842-10-55-210 through 55-224) for illustrations of the requirements on purchase options.

> Initial Measurement of the Lease Payments

842-10-30-5 At the **commencement date**, the **lease payments** shall consist of the following payments relating to the use of the **underlying asset** during the **lease term**:

a. Fixed payments, including in substance fixed payments, less any lease incentives paid or payable to the **lessee** (see paragraphs 842-10-55-30 through 55-31).
b. **Variable lease payments** that depend on an index or a rate (such as the Consumer Price Index or a market interest rate), initially measured using the index or rate at the commencement date.
c. The exercise price of an option to purchase the underlying asset if the lessee is reasonably certain to exercise that option (assessed considering the factors in paragraph 842-10-55-26).
d. Payments for **penalties** for terminating the **lease** if the lease term (as determined in accordance with paragraph 842-10-30-1) reflects the lessee exercising an option to terminate the lease.
e. Fees paid by the lessee to the owners of a special-purpose entity for structuring the transaction. However, such fees shall not be included in the **fair value** of the underlying asset for purposes of applying paragraph 842-10-25-2(d).
f. For a lessee only, amounts **probable** of being owed by the lessee under **residual value guarantees** (see paragraphs 842-10-55-34 through 55-36).

842-10-30-6 Lease payments do not include any of the following:

a. Variable lease payments other than those in paragraph 842-10-30-5(b)
b. Any guarantee by the lessee of the **lessor's** debt
c. Amounts allocated to nonlease components in accordance with paragraphs 842-10-15-33 through 15-42.

842-10-30-7 Paragraph 410-20-15-3(e) addresses the scope application of Subtopic 410-20 on asset retirement obligations to obligations of a lessee in connection with a lease (see paragraph 842-10-55-37).

842-10-30-8 See Example 25 (paragraphs 842-10-55-225 through 55-234) for an illustration of the requirements on lessee accounting for variable lease payments and Example 26 (paragraphs 842-10-55-235 through 55-238) for an illustration of the requirements on termination penalties.

> > Initial Direct Costs

842-10-30-9 Initial direct costs for a **lessee** or a **lessor** may include, for example, either of the following:

a. Commissions
b. Payments made to an existing tenant to incentivize that tenant to terminate its **lease**.

842-10-30-10 Costs to negotiate or arrange a lease that would have been incurred regardless of whether the lease was obtained, such as fixed employee salaries, are not initial direct costs. The following items are examples of costs that are not initial direct costs:

a. General overheads, including, for example, depreciation, occupancy and equipment costs, unsuccessful origination efforts, and idle time
b. Costs related to activities performed by the lessor for advertising, soliciting potential lessees, servicing existing leases, or other ancillary activities
c. 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.

Subsequent Measurement

General

> Lease Term and Purchase Options

842-10-35-1 A **lessee** shall reassess the **lease term** or a lessee option to purchase the **underlying asset** only if and at the point in time that any of the following occurs:

a. There is a significant event or a significant change in circumstances that is within the control of the lessee that 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.
b. There is an event that is written into the **contract** that obliges the lessee to exercise (or not to exercise) an option to extend or terminate the lease.
c. The lessee elects to exercise an option even though the entity had previously determined that the lessee was not reasonably certain to do so.
d. The lessee elects not to exercise an option even though the entity had previously determined that the lessee was reasonably certain to do so.

842-10-35-2 See paragraphs 842-10-55-28 through 55-29 for implementation guidance on reassessing the lease term and lessee options to purchase the underlying asset.

842-10-35-3 A **lessor** shall not reassess the lease term or a lessee option to purchase the underlying asset unless the lease is modified and that modification is not accounted for as a separate contract in accordance with paragraph 842-10-25-8. When a lessee exercises an option to extend or terminate the lease or purchase the underlying asset, the lessor shall account for the exercise of that option in the same manner as a **lease modification**.

> Subsequent Measurement of the Lease Payments

842-10-35-4 A **lessee** shall remeasure the **lease payments** if any of the following occur:

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

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

842-10-35-6 A **lessor** shall not remeasure the lease payments unless the lease is modified and that modification is not accounted for as a separate contract in accordance with paragraph 842-10-25-8.

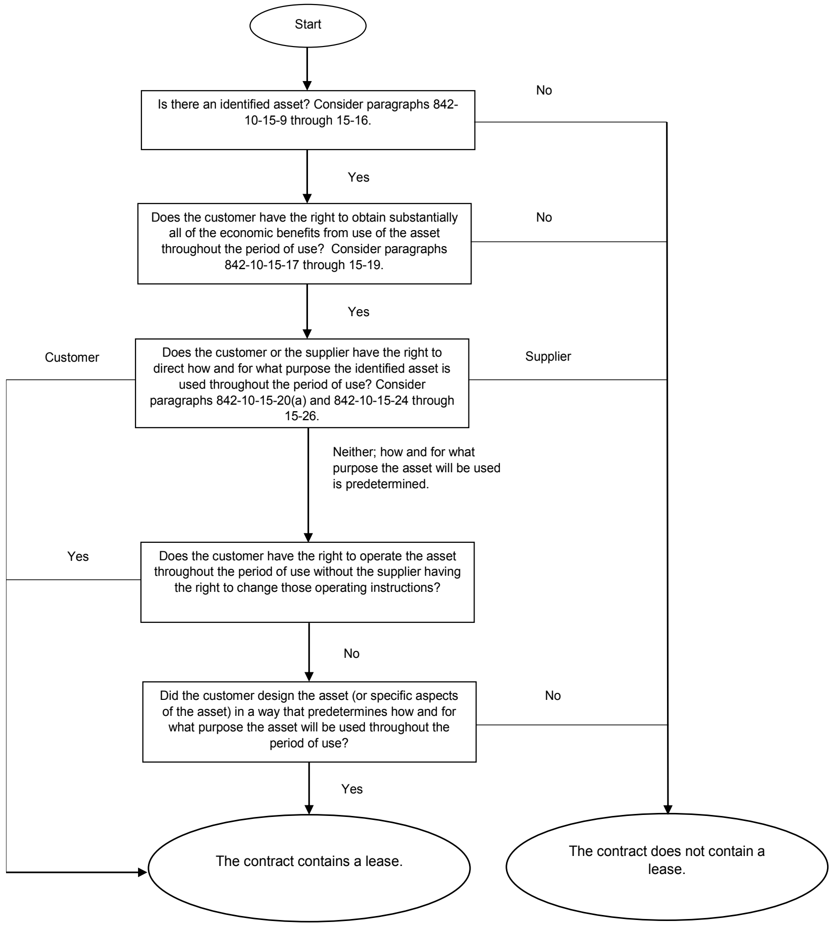
Implementation Guidance and Illustrations

General

> Implementation Guidance

> > Identifying a Lease

842-10-55-1 The following flowchart depicts the decision process to follow in identifying whether a **contract** is or contains a **lease**. The flowchart does not include all of the guidance on identifying a lease in this Subtopic and is not intended as a substitute for the guidance on identifying a lease in this Subtopic.



> > Lease Classification

842-10-55-2 When determining **lease** classification, one reasonable approach to assessing the criteria in paragraphs 842-10-25-2(c) through (d) and 842-10-25-3(b)(1) would be to conclude:

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

842-10-55-3 In some cases, it may not be practicable for an entity to determine the fair value of an underlying asset. In the context of this Topic, practicable means that a reasonable estimate of fair value can be made without undue cost or effort. It is a dynamic concept; what is practicable for one entity may not be practicable for another, what is practicable in one period may not be practicable in another, and what is practicable for one underlying asset (or class of underlying asset) may not be practicable for another. In those cases in which it is not practicable for an entity to determine the fair value of an underlying asset, lease classification should be determined without consideration of the criteria in paragraphs 842-10-25-2(d) and 842-10-25-3(b)(1).

> > > Transfer-of-Ownership Criterion

842-10-55-4 The criterion in paragraph 842-10-25-2(a) is met in **leases** that provide, upon the **lessee's** performance in accordance with the terms of the lease, that the **lessor** should execute and deliver to the lessee such documents (including, if applicable, a bill of sale) as may be required to release the **underlying asset** from the lease and to transfer ownership to the lessee.

842-10-55-5 The criterion in paragraph 842-10-25-2(a) also is met in situations in which the lease requires the payment by the lessee of a nominal amount (for example, the minimum fee required by the statutory regulation to transfer ownership) in connection with the transfer of ownership.

842-10-55-6 A provision in a lease that ownership of the underlying asset is not transferred to the lessee if the lessee elects not to pay the specified fee (whether nominal or otherwise) to complete the transfer is an option to purchase the underlying asset. Such a provision does not satisfy the transfer-of-ownership criterion in paragraph 842-10-25-2(a).

> > > Alternative Use Criterion

842-10-55-7 In assessing whether an **underlying asset** has an alternative use to the **lessor** at the end of the **lease term** in accordance with paragraph 842-10-25-

2(e), 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.

> > > Effect of Investment Tax Credits

842-10-55-8 When evaluating the **lease** classification criteria in paragraphs 842-10-25-2(d) and 842-10-25-3(b)(1), the **fair value** of the **underlying asset** should exclude any related investment tax credit retained by the **lessor** and expected to be realized by the lessor.

> > > Residual Value Guarantees for a Portfolio of Underlying Assets

842-10-55-9 Lessors may obtain **residual value guarantees** for a portfolio of **underlying assets** for which settlement is not solely based on the residual value of the individual underlying assets. In such cases, the lessor is economically assured of receiving a minimum residual value for a portfolio of assets that are subject to separate **leases** but not for each individual asset. Accordingly, when an asset has a residual value in excess of the "guaranteed" amount, that excess is offset against shortfalls in residual value that exist in other assets in the portfolio.

842-10-55-10 Residual value guarantees of a portfolio of underlying assets preclude a lessor from determining the amount of the guaranteed residual value of any individual underlying asset within the portfolio. Consequently, no such amounts should be considered when evaluating the lease classification criteria in paragraphs 842-10-25-2(d) and 842-10-25-3(b)(1).

> > > Lease of an Acquiree

842-10-55-11 In a **business combination** or an **acquisition by a not-for-profit entity**, the acquiring entity should retain the previous **lease** classification in accordance with this Subtopic unless there is a **lease modification** and that modification is not accounted for as a separate **contract** in accordance with paragraph 842-10-25-8.

> > > Lease of a Related Party

842-10-55-12 Leases between related parties should be classified in accordance with the lease classification criteria applicable to all other leases on the basis of the legally enforceable terms and conditions of the lease. In the separate financial statements of the related parties, the classification and accounting for the leases should be the same as for leases between unrelated parties.

> > > Lease Involving Facilities Owned by a Government Unit or Authority

842-10-55-13 Because of special provisions normally present in **leases** involving terminal space and other airport facilities owned by a governmental unit or authority, the **economic life** of such facilities for purposes of classifying a lease is essentially indeterminate. Likewise, it may not be practicable to determine the **fair value** of the **underlying asset**. If it is impracticable to determine the fair value of the underlying asset and such leases also do not provide for a transfer of ownership or a purchase option that the **lessee** is reasonably certain to exercise, they should be classified as **operating leases**. This guidance also applies to leases of other facilities owned by a governmental unit or authority in which the rights of the parties are essentially the same as in a lease of airport facilities. Examples of such leases may be those involving facilities at ports and bus terminals. The guidance in this paragraph is intended to apply to leases only if all of the following conditions are met:

a. The underlying asset is owned by a governmental unit or authority.
b. The underlying asset is part of a larger facility, such as an airport, operated by or on behalf of the **lessor**.
c. The underlying asset is a permanent structure or a part of a permanent structure, such as a building, that normally could not be moved to a new location.
d. The lessor, or in some circumstances a higher governmental authority, has the explicit right under the lease agreement or existing statutes or regulations applicable to the underlying asset to terminate the lease at any time during the **lease term**, such as by closing the facility containing the underlying asset or by taking possession of the facility.
e. The lease neither transfers ownership of the underlying asset to the lessee nor allows the lessee to purchase or otherwise acquire ownership of the underlying asset.
f. The underlying asset or equivalent asset in the same service area cannot be purchased or leased from a nongovernmental unit or authority. An equivalent asset in the same service area is an asset that would allow continuation of essentially the same service or activity as afforded by the underlying asset without any appreciable difference in economic results to the lessee.

842-10-55-14 Leases of underlying assets not meeting all of the conditions in paragraph 842-10-55-13 are subject to the same criteria for classifying leases under this Subtopic that are applicable to leases not involving government-owned property.

> > > Lessee Indemnification for Environmental Contamination

842-10-55-15 A provision that requires **lessee** indemnification for environmental contamination, whether for environmental contamination caused by the lessee during its use of the **underlying asset** over the **lease term** or for preexisting environmental contamination, should not affect the classification of the **lease**.

> > Lease Modifications

> > > Lease Modifications in Connection with the Refunding of Tax-Exempt Debt

842-10-55-16 In some situations, tax-exempt debt is issued to finance construction of a facility, such as a plant or hospital, that is transferred to a user of the facility by **lease**. A lease may serve as collateral for the guarantee of payments equivalent to those required to service the tax-exempt debt. Payments required by the terms of the lease are essentially the same, as to both amount and timing, as those required by the tax-exempt debt. A **lease modification** resulting from a refunding by the **lessor** of tax-exempt debt (including an **advance refunding**) should be accounted for in the same manner (that is, in accordance with paragraphs 842-10-25-8 through 25-18) as any other lease modification. For example, if the perceived economic advantages of the refunding are passed through to the **lessee** in the form of reduced **lease payments**, the lessee should account for the modification in accordance with paragraph 842-10-25-12, while the lessor should account for the modification in accordance with the applicable guidance in paragraphs 842-10-25-15 through 25-17.

> > > Master Lease Agreements

842-10-55-17 Under a master **lease** agreement, the **lessee** may gain control over the use of additional **underlying assets** during the term of the agreement. If the agreement specifies a minimum number of units or dollar value of equipment, the lessee obtaining control over the use of those additional underlying assets is not a **lease modification**. Rather, the entity (whether a lessee or a **lessor**) applies the guidance in paragraphs 842-10-15-28 through 15-42 when identifying the separate lease components and allocating the **consideration in the contract** to those components. Paragraph 842-10-55-22 explains that a master lease agreement may, therefore, result in multiple **commencement dates**.

842-10-55-18 If the master lease agreement permits the lessee to gain control over the use of additional underlying assets during the term of the agreement but does not commit the lessee to doing so, the lessee's taking control over the use of an additional underlying asset should be accounted for as a lease modification in accordance with paragraphs 842-10-25-8 through 25-18.

> > Commencement Date

842-10-55-19 In some **lease** arrangements, the **lessor** may make the **underlying asset** available for use by the **lessee** (for example, the lessee may take possession of or be given control over the use of the underlying asset) before it begins operations or makes **lease payments** under the terms of the lease. During this period, the lessee has the right to use the underlying asset and does so for the purpose of constructing a lessee asset (for example, leasehold improvements).

842-10-55-20 The **contract** may require the lessee to make lease payments only after construction is completed and the lessee begins operations. Alternatively, some contracts require the lessee to make lease payments when it takes possession of or is given control over the use of the underlying asset. The timing of when lease payments begin under the contract does not affect the **commencement date** of the lease.

842-10-55-21 Lease costs (or income) associated with building and ground leases incurred (earned) during and after a construction period are for the right to use the underlying asset during and after construction of a lessee asset. There is no distinction between the right to use an underlying asset during a construction period and the right to use that asset after the construction period. Therefore, lease costs (or income) associated with ground or building leases that are incurred (earned) during a construction period should be recognized by the lessee (or lessor) in accordance with the guidance in Subtopics 842-20 and 842-30, respectively. That guidance does not address whether a lessee that accounts for the sale or rental of real estate projects under Topic 970 should capitalize rental costs associated with ground and building leases.

> > > Master Lease Agreements

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

> > Lease Term and Purchase Options

842-10-55-23 An entity should determine the noncancellable period of a **lease** when determining the **lease term**. When assessing the length of the noncancellable period of a lease, an entity should apply the definition of a **contract** and determine the period for which the contract is enforceable. A lease is no longer enforceable when both the **lessee** and the **lessor** each have the right to terminate the lease without permission from the other party with no more than an insignificant **penalty**.

842-10-55-24 If only a lessee has the right to terminate a lease, that right is considered to be an option to terminate the lease available to the lessee that an entity considers when determining the lease term, as described in paragraph 842-10-30-1. If only a lessor has the right to terminate a lease, the noncancellable period of the lease includes the period covered by the option to terminate the lease.

842-10-55-25 The lease term begins at the **commencement date** and includes any rent-free periods provided to the lessee by the lessor.

> > > Reasonably Certain

842-10-55-26 At the **commencement date**, an entity assesses whether the **lessee** is reasonably certain to exercise or not to exercise an option by considering all economic factors relevant to that assessment—contract-based, asset-based, market-based, and entity-based factors. An entity's assessment often will require the consideration of a combination of those factors because they are interrelated. Examples of economic factors to consider include, but are not limited to, any of the following:

a. Contractual terms and conditions for the optional periods compared with current market rates, such as:
   1. The amount of **lease payments** in any optional period
   2. The amount of any **variable lease payments** or other contingent payments, such as payments under termination penalties and **residual value guarantees**
   3. The terms and conditions of any options that are exercisable after initial optional periods (for example, the terms and conditions of a purchase option that is exercisable at the end of an extension period at a rate that is currently below market rates).

b. Significant leasehold improvements that are expected to have significant economic value for the lessee when the option to extend or terminate the **lease** or to purchase the **underlying asset** becomes exercisable.
c. Costs relating to the termination of the lease and the signing of a new lease, such as negotiation costs, relocation costs, costs of identifying another underlying asset suitable for the lessee's operations, or costs associated with returning the underlying asset in a contractually specified condition or to a contractually specified location.
d. The importance of that underlying asset to the lessee's operations, considering, for example, whether the underlying asset is a specialized asset and the location of the underlying asset.

> > > Fiscal Funding Clauses

842-10-55-27 The existence of a **fiscal funding clause** in a **lease** agreement requires an assessment of the likelihood of lease cancellation through exercise of the fiscal funding clause. If it is more than **remote** that the fiscal funding clause will be exercised, the **lease term** should include only those periods for which funding is reasonably certain.

> > Reassessing the Lease Term and Purchase Options

842-10-55-28 Examples of significant events or significant changes in circumstances that a **lessee** should consider in accordance with paragraph 842-10-35-1 include, but are not limited to, the following:

a. Constructing significant leasehold improvements that are expected to have significant economic value for the lessee when the option becomes exercisable
b. Making significant modifications or customizations to the **underlying asset**
c. Making a business decision that is directly relevant to the lessee's ability to exercise or not to exercise an option (for example, extending the **lease** of a complementary asset or disposing of an alternative asset)
d. Subleasing the underlying asset for a period beyond the exercise date of the option.

842-10-55-29 A change in market-based factors (such as market rates to lease or purchase a comparable asset) should not, in isolation, trigger reassessment of the **lease term** or a lessee option to purchase the underlying asset.

> > Lease Payments

> > > Lease Incentives

842-10-55-30 Lease incentives include both of the following:

a. Payments made to or on behalf of the **lessee**
b. Losses incurred by the **lessor** as a result of assuming a lessee's preexisting lease with a third party. In that circumstance, the lessor and the lessee should independently estimate any loss attributable to that assumption. For example, the lessee's estimate of the lease incentive could be based on a comparison of the new lease with the market rental rate available for similar **underlying assets** or the market rental rate from the same lessor without the lease assumption. The lessor should estimate any loss on the basis of the total remaining costs reduced by the expected benefits from the **sublease** of use of the assumed underlying asset.

> > > In Substance Fixed Payments

842-10-55-31 Lease payments include in substance fixed lease payments. In substance fixed payments are payments that may, in form, appear to contain variability but are, in effect, unavoidable. In substance fixed payments for a **lessee** or a **lessor** may include, for example, any of the following:

a. Payments that do not create genuine variability (such as those that result from clauses that do not have economic substance)

b. The lower of the payments to be made when a lessee has a choice about which set of payments it makes, although it must make at least one set of payments.

> > > Guarantees and Indemnifications

842-10-55-32 Paragraph 460-10-15-4(c) states that, except as provided in paragraph 460-10-15-7, the provisions of Subtopic 460-10 on guarantees apply to indemnification agreements (**contracts**) that contingently require an indemnifying party (guarantor) to make payments to an indemnified party (guaranteed party) based on changes in an underlying that is related to an asset, a liability, or an equity security of the indemnified party. Paragraph 460-10-55-23A provides related implementation guidance for a tax indemnification provided to a **lessor**.

842-10-55-33 A lessor should evaluate a commitment to guarantee performance of the **underlying asset** or to effectively protect the **lessee** from obsolescence of the underlying asset in accordance with paragraphs 606-10-55-30 through 55-35 on **warranties**. If the lessor's commitment is more extensive than a typical product warranty, it might indicate that the commitment is providing a service to the lessee that should be accounted for as a nonlease component of the contract.

> > > > Residual Value Guarantees

842-10-55-34 A lease provision requiring the lessee to make up a residual value deficiency that is attributable to damage, extraordinary wear and tear, or excessive usage is similar to variable lease payments in that the amount is not determinable at the commencement date. Such a provision does not constitute a lessee guarantee of the residual value.

842-10-55-35 If the lessor has the right to require the lessee to purchase the underlying asset by the end of the lease term, the stated purchase price is included in lease payments. That amount is, in effect, a guaranteed residual value that the lessee is obligated to pay on the basis of circumstances outside its control.

842-10-55-36 A residual value guarantee obtained by the lessee from an unrelated third party for the benefit of the lessor should not be used to reduce the amount of the lessee's lease payments under paragraph 842-10-30-5(f) except to the extent that the lessor explicitly releases the lessee from obligation, including the secondary obligation, which is if the guarantor defaults, a residual value deficiency must be made up. Amounts paid in consideration for a guarantee by an unrelated third party are executory costs and are not included in the lessee's lease payments.

> > > > Obligations to Return an Underlying Asset to its Original Condition

842-10-55-37 Obligations imposed by a lease agreement to return an underlying asset to its original condition if it has been modified by the lessee (for example, a requirement to remove a lessee-installed leasehold improvement) generally would not meet the definition of lease payments or variable lease payments and would be accounted for in accordance with Subtopic 410-20 on asset retirement and environmental obligations. In contrast, costs to dismantle and remove an underlying asset at the end of the lease term that are imposed by the lease agreement generally would be considered lease payments or variable lease payments.

> > > > Indemnification Clauses for Certain Tax Benefits

842-10-55-38 Some leases contain indemnification clauses that indemnify lessors on an after-tax basis for certain tax benefits that the lessor may lose if a change in the tax law precludes realization of those tax benefits. Although the indemnification payments may appear to meet the definition of variable lease payments, those payments are not of the nature normally expected to arise under variable lease payment provisions.

842-10-55-39 Because of the close association of the indemnification payments to specific aspects of the tax law, any payments should be accounted for in a manner that recognizes the tax law association. The lease classification should not be changed.

842-10-55-40 Paragraph 842-30-55-16 discusses a lessor's accounting for guarantee payments received.

> Illustrations

> > Illustration of Identifying a Lease

842-10-55-41 Examples 1 through 10 illustrate the identification of a lease.

> > > Example 1—Rail Cars

> > > > Case A—Contract Contains a Lease

842-10-55-42 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; the cars are owned by Supplier. 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. Customer can use the cars for another purpose (for example, storage) if it so chooses. However, the contract specifies that Customer cannot transport particular types of cargo (for example, explosives). If a particular 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.

842-10-55-43 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. 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).

842-10-55-44 The contract contains leases of rail cars. Customer has the right to use 10 rail cars for 5 years.

842-10-55-45 There are 10 identified cars. The cars are explicitly 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.

842-10-55-46 Customer has the right to control the use of the 10 rail cars throughout the 5-year period of use because:

a. Customer has the right to obtain substantially all of the economic benefits from use of the cars over the five-year period of use. Customer has exclusive use of the cars throughout the period of use, including when they are not being used to transport Customer's goods.
b. Customer has the right to direct the use of the cars. The contractual restrictions on the cargo that can be transported by the cars are protective rights of 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. Customer also determines whether and how the cars will be used when not being used to transport its goods (for example, whether and when they will be used for storage). Customer has the right to change these decisions during the five-year period of use.

842-10-55-47 Although having an engine and driver (controlled by Supplier) to transport the rail cars is essential to the efficient use of the cars, Supplier's decisions in this regard do not give it the right to direct how and for what purpose the rail cars are used. Consequently, Supplier does not control the use of the cars during the period of use.

> > > > Case B—Contract Does Not Contain a Lease

842-10-55-48 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 5 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.

842-10-55-49 The contract does not contain a lease of rail cars or of an engine.

842-10-55-50 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:

a. 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.
b. 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.

842-10-55-51 Accordingly, Customer does not direct the use and does not have the right to obtain substantially all of 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 particular delivery and obtains substantially all of the economic benefits from use of the rail cars and engine. Supplier is only providing freight capacity.

> > > Example 2—Concession Space

842-10-55-52 A coffee company (Customer) enters into a contract with an airport operator (Supplier) to use a space in the airport to sell its goods for a three-year period. The contract states the amount of space and that the space may be located at any one of several boarding areas within the airport. Supplier has the right to change the location of the space allocated to Customer at any time during the period of use. There are minimal costs to Supplier associated with changing the space for the Customer: Customer uses a kiosk (that it owns) that can be moved easily to sell its goods. There are many areas in the airport that are available and that would meet the specifications for the space in the contract.

842-10-55-53 The contract does not contain a lease.

842-10-55-54 Although the amount of space Customer uses is specified in the contract, there is no identified asset. Customer controls its owned kiosk. However, the contract is for space in the airport, and this space can change at the discretion of Supplier. Supplier has the substantive right to substitute the space Customer uses because:

a. Supplier has the practical ability to change the space used by Customer throughout the period of use. There are many areas in the airport that meet the specifications for the space in the contract, and Supplier has the right to change the location of the space to other space that meets the specifications at any time without Customer's approval.
b. Supplier would benefit economically from substituting the space. There would be minimal cost associated with changing the space used by Customer because the kiosk can be moved easily. Supplier benefits from substituting the space in the airport because substitution allows Supplier to make the most effective use of the space at boarding areas in the airport to meet changing circumstances.

> > > Example 3—Fiber-Optic Cable

> > > > Case A—Contract Contains a Lease

842-10-55-55 Customer enters into a 15-year contract with a utilities company (Supplier) for the right to use 3 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. 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).

842-10-55-56 The contract contains a lease of dark fibers. Customer has the right to use the 3 dark fibers for 15 years.

842-10-55-57 There are three identified fibers. The fibers are explicitly specified in the contract and are physically distinct from other fibers within the cable. Supplier cannot substitute the fibers other than for reasons of repairs, maintenance, or malfunction.

842-10-55-58 Customer has the right to control the use of the fibers throughout the 15-year period of use because:

a. Customer has the right to obtain substantially all of the economic benefits from use of the fibers over the 15-year period of use. Customer has exclusive use of the fibers throughout the period of use.
b. Customer has the right to direct the use of the fibers. 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). Customer has the right to change these decisions during the 15-year period of use.

842-10-55-59 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. Consequently, Supplier does not control the use of the fibers during the period of use.

> > > > Case B—Contract Does Not Contain a Lease

842-10-55-60 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 3 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).

842-10-55-61 The contract does not contain a lease.

842-10-55-62 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 of the capacity of the cable. Consequently, Customer does not have the right to use an identified asset.

> > > Example 4—Retail Unit

842-10-55-63 Customer enters into a contract with property owner (Supplier) to use Retail Unit A for a five-year period. Retail Unit A is part of a larger retail space with many retail units.

842-10-55-64 Customer is granted the right to use Retail Unit A. Supplier can require Customer to relocate to another retail unit. In that case, Supplier is required to provide Customer with a retail unit of similar quality and specifications to Retail Unit A and to pay for Customer's relocation costs. Supplier would benefit economically from relocating Customer only if a major new tenant were to decide to occupy a large amount of retail space at a rate sufficiently favorable to cover the costs of relocating Customer and other tenants in the retail space that the new tenant will occupy. However, although it is possible that those circumstances will arise, at inception of the contract, it is not likely that those circumstances will arise. For example, whether a major new tenant will decide to lease a large amount of retail space at a rate that would be sufficiently favorable to cover the costs of relocating Customer is highly susceptible to factors outside Supplier's influence.

842-10-55-65 The contract requires Customer to use Retail Unit A to operate its well-known store brand to sell its goods during the hours that the larger retail space is open. Customer makes all of the decisions about the use of the retail unit during the period of use. For example, Customer decides on the mix of goods sold from the unit, the pricing of the goods sold, and the quantities of inventory held. Customer also controls physical access to the unit throughout the five-year period of use.

842-10-55-66 The contract requires Customer to make fixed payments to Supplier as well as variable payments that are a percentage of sales from Retail Unit A.

842-10-55-67 Supplier provides cleaning and security services as well as advertising services as part of the contract.

842-10-55-68 The contract contains a lease of retail space. Customer has the right to use Retail Unit A for five years.

842-10-55-69 Retail Unit A is an identified asset. It is explicitly specified in the contract. Supplier has the practical ability to substitute the retail unit, but could benefit economically from substitution only in specific circumstances. Supplier's substitution right is not substantive because, at inception of the contract, those circumstances are not considered likely to arise.

842-10-55-70 Customer has the right to control the use of Retail Unit A throughout the five-year period of use because:

a. Customer has the right to obtain substantially all of the economic benefits from use of Retail Unit A over the five-year period of use. Customer has exclusive use of Retail Unit A throughout the period of use. Although a portion of the cash flows derived from sales from Retail Unit A will flow from Customer to Supplier, this represents consideration that Customer pays Supplier for the right to use the retail unit. It does not prevent Customer from having the right to obtain substantially all of the economic benefits from use of Retail Unit A.
b. Customer has the right to direct the use of Retail Unit A. The contractual restrictions on the goods that can be sold from Retail Unit A and when Retail Unit A is open define the scope of Customer's right to use Retail Unit A. Within the scope of its right of use defined in the contract, Customer makes the relevant decisions about how and for what purpose Retail Unit A is used by being able to decide, for example, the mix of products that will be sold in the retail unit and the sale price for those products. Customer has the right to change these decisions during the five-year period of use.

842-10-55-71 Although cleaning, security, and advertising services are essential to the efficient use of Retail Unit A, Supplier's decisions in this regard do not give it the right to direct how and for what purpose Retail Unit A is used. Consequently, Supplier does not control the use of Retail Unit A during the period of use, and Supplier's decisions do not affect Customer's control of the use of Retail Unit A.

> > > Example 5—Truck Rental

842-10-55-72 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. 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. 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.

842-10-55-73 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.

842-10-55-74 Customer is responsible for driving the truck from New York to San Francisco.

842-10-55-75 The contract contains a lease of a truck. Customer has the right to use the truck for the duration of the specified trip.

842-10-55-76 There is an identified asset. The truck is explicitly specified in the contract, and Supplier does not have the right to substitute the truck.

842-10-55-77 Customer has the right to control the use of the truck throughout the period of use because:

a. Customer has the right to obtain substantially all of the economic benefits from the use of the truck over the period of use. Customer has exclusive use of the truck throughout the period of use.
b. 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. 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.

842-10-55-78 Because the duration of the contract is one week, this lease meets the definition of a short-term lease.

> > > Example 6—Ship

> > > > Case A—Contract Does Not Contain a Lease

842-10-55-79 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 of the capacity of the ship. The contract specifies the cargo to be transported on the ship and the dates of pickup and delivery.

842-10-55-80 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.

842-10-55-81 The contract does not contain a lease.

842-10-55-82 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.

842-10-55-83 Customer has the right to obtain substantially all of the economic benefits from use of the ship over the period of use. Its cargo will occupy substantially all of the capacity of the ship, thereby preventing other parties from obtaining economic benefits from use of the ship.

842-10-55-84 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. 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. 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. Customer has the same rights regarding the use of the ship as if it were one of multiple customers transporting cargo on the ship.

> > > > Case B—Contract Contains a Lease

842-10-55-85 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.

842-10-55-86 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.

842-10-55-87 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.

842-10-55-88 The contract contains a lease. Customer has the right to use the ship for five years.

842-10-55-89 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.

842-10-55-90 Customer has the right to control the use of the ship throughout the five-year period of use because:

a. Customer has the right to obtain substantially all of the economic benefits from use of the ship over the five-year period of use. Customer has exclusive use of the ship throughout the period of use.
b. 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.

842-10-55-91 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.

> > > Example 7—Aircraft

842-10-55-92 Customer enters into a contract with an aircraft owner (Supplier) for the use of an explicitly specified aircraft for a two-year period. The contract details the interior and exterior specifications for the aircraft.

842-10-55-93 There are contractual and legal restrictions in the contract on where the aircraft can fly. Subject to those restrictions, Customer determines where and when the aircraft will fly and which passengers and cargo will be transported on the aircraft.

842-10-55-94 Supplier is responsible for operating the aircraft, using its own crew. Customer is prohibited from hiring another operator for the aircraft or operating the aircraft itself during the term of the contract.

842-10-55-95 Supplier is permitted to substitute the aircraft at any time during the two-year period and must substitute the aircraft if it is not working. Any substitute aircraft must meet the interior and exterior specifications in the contract. There are significant costs involved in outfitting an aircraft in Supplier's fleet to meet Customer's specifications.

842-10-55-96 The contract contains a lease. Customer has the right to use the aircraft for two years.

842-10-55-97 There is an identified asset. The aircraft is explicitly specified in the contract, and although Supplier can substitute the aircraft, its substitution right is not substantive. Supplier's substitution right is not substantive because of the significant costs involved in outfitting another aircraft to meet the specifications required by the contract such that Supplier is not expected to benefit economically from substituting the aircraft.

842-10-55-98 Customer has the right to control the use of the aircraft throughout the two-year period of use because:

a. Customer has the right to obtain substantially all of the economic benefits from use of the aircraft over the two-year period of use. Customer has exclusive use of the aircraft throughout the period of use.
b. Customer has the right to direct the use of the aircraft. The restrictions on where the aircraft can fly define the scope of Customer's right to use the aircraft. Within the scope of its right of use, Customer makes the relevant decisions about how and for what purpose the aircraft is used throughout the two-year period of use because it decides whether, where, and when the aircraft travels as well as the passengers and cargo it will transport. Customer has the right to change these decisions throughout the two-year period of use.

842-10-55-99 Although the operation of the aircraft is 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 aircraft is used. Consequently, Supplier does not control the use of the aircraft during the period of use, and Supplier's decisions do not affect Customer's control of the use of the aircraft.

> > > Example 8—Contract for Shirts

842-10-55-100 Customer enters into a contract with a manufacturer (Supplier) to purchase a particular type, quality, and quantity of shirts for a three-year period. The type, quality, and quantity of shirts are specified in the contract.

842-10-55-101 Supplier has only one factory that can meet the needs of Customer. Supplier is unable to supply the shirts from another factory or source the shirts from a third-party supplier. The capacity of the factory exceeds the output for which Customer has contracted (that is, Customer has not contracted for substantially all of the capacity of the factory).

842-10-55-102 Supplier 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.

842-10-55-103 The contract does not contain a lease.

842-10-55-104 The factory is an identified asset. The factory is implicitly specified because Supplier can fulfill the contract only through the use of this asset.

842-10-55-105 However, 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.

842-10-55-106 Customer also does not control the use of the factory because it does not have the right to direct the use of the factory. Customer does not have the right to direct how and for what purpose the factory is used during the three-year period of use. Customer's rights are limited to specifying output from the factory in the contract with Supplier. Customer has the same rights regarding the use of the factory as other customers purchasing shirts from the factory. Supplier has the right to direct the use of the factory because Supplier can decide how and for what purpose the factory is used (that is, Supplier has the right to decide the production level at which to run the factory and which customer contracts to fulfill with the output produced).

842-10-55-107 Either the fact that Customer does not have the right to obtain substantially all of the economic benefits from use of the factory or the fact that Customer does not have the right to direct the use of the factory would be sufficient in isolation to conclude that Customer does not control the use of the factory.

> > > Example 9—Contract for Energy/Power

> > > > Case A—Contract Contains a Lease

842-10-55-108 A utility company (Customer) enters into a contract with a power company (Supplier) to purchase all of 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, while Customer receives renewable energy credits that accrue from use of the solar farm.

842-10-55-109 The contract contains a lease. Customer has the right to use the solar farm for 20 years.

842-10-55-110 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.

842-10-55-111 Customer has the right to control the use of the solar farm throughout the 20-year period of use because:

a. Customer has the right to obtain substantially all of the economic benefits from use of the solar farm over the 20-year period of use. Customer has exclusive use of the solar farm; it takes all of 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.

b. 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 (as described in paragraph 842-10-15-20(b)(2)). 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.

> > > > Case B—Contract Does Not Contain a Lease

842-10-55-112 Customer enters into a contract with Supplier to purchase all of 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 on a daily basis in 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 had no involvement in that design.

842-10-55-113 The contract does not contain a lease.

842-10-55-114 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.

842-10-55-115 Customer has the right to obtain substantially all of the economic benefits from use of the identified power plant over the three-year period of use. Customer will take all of the power produced by the power plant over the three-year term of the contract.

842-10-55-116 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.

> > > > Case C—Contract Contains a Lease

842-10-55-117 Customer enters into a contract with Supplier to purchase all of the power produced by an explicitly specified power plant for 10 years. The contract states that Customer has rights to all of the power produced by the plant (that is, Supplier cannot use the plant to fulfill other contracts).

842-10-55-118 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.

842-10-55-119 Supplier operates and maintains the plant on a daily basis in accordance with industry-approved operating practices.

842-10-55-120 The contract contains a lease. Customer has the right to use the power plant for 10 years.

842-10-55-121 There is an identified asset. The power plant is explicitly specified in the contract, and Supplier does not have the right to substitute the specified plant.

842-10-55-122 Customer has the right to control the use of the power plant throughout the 10-year period of use because:

a. Customer has the right to obtain substantially all of the economic benefits from use of the power plant over the 10-year period of use. Customer has exclusive use of the power plant; it has rights to all of the power produced by the power plant throughout the 10-year period of use.
b. 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.

842-10-55-123 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.

> > > Example 10—Contract for Network Services

> > > > Case A—Contract Does Not Contain a Lease

842-10-55-124 Customer enters into a contract with a telecommunications company (Supplier) for network services for two years. The contract requires Supplier to supply network services that meet a specified quality level. To provide the services, Supplier installs and configures servers at Customer's premises; Supplier determines the speed and quality of data transportation in the network using the servers. Supplier can reconfigure or replace the servers when needed to continuously provide the quality of network services defined in the contract. Customer does not operate the servers or make any significant decisions about their use.

842-10-55-125 The contract does not contain a lease. Instead, the contract is a service contract in which Supplier uses the equipment to meet the level of network services determined by Customer.

842-10-55-126 Customer does not control the use of the servers because Customer's only decision-making rights relate to deciding on the level of network services (the output of the servers) before the period of use—the level of network services cannot be changed during the period of use without modifying the contract. For example, even though Customer produces the data to be transported, that activity does not directly affect the configuration of the network services and, thus, it does not affect how and for what purpose the servers are used. Supplier is the only party that can make decisions about the use of the servers during the period of use. Supplier has the right to decide how data are transported using the servers, whether to reconfigure the servers, and whether to use the servers for another purpose. Accordingly, Supplier controls the use of the servers in providing network services to Customer. There is no need to assess whether the servers are identified assets because Customer does not have the right to control the use of the servers.

> > > > Case B—Contract Contains a Lease

842-10-55-127 Customer enters into a contract with an information technology company (Supplier) for the use of an identified server for three years. Supplier delivers and installs the server at Customer's premises in accordance with Customer's instructions and provides repair and maintenance services for the server, as needed, throughout the period of use. Supplier substitutes the server only in the case of malfunction. Customer decides which data to store on the server and how to integrate the server within its operations. Customer can change its decisions in this regard throughout the period of use.

842-10-55-128 The contract contains a lease. Customer has the right to use the server for three years.

842-10-55-129 There is an identified asset. The server is explicitly specified in the contract. Supplier can substitute the server only if it is malfunctioning.

842-10-55-130 Customer has the right to control the use of the server throughout the three-year period of use because:

a. Customer has the right to obtain substantially all of the economic benefits from use of the server over the three-year period of use. Customer has exclusive use of the server throughout the period of use.
b. Customer has the right to direct the use of the server. Customer makes the relevant decisions about how and for what purpose the server is used because it has the right to decide which aspect of its operations the server is used to support and which data it stores on the server. Customer is the only party that can make decisions about the use of the server during the period of use.

> > Illustrations of Allocating Consideration to Components of a Contract

842-10-55-131 Examples 11 through 14 illustrate separating components of a contract.

> > > Example 11—Allocation of Consideration to Lease and Nonlease Components of a Contract

> > > > Case A—Allocation of Consideration in the Contract

842-10-55-132 Lessor leases a bulldozer, a truck, and a crane to Lessee to be used in Lessee's construction operations for three years. Lessor also agrees to maintain each piece of equipment throughout the lease term. The total consideration in the contract is $600,000, payable in $200,000 annual installments.

842-10-55-133 Lessee and Lessor both conclude that the leases of the bulldozer, the truck, and the crane are each separate lease components because both of the criteria in paragraph 842-10-15-28 are met. That is:

a. The criterion in paragraph 842-10-15-28(a) is met because Lessee can benefit from each of the three pieces of equipment on its own or together with other readily available resources (for example, Lessee could readily lease or purchase an alternative truck or crane to use with the bulldozer).
b. The criterion in paragraph 842-10-15-28(b) is met because, despite the fact that Lessee is leasing all three machines for one purpose (that is, to engage in construction operations), the machines are not highly dependent on or highly interrelated with each other. The machines are not, in effect, inputs to a combined single item for which Lessee is

contracting. Lessor can fulfill each of its obligations to lease one of the underlying assets independently of its fulfillment of the other lease obligations, and Lessee's ability to derive benefit from the lease of each piece of equipment is not significantly affected by its decision to lease or not lease the other equipment from Lessor.

842-10-55-134 In accordance with paragraph 842-10-15-31, Lessee and Lessor will account for the nonlease maintenance services components separate from the three separate lease components (unless Lessee elects the practical expedient—see Case B [paragraphs 842-10-55-138 through 55-140]). In accordance with the identifying performance obligations guidance in paragraphs 606-10-25-19 through 25-22, Lessor further concludes that its maintenance services for each piece of leased equipment are distinct and therefore separate performance obligations, resulting in the conclusion that there are three separate lease components and three separate nonlease components (that is, three maintenance service performance obligations).

842-10-55-135 Lessor allocates the consideration in the contract to the separate lease components and nonlease components by applying the guidance in paragraphs 606-10-32-28 through 32-41. The consideration allocated to each separate lease component constitutes the lease payments for purposes of Lessor's accounting for those components.

842-10-55-136 Lessee allocates the consideration in the contract to the separate lease and nonlease components. Several suppliers provide maintenance services that relate to similar equipment such that there are observable standalone prices for the maintenance services for each piece of leased equipment. In addition, even though Lessor, who is the manufacturer of the equipment, requires that all leases of its equipment include maintenance services, Lessee is able to establish observable standalone prices for the three lease components on the basis of the price other lessors lease similar equipment on a standalone basis. The standalone prices for the separate lease and nonlease components are as follows.

	Lease	Maintenance
Bulldozer	$ 200,000	$ 50,000
Truck	120,000	20,000
Crane	240,000	70,000
	$ 560,000	$ 140,000

842-10-55-137 Lessee first allocates the consideration in the contract ($600,000) to the lease and nonlease components on a relative basis, utilizing the observable standalone prices determined in paragraph 842-10-55-136. Lessee then accounts for each separate lease component in accordance with Subtopic 842-20, treating the allocated consideration as the lease payments for each lease component. The nonlease components are accounted for by Lessee in accordance with other Topics. The allocation of the consideration to the lease and nonlease components is as follows.

	Lease	Maintenance
Bulldozer	$ 171,429	$ 42,857
Truck	102,857	17,143
Crane	205,714	60,000
	$ 480,000	$ 120,000

> > > > Case B—Lessee Elects Practical Expedient to Not Separate Lease from Nonlease Components

842-10-55-138 Assume the same facts and circumstances as in Case A (paragraphs 842-10-55-132 through 55-137), except that Lessee has made an accounting policy election to use the practical expedient to not separate nonlease from lease components for its leased construction equipment. Consequently, Lessee does not separate the maintenance services from the related lease components but, instead, accounts for the contract as containing only three lease components.

842-10-55-139 Because Lessor regularly leases each piece of equipment bundled together with maintenance services on a standalone basis, there are observable standalone prices for each of the three combined components, each of which includes the lease and the maintenance services. Because each of the three separate lease components includes the lease of the equipment and the related maintenance services, the observable standalone price for each component in this scenario is greater than the observable standalone price for each separate lease component that does not include the maintenance services in Case A.

842-10-55-140 Lessee allocates the consideration in the contract ($600,000) to the three separate lease components on a relative basis utilizing the observable standalone selling price of each separate lease component (inclusive of maintenance services) and then accounts for each separate lease component in accordance with the guidance in Subtopic 842-20, treating the allocated consideration as the lease payments for each separate lease component. The standalone prices for each of the three combined lease components is as follows.

	Standalone Price	Relative Standalone Price
Bulldozer	$ 230,000	$ 215,625
Truck	130,000	121,875
Crane	280,000	262,500
	$ 640,000	$ 600,000

> > > Example 12—Activities or Costs That Are Not Components of a Contract

> > > > Case A—Payments for Taxes and Insurance Are Variable

842-10-55-141 Lessor and Lessee enter into a five-year lease of a building. The contract designates that Lessee is required to pay for the costs relating to the asset, including the real estate taxes and the insurance on the building. The real estate taxes would be owed by Lessor regardless of whether it leased the building and who the lessee is. Lessor is the named insured on the building insurance policy (that is, the insurance protects Lessor's investment in the building, and Lessor will receive the proceeds from any claim). The annual lease payments are fixed at $10,000 per year, while the annual real estate taxes and insurance premium will vary and be billed to Lessee each year.

842-10-55-142 The real estate taxes and the building insurance are not components of the contract. The contract includes a single lease component— the right to use the building. Lessee's payments of those amounts solely represent a reimbursement of Lessor's costs and do not represent payments for goods or services in addition to the right to use the building. However, because the real estate taxes and insurance premiums during the lease term are variable, those payments are variable lease payments that do not depend on an index or a rate and are excluded from the measurement of the lease liability and recognized in profit or loss in accordance with paragraph 842-20-25-5 or 842-20-25-6.

> > > > Case B—Payment for Taxes and Insurance Are Fixed

842-10-55-143 Assume the same facts and circumstances as in Case A (paragraphs 842-10-55-141 through 55-142), except that the fixed annual lease payment is $13,000. There are no additional payments for real estate taxes or building insurance; however, the fixed payment is itemized in the contract (that is, $10,000 for rent, $2,000 for real estate taxes, and $1,000 for building insurance). Consistent with Case A, the taxes and insurance are not components of the contract. The contract includes a single lease component, the right to use the building. The $65,000 in payments Lessee will make over the 5-year lease term are all lease payments for the single component of the contract and, therefore, are included in the measurement of the lease liability.

> > > > Case C—Common Area Maintenance

842-10-55-144 Assume the same facts and circumstances as in Case B (paragraph 842-10-55-143), except that the lease is of space within the building, rather than for the entire building, and the fixed annual lease payment of $13,000 also covers Lessor's performance of common area maintenance activities (for example, cleaning of common areas, parking lot maintenance, and providing utilities to the building). Consistent with Case B, the taxes and insurance are not components of the contract. However, the common area maintenance is a component because Lessor's activities transfer services to Lessee. That is, Lessee receives a service from Lessor in the form of the common area maintenance activities it would otherwise have to undertake itself or pay another party to provide (for example, cleaning the lobby for its customers, removing snow from the parking lot for its employees and customers, and providing utilities). The common area maintenance is a single component in this contract rather than multiple components, because Lessor performs the activities as needed (for example, plows snow or undertakes minor repairs when and as necessary) over the same period of time.

842-10-55-145 Therefore, the contract in Case C includes two components—a lease component (that is, the right to use the building) and a nonlease component. The consideration in the contract of $65,000 is allocated between those 2 components; the amount allocated to the lease component is the lease payments in accounting for the lease.

> > > Example 13—Lease of a Turbine Plant

842-10-55-146 Lessor leases a gas-fired turbine plant to Lessee for eight years so that Lessee can produce electricity for its customers. The plant consists of the turbine housed within a building together with the land on which the building sits. The building was designed specifically to house the turbine, has a similar economic life as the turbine of approximately 15 years, and has no alternative use. The lease does not transfer ownership of any of the underlying assets to Lessee or grant Lessee an option to purchase any of the underlying assets. Lessor does not obtain a residual value guarantee from Lessee or any other unrelated third party. The present value of the lease payments is not substantially all of the aggregate fair value of the three underlying assets.

842-10-55-147 While the lease of the plant includes the lease of multiple underlying assets, the leases of those underlying assets do not meet the second criterion necessary to be separate lease components, which is that the right to use the underlying asset is neither dependent on nor highly interrelated with the other rights of use in the contract. Therefore, the contract contains only one lease component. The rights to use the turbine, the building, and the land are highly interrelated because each is an input to the customized combined item for which Lessee has contracted (that is, the right to use a gas-fired turbine plant that can produce electricity for distribution to Lessee's customers).

842-10-55-148 However, because the contract contains the lease of land, Lessee and Lessor also must consider the guidance in paragraph 842-10-15-29. Lessee and Lessor each conclude that the effect of accounting for the right to use the land as a separate lease component would be insignificant because Lessee's right to use the turbine, the building, and the land is coterminous and separating the right to use the land from the right to use the turbine and the building would not affect the lease classification of the turbine/building lease component. Lessee and Lessor each conclude that a single lease component comprising the turbine, the building, and the land would be classified as an operating lease, as would two separate lease components comprising the land and the turbine/building, respectively.

842-10-55-149 The predominant asset in the single lease component is the turbine. Lessee entered into the lease primarily to obtain the power-generation capabilities of the turbine. The building and land enable Lessee to obtain the benefits from use of the turbine. The land and building would have little, if any, use or value to Lessee in this contract without the turbine. Therefore, the remaining economic life of the turbine is considered in evaluating the classification of the single lease component.

> > > Example 14—Determining the Consideration in the Contract—Variable Payments

> > > > Case A—Variable Payments That Relate to the Lease Component and the Nonlease Component

842-10-55-150 Lessee and Lessor enter into a three-year lease of equipment that includes maintenance services on the equipment throughout the three-year lease term. Lessee will pay Lessor $100,000 per year plus an additional $7,000 each year that the equipment is operating a minimum number of hours at a specified level of productivity (that is, the equipment is not malfunctioning or inoperable). The potential $7,000 payment each year is variable because the payment depends on the equipment operating a minimum number of hours at a specified level of productivity. The lease is an operating lease.

842-10-55-151 In accordance with paragraph 842-10-15-35, variable payments other than those that depend on an index or a rate are not accounted for as consideration in the contract by Lessee. Therefore, the consideration in the contract to be allocated by Lessee to the equipment lease and the maintenance services at lease commencement includes only the fixed payments of $100,000 each year (or $300,000 in total). Lessee allocates the consideration in the contract to the equipment lease and the maintenance services on the basis of the standalone prices of each, which, for purposes of this example, are $285,000 and $45,000, respectively.

	Standalone Price	Relative Standalone Price
Lease	$ 285,000	$ 259,091
Maintenance	45,000	40,909
	$ 330,000	$ 300,000

Each $100,000 annual fixed payment and each variable payment are allocated to the equipment lease and the maintenance services on the same basis as the initial allocation of the consideration in the contract (that is, 86.4 percent to the equipment lease and 13.6 percent to the maintenance services). Therefore, annual lease expense, excluding variable expense, is $86,364. Lessee recognizes the expense related to the variable payments in accordance with paragraphs 842-20-25-6 and 842-20-55-1 through 55-2.

842-10-55-152 In accordance with paragraphs 842-10-15-39 through 15-40, Lessor also concludes that the potential variable payments should not be accounted for as consideration in the contract. That is because the potential variable payment each year is not solely related to performance of the nonlease maintenance services; the quality and condition of the underlying asset also substantively affect whether Lessor will earn those amounts. Therefore, Lessor's allocation of the consideration in the contract ($300,000) in this Example is the same as Lessee. Lessor, in the same manner as Lessee, also will recognize the income related to the variable payments and allocate that income between the lease and nonlease maintenance services (on the same basis as the initial allocation of the consideration in the contract), when and if earned.

> > > > Case B—Variable Payments That Relate Specifically to a Nonlease Component

842-10-55-153 Assume the same facts and circumstances as in Case A (paragraphs 842-10-55-150 through 55-152), except in this scenario the maintenance services are highly specialized and no entity would expect the equipment to meet the performance metrics without the specialized maintenance services.

842-10-55-154 Lessee would account for the potential variable payments consistent with Case A. The rationale for this accounting also is consistent with that in Case A.

842-10-55-155 In contrast to Case A, Lessor concludes that the variable payments relate specifically to an outcome from Lessor's performance of its maintenance services. Therefore, Lessor evaluates the variable payments in accordance with the variable consideration guidance in paragraphs 606-10-32-5 through 32-13. If Lessor estimates, using the most likely amount method, that it will be entitled to receive the $21,000 in variable payments and that it is probable that including that amount in the transaction price for the maintenance services would not result in a significant revenue reversal when the uncertainty of the performance bonus is resolved, the $21,000 would be included in the consideration in the contract. Because allocating the $21,000 entirely to the maintenance services would not result in an allocation that is consistent with the allocation objective in paragraph 606-10-32-28 (that is, it would result in allocating $61,909 to the maintenance services and the remainder to the equipment lease, which would not reasonably depict the consideration to which Lessor expects to be entitled for each component), the entire consideration in the contract of $321,000 is allocated on a relative standalone price basis as follows.

	Standalone Price	Relative Standalone Price
Lease	$ 285,000	$ 277,227
Maintenance	45,000	43,773
	$ 330,000	$ 321,000

842-10-55-156 The $277,227 allocated to the equipment lease is the lease payment in accounting for the lease in accordance with Subtopic 842-30. Lessor will recognize the consideration in the contract allocated to the maintenance services in accordance with the guidance on the satisfaction of performance obligations in paragraphs 606-10-25-23 through 25-37. If the consideration in the contract changes (for example, because Lessor no longer estimates that it will receive the full $21,000 in potential variable payments), Lessor will allocate the change in the transaction price on the same basis as was initially done.

> > > > Case C—Allocating Variable Payments Entirely to a Nonlease Component

842-10-55-157 Assume the same facts and circumstances as in Case B (paragraphs 842-10-55-153 through 55-156), except that in this scenario all of the following apply:

a. The potential variable payments are $14,000 per year ($42,000 in total), and the annual fixed payments are $93,000 per year ($279,000 in total).
b. While Lessor’s estimate of the variable payments to which it will be entitled is $42,000, Lessor concludes that it is not probable that including the full $42,000 in potential variable payments in the consideration in the

contract will not result in a significant revenue reversal (that is, the entity applies the constraint on variable consideration in paragraph 606-10-32-11). Lessor concludes that only $28,000 is probable of not resulting in a significant revenue reversal. Therefore, the consideration in the contract is initially $307,000 ($279,000 + $28,000).

842-10-55-158 In contrast to Case B, Lessor concludes that allocating the variable payments entirely to the maintenance services and the fixed payments entirely to the equipment lease is consistent with the allocation objective in paragraph 606-10-32-28. This is because $42,000 (Lessor considers its estimate of the variable payments to which it expects to be entitled exclusive of the constraint on variable consideration in Topic 606 on revenue recognition) and $279,000 approximate the standalone price of the maintenance services ($45,000) and the equipment lease ($285,000), respectively. Because the variable payments are allocated entirely to the maintenance services, if the consideration in the contract changes (for example, because Lessor concludes it is now probable that it will earn the full $42,000 in variable payments), that change is allocated entirely to the maintenance services component in the contract.

> > Illustrations of Lease Modifications

842-10-55-159 Examples 15 through 22 illustrate the accounting for lease modifications.

> > > Lessee

> > > > Example 15—Modification Accounted for As a Separate Contract

842-10-55-160 Lessee enters into a 10-year lease for 10,000 square feet of office space. At the beginning of Year 6, Lessee and Lessor agree to modify the lease for the remaining 5 years to include an additional 10,000 square feet of office space in the same building. The increase in the lease payments is commensurate with the market rate at the date the modification is agreed for the additional 10,000 square feet of office space.

842-10-55-161 Lessee accounts for the modification as a new contract, separate from the original contract. This is because the modification grants Lessee an additional right of use as compared with the original contract, and the increase in the lease payments is commensurate with the standalone price of the additional right of use. Accordingly, from the effective date of the modification, Lessee would have 2 separate contracts, each of which contain a single lease component—the original, unmodified contract for 10,000 square feet of office space and the new contract for 10,000 additional square feet of office space, respectively. Lessee would not make any adjustments to the accounting for the original lease as a result of this modification.

> > > > Example 16—Modification That Increases the Lease Term

> > > > > Case A—No Change in Lease Classification

842-10-55-162 Lessee and Lessor enter into a 10-year lease for 10,000 square feet of office space in a building with a remaining economic life of 50 years. Annual payments are $100,000, paid in arrears. Lessee's incremental borrowing rate at the commencement date is 6 percent. The lease is classified as an operating lease. At the beginning of Year 6, Lessee and Lessor agree to modify the lease such that the total lease term increases from 10 years to 15 years. The annual lease payments increase to $110,000 per year for the remaining 10 years after the modification. Lessee's incremental borrowing rate is 7 percent at the date the modification is agreed to by the parties.

842-10-55-163 At the beginning of Year 6, Lessee's lease liability and its right-of-use asset both equal $421,236 (that is, because the lease payments are made annually in arrears and because the lease payments are even throughout the lease term, the lease liability and right-of-use asset will be equal).

842-10-55-164 The modification does not grant an additional right of use to the lessee; rather, it changes (modifies) an attribute of the right to use the 10,000 square feet of office space Lessee already controls. That is, after the modification, Lessee still controls only a single right of use transferred to Lessee at the original lease commencement date.

842-10-55-165 Because the modification does not grant Lessee an additional right of use, the modification cannot be a separate contract. Therefore, at the effective date of the modification, Lessee reassesses classification of the lease (which does not change in this Example—see Case B [paragraphs 842-10-55-166 through 55-167] for a change in lease classification) and remeasures the lease liability on the basis of the 10-year remaining lease term, 10 remaining payments of $110,000, and its incremental borrowing rate at the effective date of the modification of 7 percent. Consequently, the modified lease liability equals $772,594. The increase to the lease liability of $351,358 is recorded as an adjustment to the right-of-use asset (that is, there is no income or loss effect from the modification).

> > > > > Case B—Change in Lease Classification

842-10-55-166 Assume the same facts as in Case A (paragraphs 842-10-55-162 through 55-165), except that the underlying asset is a piece of equipment with a 12-year remaining economic life at the effective date of the modification. Consequently, when the lessee reassesses classification of the lease in accordance with paragraph 842-10-25-1 as of the effective date of the modification based on the modified rights and obligations of the parties, the lessee classifies the modified lease as a finance lease (that is, because the remaining lease term of 10 years is for a major part of the 12-year remaining economic life of the equipment).

842-10-55-167 Consistent with Case A, at the effective date of the modification, the lessee remeasures its lease liability based on the 10-year remaining lease term, 10 remaining payments of $110,000, and its incremental borrowing rate of 7 percent. Consequently, the modified lease liability equals $772,594. The increase to the lease liability of $351,358 is recorded as an adjustment to the right-of-use asset (that is, there is no income or loss effect from the modification). However, different from Case A, beginning on the effective date of the modification, Lessee accounts for the 10-year modified lease as a finance lease.

> > > > Example 17—Modification That Grants an Additional Right of Use

842-10-55-168 Lessee enters into a 10-year lease for 10,000 square feet of office space. The lease payments are $100,000 per year, paid in arrears. Lessee's incremental borrowing rate at lease commencement is 6 percent. At the beginning of Year 6, Lessee and Lessor agree to modify the contract to include an additional 10,000 square feet of office space on a different floor of the building for the final 4 years of the original 10-year lease term for a total annual fixed payment of $150,000 for the 20,000 square feet.

842-10-55-169 The increase in the lease payments (of $50,000 per year) is at a substantial discount to the market rate at the date the modification is agreed to for leases substantially similar to that for the new 10,000 square feet of office space that cannot be attributed solely to the circumstances of the contract. Consequently, Lessee does not account for the modification as a separate contract.

842-10-55-170 Instead, Lessee accounts for the modified contract, which contains 2 separate lease components—first, the original 10,000 square feet of office space and, second, the right to use the additional 10,000 square feet of office space for 4 years that commences 1 year after the effective date of the modification. There are no nonlease components of the modified contract. The total lease payments, after the modification, are $700,000 (1 payment of $100,000 + 4 payments of $150,000).

842-10-55-171 Lessee allocates the lease payments in the modified contract to the 2 separate lease components on a relative standalone price basis, which, in this Example, results in the allocation of $388,889 to the original space lease and $311,111 to the additional space lease. The allocation is based on the remaining lease terms of each separate lease component (that is, 5 years for the original 10,000-square-foot lease and 4 years for the additional 10,000-square-foot lease). The remaining lease cost for each separate lease component is equal to the total payments, as allocated, which will be recognized on a straight-line basis over their respective lease terms. Lessee remeasures the lease liability for the original space lease as of the effective date of the modification—the lease classification of which does not change as a result of the modification—on the basis of all of the following:

a. A remaining lease term of 5 years
b. Annual allocated lease payments of $77,778 in Years 6 through 10 (see paragraph 842-10-55-173)
c. Lessee's incremental borrowing rate at the effective date of the modification of 7 percent.

842-10-55-172 The remeasured lease liability for the original space lease equals $318,904. Lessee recognizes the difference between the carrying amount of the modified lease liability and the carrying amount of the lease liability immediately before the modification of $102,332 ($421,236 – $318,904) as an adjustment to the right-of-use asset.

842-10-55-173 During Year 6, Lessee recognizes lease cost of $77,778. At the end of Year 6, Lessee makes its lease payment of $100,000, of which $77,778 is allocated to the lease of the original office space and $22,222 is allocated to the lease of the additional office space as a prepayment of rent. Lessee allocates the lease payment in this manner to reflect even payments for the even use of the separate lease components over their respective lease terms.

842-10-55-174 At the commencement date of the separate lease component for the additional office space, which is 1 year after the effective date of the modification, Lessee measures and recognizes the lease liability at $241,896 on the basis of all of the following:

a. A lease term of 4 years
b. Four allocated annual payments of $72,222 ([allocated lease payments of $311,111 − $22,222 rent prepayment] ÷ 4 years)
c. Lessee's incremental borrowing rate at the commencement date of the separate lease component for the additional office space of 7.5 percent.

842-10-55-175 At the commencement date, the right-of-use asset for the additional office space lease component is recognized and measured at $264,118 (the sum of the lease liability of $241,896 and the prepaid rent asset of $22,222).

842-10-55-176 During Years 7–10, Lessee recognizes lease cost of $77,778 each year for each separate lease component and allocates each $150,000 annual lease payment of $77,778 to the original office space lease and $72,222 to the additional office space lease.

> > > > Example 18—Modification That Decreases the Scope of a Lease

842-10-55-177 Lessee enters into a 10-year lease for 10,000 square feet of office space. The annual lease payment is initially $100,000, paid in arrears, and increases 5 percent each year during the lease term. Lessee's incremental borrowing rate at lease commencement is 6 percent. Lessee does not provide a residual value guarantee. The lease does not transfer ownership of the office space to Lessee or grant Lessee an option to purchase the space. The lease is an operating lease for all of the following reasons:

a. The lease term is 10 years, while the office building has a remaining economic life of 40 years.
b. The fair value of the office space is estimated to be significantly in excess of the present value of the lease payments.
c. The office space is expected to have an alternative use to Lessor at the end of the lease term.

842-10-55-178 At the beginning of Year 6, Lessee and Lessor agree to modify the original lease for the remaining 5 years to reduce the lease to only 5,000 square feet of the original space and to reduce the annual lease payment to $68,000. That amount will increase 5 percent each year thereafter of the remaining lease term.

842-10-55-179 The classification of the lease does not change as a result of the modification. It is clear based on the terms of the modified lease that it is not a finance lease because the modification reduces both the lease term and the lease payments. Lessee remeasures the lease liability for the modified lease at the effective date of the modification on the basis of all of the following:

a. A remaining lease term of 5 years
b. Lease payments of $68,000 in the year of modification (Year 6), increasing by 5 percent each year thereafter
c. Lessee's incremental borrowing rate at the effective date of the modification of 7 percent.

842-10-55-180 The remeasured lease liability equals $306,098.

> > > > > Case A—Remeasuring the Right-of-Use Asset Based on Change in Lease Liability

842-10-55-181 The difference between the premodification liability and the modified lease liability is $284,669 ($590,767 – $306,098). That difference is 48.2 percent ($284,669 ÷ $590,767) of the premodification lease liability. The decrease in the lease liability reflects the early termination of the right to use 5,000 square feet of space (50 percent of the original leased space), the change in the lease payments, and the change in the discount rate.

842-10-55-182 Lessee decreases the carrying amount of the right-of-use asset to reflect the partial termination of the lease based on the adjustment to the carrying amount of the lease liability, with any difference recognized in profit or loss. The premodification right-of-use asset is $514,436. Therefore, at the effective date of the modification, Lessee reduces the carrying amount of the right-of-use asset by $247,888 (48.2% × $514,436). Lessee recognizes the difference between the adjustment to the lease liability and the adjustment to the right-of-use asset ($284,669 – $247,888 = $36,781) as a gain.

> > > > > Case B—Remeasuring the Right-of-Use Asset Based on the Remaining Right of Use

842-10-55-183 Lessee determines the proportionate decrease in the carrying amount of the right-of-use asset based on the remaining right-of-use asset (that is, 5,000 square feet corresponding to 50 percent of the original right-of-use asset).

842-10-55-184 Fifty percent of the premodification right-of-use asset is $257,218 (50% x $514,436). Fifty percent of the premodification lease liability is $295,384 (50% x $590,767). Consequently, Lessee decreases the carrying amount of the right-of-use asset by $257,218 and the carrying amount of the lease liability by

$295,384. At the effective date of the modification, Lessee recognizes the difference between the decrease in the lease liability and the decrease in the right-of-use asset of $38,166 ($295,384 − $257,218) as a gain.

842-10-55-185 Lessee recognizes the difference between the remaining lease liability of $295,384 and the modified lease liability of $306,098 (which equals $10,714) as an adjustment to the right-of-use asset reflecting the change in the consideration paid for the lease and the revised discount rate.

> > > > Example 19—Modification That Changes the Lease Payments Only

842-10-55-186 Lessee enters into a 10-year lease for 10,000 square feet of office space. The lease payments are $95,000 in Year 1, paid in arrears, and increase by $1,000 every year thereafter. The original discount rate for the lease is 6 percent. The lease is an operating lease. At the beginning of Year 6, Lessee and Lessor agree to modify the original lease for the remaining 5 years to reduce the lease payments by $7,000 each year (that is, the lease payments will be $93,000 in Year 6 and will continue to increase by $1,000 every year thereafter). The modification only changes the lease payments and, therefore, cannot be accounted for as a separate contract. The classification of the lease does not change as a result of the modification.

842-10-55-187 Lessee remeasures the lease liability for the modified lease on the basis of all of the following:

a. Remaining lease term of 5 years
b. Payments of $93,000 in Year 6, increasing by $1,000 each year for the remainder of the lease term
c. Lessee's incremental borrowing rate at the effective date of the modification of 7 percent.

842-10-55-188 The remeasured lease liability equals $388,965. Lessee recognizes the difference between the carrying amount of the modified lease liability and the lease liability immediately before the effective date of the modification of $40,206 ($429,171 premodification lease liability – $388,965 modified lease liability) as a corresponding reduction to the right-of-use asset. Therefore, the adjusted right-of-use asset equals $376,465 as of the effective date of the modification. Lessee calculates its remaining lease cost as $462,500 (the sum of the total lease payments, as adjusted for the effects of the lease modification, of $960,000 reduced by the total lease cost recognized in prior periods of $497,500), which it will recognize on a straight-line basis over the remaining lease term.

842-10-55-189 During Year 6, Lessee recognizes lease cost of $92,500 ($462,500 remaining lease cost ÷ 5 years). As of the end of Year 6, Lessee's lease liability equals $323,193 (present value of the remaining lease payments, discounted at 7 percent), and its right-of-use asset equals $311,193 (the balance of the lease liability – the remaining accrued rent balance of $12,000). Lessee recognizes additional lease cost of $92,500 each year of the remaining lease term and measures its lease liability and right-of-use asset in the same manner as at the end of Year 6 each remaining year of the lease term. The following are the balances of the lease liability and the right-of-use asset at the end of Years 7 through 10 of the lease.

	Lease Liability	Right-of-Use Asset
Year 7	$ 251,816	$ 241,316
Year 8	$ 174,443	$ 166,443
Year 9	$ 90,654	$ 86,154
Year 10	$ -	$ -

> > > Lessor

> > > > Example 20—Modification of an Operating Lease That Does Not Change Lease Classification

842-10-55-190 Lessor enters into a 10-year lease with Lessee for 10,000 square feet of office space. The annual lease payments are $100,000 in the first year, increasing by 5 percent each year thereafter, payable in arrears. The lease term is not for a major part of the remaining economic life of the office space (40 years), and the present value of the lease payments is not substantially all of the fair value of the office space. Furthermore, the title does not transfer to Lessee as a consequence of the lease, the lease does not contain an option for Lessee to purchase the office space, and the asset is not specialized such that it clearly has an alternative use to Lessor at the end of the lease term. Consequently, the lease is classified as an operating lease.

842-10-55-191 At the beginning of Year 6, Lessee and Lessor agree to amend the original lease for the remaining 5 years to include an additional 10,000 square feet of office space in the same building for a total annual fixed payment of $150,000. The increase in total consideration is at a discount both to the current market rate for the new 10,000 square feet of office space and in the context of that particular contract. The modified lease continues to be classified as an operating lease.

842-10-55-192 At the effective date of the modification (at the beginning of Year 6), Lessor has an accrued lease rental asset of $76,331 (rental income recognized on a straight-line basis for the first 5 years of the lease of $628,895 [$1,257,789 ÷ 10 years = $125,779 per year] less lease payments for the first 5 years of $552,564 [that is, $100,000 in Year 1, $105,000 in Year 2, $110,250 in Year 3, $115,763 in Year 4, and $121,551 in Year 5]).

842-10-55-193 Because the change in pricing of the lease is not commensurate with the standalone price for the additional right-of-use asset, Lessor does not account for the modification as a new lease, separate from the original 10-year lease. Instead, Lessor accounts for the modified lease prospectively from the effective date of the modification, recognizing the lease payments to be made under the modified lease of $750,000 ($150,000 × 5 years), net of Lessor's accrued rent asset of $76,331, on a straight-line basis over the remaining 5-year lease term ($673,669 ÷ 5 years = $134,734 per year). At the end of the lease, Lessor will have recognized as lease income the $1,302,564 in lease payments it receives from Lessee during the 10-year lease term.

> > > > Example 21—Modification of an Operating Lease That Changes Lease Classification

> > > > > Case A—Operating Lease to Sales-Type Lease

842-10-55-194 Lessor enters into a four-year lease of a piece of nonspecialized equipment. The annual lease payments are $81,000 in the first year, increasing by 5 percent each year thereafter, payable in arrears. The estimated residual value of the equipment is $90,000, of which none is guaranteed. The remaining economic life of the equipment at lease commencement is seven years. The carrying amount of the equipment and its fair value are both $425,000 at the commencement date. The lease is not for a major part of the remaining economic life of the equipment, and the present value of the lease payments is not substantially all of the fair value of the equipment. Furthermore, title does not transfer to Lessee as a result of the lease, the lease does not contain an option for Lessee to purchase the underlying asset, and because the asset is nonspecialized, it is expected to have an alternative use to Lessor at the end of the lease term. Consequently, the lease is classified as an operating lease.

842-10-55-195 At the beginning of Year 3, Lessee and Lessor agree to extend the lease term by two years. That is, the modified lease is now a six-year lease, as compared with the original four-year lease. The additional two years were not an option when the original lease was negotiated. The modification alters the Lessee's right to use the equipment; it does not grant Lessee an additional right of use. Therefore, Lessor does not account for the modification as a separate contract from the original four-year lease contract.

842-10-55-196 On the effective date of the modification, the fair value of the equipment is $346,250, and the remaining economic life of the equipment is 5 years. The estimated residual value of the equipment is $35,000, of which none is guaranteed. The modified lease is for a major part of the remaining economic life of the equipment at the effective date of the modification (four years out of the five-year-remaining economic life of the equipment). Consequently, the modified lease is classified as a sales-type lease.

842-10-55-197 In accounting for the modification, Lessor determines the discount rate for the modified lease (that is, the rate implicit in the modified lease) to be 7.6

percent. Lessor recognizes the net investment in the modified lease of $346,250 and derecognizes both the accrued rent and the equipment at the effective date of the modification. Lessor also recognizes, in accordance with paragraph 842-10-25-15(b), selling profit of $34,169 ($320,139 lease receivable – $8,510 accrued rent balance – the $277,460 carrying amount of the equipment derecognized, net of the unguaranteed residual asset [$277,460 = $303,571 – $26,111]). After the effective date of the modification, Lessor accounts for the modified lease in the same manner as any other sales-type lease in accordance with Subtopic 842-30.

> > > > > Case B—Operating Lease to Direct Financing Lease

842-10-55-198 At the beginning of Year 3, Lessee and Lessor enter into a modification to extend the lease term by 1 year, and Lessee agrees to make lease payments of $108,000 per year for each of the remaining 3 years of the modified lease. No other terms of the contract are modified. Concurrent with the execution of the modification, Lessor obtains a residual value guarantee from an unrelated third party for $40,000. Consistent with Case A (paragraphs 842-10-55-194 through 55-197), at the effective date of the modification the fair value of the equipment is $346,250, the carrying amount of the equipment is $303,571, and Lessor's accrued rent balance is $8,510. The estimated residual value at the end of the modified lease term is $80,000. The discount rate for the modified lease is 7.356 percent.

842-10-55-199 Lessor reassesses the lease classification as of the effective date of the modification and concludes that the modified lease is a direct financing lease because none of the criteria in paragraph 842-10-25-2 and both criteria in paragraph 842-10-25-3(b) are met.

842-10-55-200 Therefore, at the effective date of the modification, Lessor recognizes a net investment in the modified lease of $312,081, which is the fair value of the equipment ($346,250) less the selling profit on the lease ($34,169 = $313,922 lease receivable – $8,510 accrued rent balance – the $271,243 carrying amount of the equipment derecognized, net of the unguaranteed residual asset [$271,243 = $303,571 – $32,328]), which is deferred as part of the net investment in the lease. After the effective date of the modification, Lessor accounts for the modified lease in the same manner as any other direct financing lease in accordance with Subtopic 842-30.

> > > > Example 22—Modification of a Direct Financing Lease

842-10-55-201 Lessor enters into a six-year lease of a piece of new, nonspecialized equipment with a nine-year economic life. The annual lease payments are $11,000, payable in arrears. The estimated residual value of the equipment is $21,000, of which $15,000 is guaranteed by a third-party unrelated to Lessee or Lessor. The lease does not contain an option for Lessee to purchase the equipment, and the title does not transfer to Lessee as a consequence of the lease. The fair value of the equipment at lease commencement is $65,240, which is equal to its cost (and carrying amount). Lessor incurs no initial direct costs in connection with the lease. The rate implicit in the lease is 7.5 percent such that the present value of the lease payments is $51,632 and does not amount to substantially all of the fair value of the equipment.

842-10-55-202 The Lessor concludes that the lease is not a sales-type lease because none of the criteria in paragraph 842-10-25-2 are met. However, the sum of the present value of the lease payments and the present value of the residual value of the underlying asset guaranteed by the third-party guarantor is $61,352, which is substantially all of the fair value of the equipment, and collectibility of the lease payments is probable. Consequently, the lease is classified as a direct financing lease. Lessor recognizes the net investment in the lease of $65,240 (which includes the lease receivable of $61,352 and the present value of the unguaranteed residual value of $3,888 [the present value of the difference between the expected residual value of $21,000 and the guaranteed residual value of $15,000]) and derecognizes the equipment with a carrying amount of $65,240.

842-10-55-203 At the end of Year 1, Lessor receives a lease payment of $11,000 from Lessee and recognizes interest income of $4,893 ($65,240 × 7.5%). Therefore, the carrying amount of the net investment in the lease is $59,133 ($65,240 + $4,893 – $11,000).

> > > > > Case A—Direct Financing Lease to Direct Financing Lease

842-10-55-204 At the end of Year 1, the lease term is reduced by 1 year and the annual lease payment is reduced to $10,000 for the remaining 4 years of the modified lease term. The estimated residual value of the equipment at the end of the modified lease term is $33,000, of which $30,000 is guaranteed by the unrelated third party, while the fair value of the equipment is $56,000. The remaining economic life of the equipment is 8 years, and the present value of the remaining lease payments, discounted using the rate implicit in the modified lease of 8.857 percent, is $32,499. Lessor concludes that the modified lease is not a sales-type lease because none of the criteria in paragraph 842-10-25-2 are met. However, the sum of the present value of the lease payments and the present value of the residual value of the underlying asset guaranteed by the third-party guarantor, discounted using the rate implicit in the modified lease of 8.857 percent, is $53,864, which is substantially all of the fair value of the equipment, and collectibility of the lease payments is probable. As such, the modified lease is classified as a direct financing lease.

842-10-55-205 In accounting for the modification in accordance with paragraph 842-10-25-16(a), Lessor carries forward the balance of the net investment in the lease of $59,133 immediately before the effective date of the modification as the opening balance of the net investment in the modified lease. To retain the same net investment in the lease even while the lease payments, the lease term, and the estimated residual value have all changed, Lessor adjusts the discount rate for the lease from the rate implicit in the modified lease of 8.857 percent to 6.95 percent. This discount rate is used to calculate interest income on the net investment in the lease throughout the remaining term of the modified lease and will result, at the end of the modified lease term, in a net investment balance that equals the estimated residual value of the underlying asset of $33,000.

> > > > > Case B—Direct Financing Lease to Sales-Type Lease

842-10-55-206 At the end of Year 1, the lease term is extended for two years. The lease payments remain $11,000 annually, paid in arrears, for the remainder of the lease term. The estimated residual value is $6,500, of which none is guaranteed. The rate implicit in the modified lease is 7.58 percent. At the effective date of the modification, the remaining economic life of the equipment is 8 years, and the fair value of the equipment is $62,000. Because the modified lease term is now for the major part of the remaining economic life of the equipment, the modified lease is classified as a sales-type lease.

842-10-55-207 On the effective date of the modification, Lessor recognizes a net investment in the sales-type lease of $62,000, which is equal to the fair value of the equipment at the effective date of the modification, and derecognizes the carrying amount of the net investment in the original direct financing lease of $59,133. The difference of $2,867 is the selling profit on the modified lease. After the effective date of the modification, Lessor accounts for the sales-type lease in the same manner as any other sales-type lease in accordance with Subtopic 842-30.

> > > > > Case C—Direct Financing Lease to Operating Lease

842-10-55-208 At the end of Year 1, the lease term is reduced by 2 years, and the lease payments are reduced to $9,000 per year for the remaining 3-year lease term. The estimated residual value is revised to $33,000, of which only $13,000 is guaranteed by an unrelated third party. The fair value of the equipment at the effective date of the modification is $56,000. The modified lease does not transfer the title of the equipment to Lessee or grant Lessee an option to purchase the equipment. The modified lease is classified as an operating lease because it does not meet any of the criteria to be classified as a sales-type lease or as a direct financing lease.

842-10-55-209 Therefore, at the effective date of the modification, Lessor derecognizes the net investment in the lease, which has a carrying amount of $59,133, and recognizes the equipment at that amount. Collectibility of the lease payments is probable; therefore, Lessor will recognize the $27,000 ($9,000 × 3 years) in lease payments on a straight-line basis over the 3-year modified lease term, as well as depreciation on the rerecognized equipment.

> > Illustration of Lessee Accounting for Purchase Options

842-10-55-210 Examples 23 through 24 illustrate the evaluation of whether a lessee is reasonably certain to exercise an option to purchase the underlying asset.

> > > Example 23—Lessee Purchase Option

842-10-55-211 Lessee enters into a 5-year lease of equipment with annual lease payments of $59,000, payable at the end of each year. There are no initial direct costs incurred by Lessee or lease incentives. At the end of Year 5, Lessee has an option to purchase the equipment for $5,000. The expected residual value of the equipment at the end of the lease is $75,000. Because the exercise price of the purchase option is significantly discounted from the expected fair value of the equipment at the time the purchase option becomes exercisable, Lessee concludes that it is reasonably certain to exercise the purchase option. The fair value of the equipment at the commencement date is $250,000, and its economic life is 7 years. The discount rate for the lease, which is Lessee's incremental borrowing rate because the rate implicit in the lease is not available, is 6.5 percent.

842-10-55-212 Because the lease grants Lessee an option to purchase the underlying asset that it is reasonably certain to exercise, Lessee classifies the lease as a finance lease.

842-10-55-213 Lessee recognizes the lease liability at the commencement date at $248,834 (the present value of 5 payments of $59,000 + the present value of the $5,000 payment for the purchase option, discounted at 6.5%). Because there are no initial direct costs, lease incentives, or other payments made to Lessor at or before the commencement date, Lessee recognizes the right-of-use asset at the same amount as the lease liability.

842-10-55-214 Lessee amortizes the right-of-use asset over the seven-year expected useful life of the equipment, rather than over the lease term of five years, because Lessee is reasonably certain to exercise the option to purchase the equipment. Lessee depreciates its owned assets on a straight-line basis. Therefore, the right-of-use asset is amortized on a straight-line basis.

842-10-55-215 During the first year of the lease, Lessee recognizes interest expense on the lease liability of $16,174 (6.5% × $248,834) and amortization of the right-of-use asset of $35,548 ($248,834 ÷ 7).

842-10-55-216 At the end of Year 1, the right-of-use asset is $213,286 ($248,834 – $35,548), and the lease liability is $206,008 ($248,834 + $16,174 – $59,000).

842-10-55-217 At the end of Year 5, the carrying amount of the right-of-use asset is $71,094 ($248,834 – [$35,548 × 5]), and the remaining lease liability is $5,000, which is the exercise price of the purchase option. Lessee exercises the purchase option and settles the remaining lease liability. If the right-of-use asset was not previously presented together with property, plant, and equipment, Lessee reclassifies the right-of-use asset to property, plant, and equipment and applies Topic 360 to the asset beginning on the date the purchase option is exercised.

> > > Example 24—Lessee Purchase Option

842-10-55-218 Lessee enters into a 5-year lease of specialized equipment with annual lease payments of $65,000, payable in arrears. There are no initial direct costs or lease incentives. At the end of Year 5, Lessee has an option to purchase the equipment for $90,000, which is the expected fair value of the equipment at that date. Lessor constructed the equipment specifically for the needs of Lessee. Furthermore, the specialized equipment is vital to Lessee's business; without this asset, Lessee would be required to halt operations while a new asset was built or customized. As such, Lessee concludes that it is reasonably certain to exercise the purchase option because the specialized nature, specifications of the asset, and its role in Lessee's operations create a significant economic incentive for Lessee to do so. The fair value of the equipment at the commencement date is $440,000, and its economic life is 10 years. Lessee's incremental borrowing rate is 6.5 percent, which reflects the fixed rate at which Lessee could borrow an amount similar to that of the lease payments ([$65,000 x 5 lease payments] + the $90,000 purchase option exercise price = $415,000) in the same currency, for the same term, and with similar collateral as in the lease at the commencement date.

842-10-55-219 The lease grants Lessee an option to purchase the underlying asset that it is reasonably certain to exercise. In addition, the underlying asset is of such a specialized nature that it is expected to have no alternative use to Lessor at the end of the lease term. As such, Lessee classifies the lease as a finance lease.

842-10-55-220 Lessee recognizes the lease liability at the commencement date at $335,808 (the present value of 5 payments of $65,000 + the present value of the $90,000 payment for the purchase option to be made at the end of Year 5, discounted at 6.5%). Because there are no initial direct costs, lease incentives, or other payments made to Lessor at or before the commencement date, Lessee recognizes the right-of-use asset at the same amount as the lease liability.

842-10-55-221 Lessee amortizes the right-of-use asset over the 10-year expected useful life of the equipment rather than over the lease term of 5 years, because Lessee is reasonably certain to exercise the option to purchase the equipment. Lessee depreciates its owned assets on a straight-line basis. Therefore, the right-of-use asset is amortized on a straight-line basis.

842-10-55-222 During the first year of the lease, Lessee recognizes interest expense on the lease liability of $21,828 (6.5% × $335,808) and amortization of the right-of-use asset of $33,581 ($335,808 ÷ 10).

842-10-55-223 At the end of Year 1, the right-of-use asset is $302,227 ($335,808 – $33,581), and the lease liability is $292,636 ($335,808 + $21,828 – $65,000).

842-10-55-224 At the end of Year 5, the carrying amount of the right-of-use asset is $167,903 ($335,808 – $33,581 × 5), and the remaining lease liability is $90,000, which is the amount of the purchase option. Lessee exercises the option to purchase the equipment and settles the remaining lease liability. If the right-of-use asset was not previously presented together with property, plant, and equipment, Lessee reclassifies the right-of-use asset to property, plant, and equipment and will apply Topic 360 to the equipment beginning on the date the purchase option is exercised.

> > Illustrations of Lessee Accounting for Variable Lease Payments

842-10-55-225 Example 25 illustrates how a lessee accounts for variable lease payments that depend on an index or a rate and variable lease payments that are linked to performance.

> > > Example 25—Variable Lease Payments That Depend on an Index or a Rate and Variable Lease Payments Linked to Performance

> > > > Case A—Variable Lease Payments That Depend on an Index or a Rate

842-10-55-226 Lessee enters into a 10-year lease of a building with annual lease payments of $100,000, payable at the beginning of each year. The contract specifies that lease payments for each year will increase on the basis of the increase in the Consumer Price Index for the preceding 12 months. The Consumer Price Index at the commencement date is 125. This Example ignores any initial direct costs. The lease is classified as an operating lease.

842-10-55-227 The rate implicit in the lease is not readily determinable. Lessee's incremental borrowing rate is 8 percent, which reflects the rate at which Lessee could borrow an amount equal to the lease payment in the same currency, over a similar term, and with similar collateral as in the lease.

842-10-55-228 At the commencement date, Lessee makes the lease payment for the first year and measures the lease liability at $624,689 (the present value of 9 payments of $100,000 discounted at the rate of 8 percent). The right-of-use asset is equal to the lease liability plus the prepaid rent ($724,689).

842-10-55-229 Lessee prepares financial statements on an annual basis. Lessee determines the cost of the lease to be $1 million (the total lease payments for the lease term). The annual lease expense to be recognized is $100,000 ($1 million ÷ 10 years).

842-10-55-230 At the end of the first year of the lease, the Consumer Price Index is 128. Lessee calculates the payment for the second year, adjusted to the Consumer Price Index, to be $102,400 ($100,000 × 128 ÷ 125).

842-10-55-231 Because Lessee has not remeasured the lease liability for another reason, Lessee does not make an adjustment to the lease liability to reflect the Consumer Price Index at the end of the reporting period; that is, the lease liability continues to reflect annual lease payments of $100,000 (8 remaining annual payments of $100,000, discounted at the rate of 8 percent is $574,664). However, the Year 2 payment amount of $102,400 (the $100,000 annual fixed payment + $2,400 variable lease payment) will be recognized in profit or loss for Year 2 of the lease and classified as cash flow from operations in Lessee's statement of cash flows. In its quantitative disclosures, Lessee will include $100,000 of the $102,400 in its disclosure of operating lease cost and $2,400 in its disclosure of variable lease cost.

> > > > Case B—Variable Lease Payments Linked to Performance

842-10-55-232 Lessee enters into a 10-year lease of a building with annual lease payments of $100,000, payable at the beginning of each year. The contract specifies that Lessee also is required to make variable lease payments each year of the lease, which are determined as 2 percent of Lessee's sales generated from the building.

842-10-55-233 At the commencement date, Lessee measures the lease liability and right-of-use asset at the same amounts as in Case A (paragraphs 842-10-55-226 through 55-231) because the 2 percent royalty that will be paid each year to Lessor under the lease is a variable lease payment, which means that payment is not included in the measurement of the lease liability (or the right-of-use asset) at any point during the lease.

842-10-55-234 During the first year of the lease, Lessee generates sales of $1.2 million from the building and, therefore, recognizes total lease cost of $124,000 ($100,000 + [2% × $1.2 million]). In its quantitative disclosures, Lessee will include $100,000 of the $124,000 in its disclosure of operating lease cost and $24,000 in its disclosure of variable lease cost.

> > Illustration of Lessee Accounting for Termination Penalties

842-10-55-235 Example 26 illustrates how a lessee accounts for termination penalties.

> > > Example 26—Termination Penalties

842-10-55-236 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.

842-10-55-237 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 in paragraph 842-10-55-26.

842-10-55-238 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 6 years plus the penalty of $20,000 payable at the end of Year 6.

> > Illustration of Initial Direct Costs

842-10-55-239 Example 27 illustrates initial direct costs.

> > > Example 27—Initial Direct Costs

842-10-55-240 Lessee and Lessor enter into an operating lease. The following costs are incurred in connection with the lease:

Travel costs related to lease proposal	$ 7,000
External legal fees	22,000
Allocation of employee costs for time negotiating lease terms and conditions	6,000
Commissions to brokers	10,000
Total costs incurred by Lessor	$ 45,000

External legal fees	$ 15,000
Allocation of employee costs for time negotiating lease terms and conditions	7,000
Payments made to existing tenant to obtain the lease	20,000
Total costs incurred by Lessee	$ 42,000

842-10-55-241 Lessor capitalizes initial direct costs of $10,000, which it recognizes ratably over the lease term, consistent with its recognition of lease income. The $10,000 in broker commissions is an initial direct cost because that cost was incurred only as a direct result of obtaining the lease (that is, only as a direct result of the lease being executed). None of the other costs incurred by Lessor 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 Lessor would be required to pay its attorneys for negotiating and drafting the lease even if Lessee did not execute the lease.

842-10-55-242 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. The $20,000 payment to the existing tenant is an initial direct cost because that cost is only incurred 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).

> > Illustrations of Transition

> > > Illustration of Lessee Transition—Existing Capital Lease

842-10-55-243 Example 28 illustrates lessee accounting for the transition of existing capital leases.

> > > > Example 28—Lessee Transition—Existing Capital Lease

842-10-55-244 The effective date of the guidance in this Topic for Lessee is January 1, 20X4. Lessee enters into a 7-year lease of an asset on January 1, 20X1, with annual lease payments of $25,000 payable at the end of each year. The lease includes a residual value guarantee by Lessee of $8,190. Lessee's incremental borrowing rate on the date of commencement was 6 percent. Lessee accounts for the lease as a capital lease. At lease commencement, Lessee defers initial direct costs of $2,800, which will be amortized over the lease term. On January 1, 20X2 (and before transition adjustments), Lessee has a lease liability of $128,707, a lease asset of $124,434, and unamortized initial direct costs of $2,400.

842-10-55-245 January 1, 20X2 is the beginning of the earliest comparative period presented in the financial statements in which Lessee first applies the guidance in this Topic. Lessee has elected the package of practical expedients in paragraph 842-10-65-1(f). As such, Lessee accounts for the lease as a finance lease, without reassessing whether the contract contains a lease or whether classification of the lease would be different in accordance with this Topic. Lessee also does not reassess whether the unamortized initial direct costs on January 1, 20X2, would have met the definition of initial direct costs in this Topic at lease commencement.

842-10-55-246 On January 1, 20X2, Lessee recognizes a lease liability at the carrying amount of the capital lease obligation on December 31, 20X1, of $128,707 and a right-of-use asset at the carrying amount of the capital lease asset of $126,834 (which includes unamortized initial direct costs of $2,400 that were included in the capital lease asset). Lessee subsequently measures the lease liability and the right-of-use asset in accordance with Subtopic 840-30 until the effective date.

842-10-55-247 Beginning on the effective date, Lessee applies the subsequent measurement guidance in Section 842-20-35, including the reassessment requirements, except for the requirement to reassess amounts probable of being owed under residual value guarantees. Such amounts will only be reassessed if there is a remeasurement of the lease liability for another reason, including as a result of a lease modification (that is, not accounted for as a separate contract).

> > > Illustration of Lessee Transition—Existing Operating Lease

842-10-55-248 Example 29 illustrates lessee accounting for the transition of existing operating leases.

> > > > Example 29—Lessee Transition—Existing Operating Lease

842-10-55-249 The effective date of the guidance in this Topic for Lessee is January 1, 20X4. Lessee enters into a five-year lease of an asset on January 1, 20X1, with annual lease payments payable at the end of each year. Lessee accounts for the lease as an operating lease. At lease commencement, Lessee defers initial direct costs of $500, which will be amortized over the lease term. On January 1, 20X2 (and before transition adjustments), Lessee has an accrued rent liability of $1,200 for the lease, reflecting rent that was previously recognized as an expense but was not yet paid as of that date. Four lease payments (1 payment of $31,000 followed by 3 payments of $33,000) and unamortized initial direct costs of $400 remain.

842-10-55-250 January 1, 20X2 is the beginning of the earliest comparative period presented in the financial statements in which Lessee first applies the guidance in this Topic. On January 1, 20X2, Lessee's incremental borrowing rate is 6 percent. Lessee has elected the package of practical expedients in paragraph 842-10-65-1(f). As such, Lessee accounts for the lease as an operating lease, without reassessing whether the contract contains a lease or whether classification of the lease would be different in accordance with this Topic. Lessee also does not reassess whether the unamortized initial direct costs on January 1, 20X2, would have met the definition of initial direct costs in this Topic at lease commencement.

842-10-55-251 On January 1, 20X2, Lessee measures the lease liability at $112,462, which is the present value of 1 payment of $31,000 and 3 payments of $33,000 discounted using the rate of 6 percent. The right-of-use asset is equal to the lease liability before adjustment for accrued rent and unamortized initial direct costs, which were not reassessed because Lessee elected the practical expedients in paragraph 842-10-65-1(f).

842-10-55-252 On January 1, 20X2, Lessee recognizes a lease liability of $112,462 and a right-of-use asset of $111,662 ($112,462 – $1,200 + $400).

842-10-55-253 From the transition date (January 1, 20X2) on, Lessee will continue to measure and recognize the lease liability at the present value of the sum of the remaining minimum rental payments (as that term was applied under Topic 840) and the right-of-use asset in accordance with this Topic.

842-10-55-254 Beginning on the effective date of January 1, 20X4, Lessee applies the subsequent measurement guidance in Section 842-20-35, including the reassessment requirements.

Transition and Open Effective Date Information

General

> Transition Related to Accounting Standards Update No. 2016-02, *Leases (Topic 842)*

842-10-65-1 The following represents the transition and effective date information related to Accounting Standards Update No. 2016-02, *Leases (Topic 842)*:

a. A **public business entity**, a **not-for-profit entity** that has issued or is a conduit bond obligor for securities that are traded, listed, or quoted on an exchange or an over-the-counter market, and an employee benefit plan that files or furnishes financial statements with or to the U.S. Securities and Exchange Commission shall apply the pending content that links to this paragraph for financial statements issued for fiscal years beginning after December 15, 2018, and interim periods within those fiscal years. Earlier application is permitted.
b. All other entities shall apply the pending content that links to this paragraph for financial statements issued for fiscal years beginning after December 15, 2019, and interim periods within fiscal years beginning after December 15, 2020. Earlier application is permitted.
c. In the financial statements in which an entity first applies the pending content that links to this paragraph, the entity shall recognize and measure **leases** within the scope of the pending content that links to this paragraph that exist at the beginning of the earliest comparative period presented, using the approach described in (i) through (ee).
d. An entity shall adjust equity at the beginning of the earliest comparative period presented, and the other comparative amounts disclosed for each prior period presented in the financial statements, as if the pending content that links to this paragraph had always been applied, subject to the requirements in (h) through (dd).
e. If a **lessee** elects not to apply the recognition and measurement requirements in the pending content that links to this paragraph to **short-term leases**, the lessee shall not apply the approach described in (k) through (s) to short-term leases.

See Examples 28 through 29 (paragraphs 842-10-55-243 through 55-254) for illustrations of the transition requirements.

Practical expedients

f. An entity may elect the following practical expedients, which must be elected as a package and applied consistently by an entity to all of its leases (including those for which the entity is a lessee or a **lessor**), when applying the pending content that links to this paragraph to leases that commenced before the effective date:
   1. An entity need not reassess whether any expired or existing **contracts** are or contain leases.
   2. An entity need not reassess the lease classification for any expired or existing leases (that is, all existing leases that were classified as **operating leases** in accordance with Topic 840 will be classified as operating leases, and all existing leases that were classified as capital leases in accordance with Topic 840 will be classified as **finance leases**).
   3. An entity need not reassess **initial direct costs** for any existing leases.

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

Amounts previously recognized in respect of business combinations

h. If an entity has previously recognized an asset or a liability in accordance with Topic 805 on **business combinations** relating to favorable or unfavorable terms of an operating lease acquired as part of a business combination, the entity shall do all of the following:
   1. Derecognize that asset and liability (except for those arising from operating leases for which the entity is a lessor).
   2. Adjust the carrying amount of the right-of-use asset by a corresponding amount if the entity is a lessee.
   3. Make a corresponding adjustment to equity at the beginning of the earliest comparative period presented if assets or liabilities arise from leases classified as **sales-type leases** or **direct financing leases** in accordance with Topic 840 for which the entity is a lessor.

Disclosure

i. An entity shall provide the transition disclosures required by Topic 250 on accounting changes and error corrections, except for the requirements in paragraph 250-10-50-1(b)(2).

j. If an entity uses one or both of the practical expedients in (f) and (g), it shall disclose that fact.

Lessees

Leases previously classified as operating leases under Topic 840

k. A lessee should initially recognize a right-of-use asset and a **lease liability** at the later of the beginning of the earliest period presented in the financial statements and the **commencement date of the lease**.
l. Unless, on or after the effective date, the lease is modified (and that modification is not accounted for as a separate contract in accordance with paragraph 842-10-25-8) or the lease liability is required to be remeasured in accordance with paragraph 842-20-35-4, a lessee shall measure the lease liability at the present value of the sum of the following, using a **discount rate for the lease** (which, for entities that are not public business entities, can be a risk-free rate determined in accordance with paragraph 842-20-30-3) established at the later of the beginning of the earliest period presented in the financial statements and the commencement date of the lease:
    1. The remaining minimum rental payments (as defined under Topic 840).
    2. Any amounts **probable** of being owed by the lessee under a **residual value guarantee**.
m. For each lease classified as an operating lease in accordance with paragraphs 842-10-25-2 through 25-3, a lessee shall initially measure the right-of-use asset at the initial measurement of the lease liability adjusted for both of the following:
    1. The items in paragraph 842-20-35-3(b), as applicable.
    2. The carrying amount of any liability recognized in accordance with Topic 420 on exit or disposal cost obligations for the lease.
n. For each lease classified as an operating lease in accordance with paragraphs 842-10-25-2 through 25-3, a lessee shall subsequently measure the right-of-use asset throughout the remaining lease term in accordance with paragraph 842-20-35-3(b). If the initial measurement of the right-of-use asset in (m) is adjusted for the carrying amount of a liability recognized in accordance with Topic 420 on exit or disposal cost obligations for the lease, the lessee shall apply the recognition and subsequent measurement guidance in Sections 842-20-25 and 842-20-35, respectively, when the right-of-use asset has been impaired.
o. For each lease classified as a finance lease in accordance with paragraph 842-10-25-2, a lessee shall measure the right-of-use asset as the applicable proportion of the lease liability at the commencement date, which can be imputed from the lease liability determined in accordance with (l). The applicable proportion is the remaining lease term at the beginning of the earliest comparative period presented relative to the total lease term. A lessee shall adjust the right-of-use asset recognized by the carrying amount of any prepaid or accrued **lease payments** and the

carrying amount of any liability recognized in accordance with Topic 420 for the lease.

p. Any unamortized initial direct costs at the later of the beginning of the earliest period presented in the financial statements or the commencement date of the lease that do not meet the definition of initial direct costs in this Topic shall be written off as an adjustment to equity at the later of the beginning of the earliest period presented in the financial statements and the commencement date of the lease.

q. If a modification to the contractual terms and conditions occurs on or after the effective date, and the modification does not result in a separate contract in accordance with paragraph 842-10-25-8, or the lessee is required to remeasure the lease liability for any reason (see paragraphs 842-20-35-4 through 35-5), the lessee shall follow the requirements in this Topic from the **effective date of the modification** or the remeasurement date.

Leases previously classified as capital leases under Topic 840

r. For each lease classified as a finance lease in accordance with this Topic, a lessee shall do all of the following:
   1. Recognize a right-of-use asset and a lease liability at the carrying amount of the lease asset and the capital lease obligation in accordance with Topic 840 at the later of the beginning of the earliest comparative period presented or the commencement date of the lease.
   2. Include any unamortized initial direct costs that meet the definition of initial direct costs in this Topic in the measurement of the right-of-use asset established in (r)(1).
   3. Write off, as an adjustment to equity, any unamortized initial direct costs at the later of the beginning of the earliest period presented in the financial statements or the commencement date of the lease that do not meet the definition of initial direct costs in this Topic and that are not included in the measurement of the capital lease asset under Topic 840 (unless the lessee elects the practical expedients described in (f)).
   4. Subsequently measure the right-of-use asset and the lease liability in accordance with Section 840-20-35 before the effective date.
   5. Apply the subsequent measurement guidance in paragraphs 842-20-35-4 through 35-5 and 842-20-35-8 after the effective date. However, when applying the pending content in paragraph 842-20-35-4, a lessee shall not remeasure the lease payments for amounts probable of being owed under residual value guarantees in accordance with paragraph 842-10-35-4(c)(3).
   6. Classify the assets and liabilities held under capital leases as right-of-use assets and lease liabilities arising from finance leases for the purposes of presentation and disclosure.

s. For each lease classified as an operating lease in accordance with this Topic, a lessee shall do the following:
   1. Derecognize the carrying amount of any capital lease asset and capital lease obligation in accordance with Topic 840 at the later of the beginning of the earliest comparative period presented or the commencement date of the lease. Any difference between the carrying amount of the capital lease asset and the capital lease obligation shall be accounted for in the same manner as prepaid or accrued rent.
   2. Recognize a right-of-use asset and a lease liability in accordance with paragraph 842-20-35-3 if the lease commenced before the beginning of the earliest period presented in the financial statements.
   3. Recognize a right-of-use asset and a lease liability in accordance with paragraph 842-20-30-1 at the commencement date of the lease if the lease commenced after the beginning of the earliest period presented in the financial statements.
   4. Account for the operating lease in accordance with the guidance in Subtopic 842-20 after initial recognition in accordance with (r)(2) or (r)(3).
   5. Write off, as an adjustment to equity, any unamortized initial direct costs at the later of the beginning of the earliest period presented in the financial statements or the commencement date of the lease that do not meet the definition of initial direct costs in this Topic.

t. If a modification to the contractual terms and conditions occurs on or after the effective date, and the modification does not result in a separate contract in accordance with paragraph 842-10-25-8, or the lessee is required to remeasure the lease liability in accordance with paragraph 842-20-35-4, the lessee shall subsequently account for the lease in accordance with the requirements in this Topic beginning on the effective date of the modification or the remeasurement date.

Build-to-suit lease arrangements

u. A lessee shall apply a modified retrospective transition approach for leases accounted for as build-to-suit arrangements under Topic 840 that are existing at, or entered into after, the beginning of the earliest comparative period presented in the financial statements as follows:
   1. If an entity has recognized assets and liabilities solely as a result of a transaction's build-to-suit designation in accordance with Topic 840, the entity should derecognize those assets and liabilities at the later of the beginning of the earliest comparative period presented in the financial statements and the date that the lessee is determined to be the accounting owner of the asset in accordance with Topic 840. Any difference should be recorded as an adjustment to equity at that date. The lessee shall apply the lessee transition requirements in (k) through (s) to the lease.

2. If the construction period of the build-to-suit lease concluded before the beginning of the earliest comparative period presented in the financial statements and the transaction qualified as a sale and leaseback transaction in accordance with Subtopic 840-40 before the date of initial application, the entity shall follow the general lessee transition requirements for the lease.

Lessors

Leases previously classified as operating leases under Topic 840

v. For each lease classified as an operating lease in accordance with this Topic, a lessor shall do all of the following:
    1. Continue to recognize the carrying amount of the underlying asset and any lease assets or liabilities at the later of the date of initial application and the commencement date as the same amounts recognized by the lessor immediately before that date in accordance with Topic 840.
    2. Account for previously recognized securitized receivables as secured borrowings in accordance with other Topics.
    3. Write off, as an adjustment to equity, any unamortized initial direct costs at the later of the beginning of the earliest period presented in the financial statements or the commencement date of the lease that do not meet the definition of initial direct costs in this Topic (unless the lessor elects the practical expedients described in (f)).

w. For each lease classified as a direct financing or a sales-type lease in accordance with this Topic, the objective is to account for the lease, beginning on the later of the beginning of the earliest comparative period presented in the financial statements and the commencement date of the lease, as if it had always been accounted for as a direct financing lease or a sales-type lease in accordance with this Topic. Consequently, a lessor shall do all of the following:
    1. Derecognize the carrying amount of the underlying asset at the later of the beginning of the earliest comparative period presented in the financial statements and the commencement date of the lease.
    2. Recognize a **net investment in the lease** at the later of the beginning of the earliest comparative period presented in the financial statements and the commencement date of the lease as if the lease had been accounted for as a direct financing lease or a sales-type lease in accordance with Subtopic 842-30 since lease commencement.
    3. Record any difference between the amounts in (w)(1) and (w)(2) as an adjustment to equity.
    4. Account for the lease in accordance with this Topic after the later of the beginning of the earliest comparative period presented in the financial statements and the commencement date of the lease.

Leases previously classified as direct financing or sales-type leases under Topic 840

x. For each lease classified as a direct financing lease or a sales-type lease in accordance with this Topic, do all of the following:
   1. Continue to recognize a net investment in the lease at the later of the beginning of the earliest comparative period presented in the financial statements and the commencement date of the lease, at the carrying amount of the net investment at that date. This would include any unamortized initial direct costs capitalized as part of the lessor's net investment in the lease in accordance with Topic 840.
   2. Before the effective date, a lessor shall account for the lease in accordance with Topic 840.
   3. Beginning on the effective date, a lessor shall account for the lease in accordance with the recognition, subsequent measurement, presentation, and disclosure guidance in Subtopic 842-30.
   4. Beginning on the effective date, if a lessor modifies the lease (and the modification is not accounted for as a separate contract in accordance with paragraph 842-10-25-8), it shall account for the modified lease in accordance with paragraph 842-10-25-16 if the modified lease is classified as a direct financing lease after the modification or paragraph 842-10-25-17 if the modified lease is classified as a sales-type lease after the modification. A lessor shall not remeasure the net investment in the lease on or after the effective date unless the lease is modified (and the modification is not accounted for as a separate contract in accordance with paragraph 842-10-25-8).

y. For each lease classified as an operating lease in accordance with this Topic, the objective is to account for the lease, beginning on the later of the beginning of the earliest comparative period presented in the financial statements and the commencement date of the lease, as if it had always been accounted for as an operating lease in accordance with this Topic. Consequently, a lessor shall do all of the following:
   1. Recognize the underlying asset at what the carrying amount would have been had the lease been classified as an operating lease under Topic 840.
   2. Derecognize the carrying amount of the net investment in the lease.
   3. Record any difference between the amounts in (y)(1) and (y)(2) as an adjustment to equity.
   4. Subsequently account for the operating lease in accordance with this Topic and the underlying asset in accordance with other Topics.

Leases previously classified as leveraged leases under Topic 840

z. For leases that were classified as **leveraged leases** in accordance with Topic 840, and for which the commencement date is before the effective date, a lessor shall apply the requirements in Subtopic 842-50. If a leveraged lease is modified on or after the effective date, it shall be accounted for as a new lease as of the effective date of the modification in accordance with the guidance in Subtopics 842-10 and 842-30.

1. A lessor shall apply the pending content that links to this paragraph to a leveraged lease that meets the criteria in (z) that is acquired in a business combination or an **acquisition by a not-for-profit entity** on or after the effective date.

Sale and leaseback transactions before the beginning of the earliest comparative period presented

aa. If a previous sale and leaseback transaction was accounted for as a sale and a leaseback in accordance with Topic 840, an entity shall not reassess the transaction to determine whether the transfer of the asset would have been a sale in accordance with paragraphs 842-40-25-1 through 25-3.

bb. If a previous sale and leaseback transaction was accounted for as a failed sale and leaseback transaction in accordance with Topic 840 and remains a failed sale at the effective date, the entity shall reassess whether a sale would have occurred at any point on or after the beginning of the earliest period presented in the financial statements in accordance with paragraphs 842-40-25-1 through 25-3. The sale and leaseback transaction shall be accounted for on a modified retrospective basis from the date a sale is determined to have occurred, in accordance with the requirements in (cc) through (dd).

cc. An entity shall account for the leaseback in accordance with the lessee and lessor transition requirements in (k) through (y).

dd. If a previous sale and leaseback transaction was accounted for as a sale and capital leaseback in accordance with Topic 840, the transferor shall continue to recognize any deferred gain or loss that exists at the later of the beginning of the earliest comparative period presented in the financial statements or the date of the sale of the underlying asset as follows:

1. If the underlying asset is land only, straight line over the remaining lease term.
2. If the underlying asset is not land only and the leaseback is a finance lease, in proportion to the amortization of the right-of-use asset.
3. If the underlying asset is not land only and the leaseback is an operating lease, in proportion to the recognition in profit or loss of the total lease cost.

ee. If a previous sale and leaseback transaction was accounted for as a sale and operating leaseback in accordance with Topic 840, the transferor shall do the following:

1. Recognize any deferred gain or loss not resulting from off-market terms (that is, where the consideration for the sale of the asset is not at **fair value** or the lease payments are not at market rates) as a

cumulative-effect adjustment at the later of the date of initial application (to equity) or the date of sale (to earnings of the comparative period presented).

2. Recognize any deferred loss resulting from the consideration for the sale of the asset not being at fair value or the lease payments not being at market rates as an adjustment to the leaseback right-of-use asset at the date of initial application.
3. Recognize any deferred gain resulting from the consideration for the sale of the asset not being at fair value or the lease payments not being at market rates as a financial liability at the date of initial application.

4. Add Subtopic 842-20, with a link to transition paragraph 842-10-65-1, as follows:

[For ease of readability, the new Subtopic is not underlined.]

Leases—Lessee

Overview and Background

General

842-20-05-1 This Subtopic addresses accounting by **lessees** for **leases** that have been classified as **finance leases** or **operating leases** in accordance with the requirements in Subtopic 842-10. Lessees shall follow the requirements in this Subtopic as well as those in Subtopic 842-10.

Scope and Scope Exceptions

General

842-20-15-1 This Subtopic follows the same Scope and Scope Exceptions as outlined in the Overall Subtopic.

Glossary

Acquiree

The **business** or **businesses** that the **acquirer** obtains control of in a **business combination**. This term also includes a nonprofit activity or business that a not-for-profit acquirer obtains control of in an **acquisition by a not-for-profit entity**.

Acquirer

The entity that obtains control of the **acquiree**. However, in a **business combination** in which a **variable interest entity** (VIE) is acquired, the primary beneficiary of that entity always is the acquirer.

Acquisition by a Not-for-Profit Entity

A transaction or other event in which a not-for-profit acquirer obtains control of one or more nonprofit activities or businesses and initially recognizes their assets and liabilities in the acquirer's financial statements. When applicable guidance in Topic 805 is applied by a **not-for-profit entity**, the term **business combination** has the same meaning as this term has for a for-profit entity. Likewise, a reference to business combinations in guidance that links to Topic 805 has the same meaning as a reference to acquisitions by not-for-profit entities.

Business

An integrated set of activities and assets that is capable of being conducted and managed for the purpose of providing a return in the form of dividends, lower costs, or other economic benefits directly to investors or other owners, members, or participants. Additional guidance on what a business consists of is presented in paragraphs 805-10-55-4 through 55-9.

Business Combination

A transaction or other event in which an **acquirer** obtains control of one or more **businesses.** Transactions sometimes referred to as true mergers or mergers of equals also are business combinations. See also **Acquisition by a Not-for-Profit Entity**.

Commencement Date of the Lease (Commencement Date)

The date on which a **lessor** makes an **underlying asset** available for use by a **lessee**. See paragraphs 842-10-55-19 through 55-21 for implementation guidance on the commencement date.

Contract

An agreement between two or more parties that creates enforceable rights and obligations.

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).

Discount Rate for the Lease

For a **lessee**, the discount rate for the **lease** is the **rate implicit in the lease** unless that rate cannot be readily determined. In that case, the lessee is required to use its **incremental borrowing rate**.

For a **lessor**, the discount rate for the lease is the rate implicit in the lease.

Fair Value (second definition)

The price that would be received to sell an asset or paid to transfer a liability in an **orderly transaction** between **market participants** at the measurement date.

Finance Lease

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

Incremental Borrowing Rate

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.

Initial Direct Costs

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

Lease

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.

Lease Liability

A **lessee's** obligation to make the **lease payments** arising from a **lease**, measured on a discounted basis.

Lease Modification

A change to the terms and conditions of a **contract** that results in a change in the scope of or the consideration for a **lease** (for example, a change to the terms and conditions of the contract that adds or terminates the right to use one or more underlying assets or extends or shortens the contractual lease term).

Lease Payments

See paragraph 842-10-30-5 for what constitutes lease payments from the perspective of a **lessee** and a **lessor**.

Lease Term

The noncancellable period for which a **lessee** has the right to use an **underlying asset**, together with all of the following:

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

Legal Entity

Any legal structure used to conduct activities or to hold assets. Some examples of such structures are corporations, partnerships, limited liability companies, grantor trusts, and other trusts.

Lessee

An entity that enters into a **contract** to obtain the right to use an **underlying asset** for a period of time in exchange for consideration.

Lessor

An entity that enters into a **contract** to provide the right to use an **underlying asset** for a period of time in exchange for consideration.

Market Participants

Buyers and sellers in the principal (or most advantageous) market for the asset or liability that have all of the following characteristics:

a. They are independent of each other, that is, they are not **related parties**, although the price in a related-party transaction may be used as an input to a fair value measurement if the reporting entity has evidence that the transaction was entered into at market terms
b. They are knowledgeable, having a reasonable understanding about the asset or liability and the transaction using all available information, including information that might be obtained through due diligence efforts that are usual and customary
c. They are able to enter into a transaction for the asset or liability
d. They are willing to enter into a transaction for the asset or liability, that is, they are motivated but not forced or otherwise compelled to do so.

Monetary Liability

An obligation to pay a sum of money the amount of which is fixed or determinable without reference to future prices of specific goods and services.

Not-for-Profit Entity

An entity that possesses the following characteristics, in varying degrees, that distinguish it from a business entity:

a. Contributions of significant amounts of resources from resource providers who do not expect commensurate or proportionate pecuniary return
b. Operating purposes other than to provide goods or services at a profit
c. Absence of ownership interests like those of business entities.

Entities that clearly fall outside this definition include the following:

a. All investor-owned entities
b. Entities that provide dividends, lower costs, or other economic benefits directly and proportionately to their owners, members, or participants, such as mutual insurance entities, credit unions, farm and rural electric cooperatives, and employee benefit plans.

Operating Lease

From the perspective of a **lessee**, any **lease** other than a **finance lease**.

From the perspective of a **lessor**, any lease other than a **sales-type lease** or a **direct financing lease**.

Orderly Transaction

A transaction that assumes exposure to the market for a period before the measurement date to allow for marketing activities that are usual and customary for transactions involving such assets or liabilities; it is not a forced transaction (for example, a forced liquidation or distress sale).

Probable (second definition)

The future event or events are likely to occur.

Rate Implicit in the Lease

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

Related Parties

Related parties include:

a. Affiliates of the entity
b. Entities for which investments in their equity securities would be required, absent the election of the fair value option under the Fair Value Option Subsection of Section 825-10-15, to be accounted for by the equity method by the investing entity
c. Trusts for the benefit of employees, such as pension and profit-sharing trusts that are managed by or under the trusteeship of management
d. Principal owners of the entity and members of their immediate families
e. Management of the entity and members of their immediate families
f. Other parties with which the entity may deal if one party controls or can significantly influence the management or operating policies of the other to an extent that one of the transacting parties might be prevented from fully pursuing its own separate interests
g. Other parties that can significantly influence the management or operating policies of the transacting parties or that have an ownership interest in one of the transacting parties and can significantly influence the other to an extent that one or more of the transacting parties might be prevented from fully pursuing its own separate interests.

Residual Value Guarantee

A guarantee made to a **lessor** that the value of an **underlying asset** returned to the lessor at the end of a **lease** will be at least a specified amount.

Right-of-Use Asset

An asset that represents a **lessee's** right to use an **underlying asset** for the **lease term**.

Sales-Type Lease

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

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.

Sublease

A transaction in which an **underlying asset** is re-leased by the **lessee** (or intermediate **lessor**) to a third party (the sublessee) and the original (or head) **lease** between the lessor and the lessee remains in effect.

Underlying Asset

An asset that is the subject of a **lease** for which a right to use that asset has been conveyed to a **lessee**. The underlying asset could be a physically distinct portion of a single asset.

Useful Life

The period over which an asset is expected to contribute directly or indirectly to future cash flows.

Variable Interest Entity

A **legal entity** subject to consolidation according to the provisions of the Variable Interest Entities Subsections of Subtopic 810-10.

Variable Lease Payments

Payments made by a **lessee** to a **lessor** for the right to use an **underlying asset** that vary because of changes in facts or circumstances occurring after the **commencement date**, other than the passage of time.

Recognition

General

842-20-25-1 At the **commencement date**, a **lessee** shall recognize a **right-of-use asset** and a **lease liability**.

> Short-Term Leases

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 lease payments** in the period in which the obligation for those payments is incurred (consistent with paragraphs 842-20-55-1 through 55-2). The accounting policy election for short-term leases shall be made by class of **underlying asset** to which the right of use relates.

842-20-25-3 If the lease term or the assessment of a lessee option to purchase the underlying asset changes such that, after the change, the remaining lease term extends more than 12 months from the end of the previously determined lease term or the lessee is reasonably certain to exercise its option to purchase the underlying asset, the lease no longer meets the definition of a short-term lease and the lessee shall apply the remainder of the guidance in this Topic as if the date of the change in circumstances is the **commencement date**.

842-20-25-4 See Example 1 (paragraphs 842-20-55-13 through 55-16) for an illustration of the requirements on short-term leases.

> Finance Leases

842-20-25-5 After the **commencement date**, a **lessee** shall recognize in profit or loss, unless the costs are included in the carrying amount of another asset in accordance with other Topics:

a. Amortization of the **right-of-use asset** and interest on the **lease liability**
b. **Variable lease payments** not included in the lease liability in the period in which the obligation for those payments is incurred (see paragraphs 842-20-55-1 through 55-2)
c. Any impairment of the right-of-use asset determined in accordance with paragraph 842-20-35-9.

> Operating Leases

842-20-25-6 After the **commencement date**, a **lessee** shall recognize all of the following in profit or loss, unless the costs are included in the carrying amount of another asset in accordance with other Topics:

a. A single lease cost, calculated so that the remaining cost of the **lease** (as described in paragraph 842-20-25-8) is allocated over the remaining **lease term** on a straight-line basis unless another systematic and rational basis is more representative of the pattern in which benefit is expected to be derived from the right to use the **underlying asset** (see paragraph 842-20-55-3), unless the **right-of-use asset** has been impaired in accordance with paragraph 842-20-35-9, in which case the single lease cost is calculated in accordance with paragraph 842-20-25-7
b. **Variable lease payments** not included in the **lease liability** in the period in which the obligation for those payments is incurred (see paragraphs 842-20-55-1 through 55-2)
c. Any impairment of the right-of-use asset determined in accordance with paragraph 842-20-35-9.

842-20-25-7 After a right-of-use asset has been impaired in accordance with paragraph 842-20-35-9, the single lease cost described in paragraph 842-20-25-6(a) shall be calculated as the sum of the following:

a. Amortization of the remaining balance of the right-of-use asset after the impairment on a straight-line basis, unless another systematic basis is more representative of the pattern in which the lessee expects to consume the remaining economic benefits from its right to use the underlying asset
b. Accretion of the lease liability, determined for each remaining period during the lease term as the amount that produces a constant periodic discount rate on the remaining balance of the liability.

842-20-25-8 Throughout the lease term, the remaining cost of an **operating lease** for which the right-of-use asset has not been impaired consists of the following:

a. The total **lease payments** (including those paid and those not yet paid), reflecting any adjustment to that total amount resulting from either a remeasurement in accordance with paragraphs 842-10-35-4 through 35-5 or a **lease modification**; plus
b. The total **initial direct costs** attributable to the lease; minus
c. The periodic lease cost recognized in prior periods.

Initial Measurement

General

842-20-30-1 At the **commencement date**, a **lessee** shall measure both of the following:

a. The **lease liability** at the present value of the **lease payments** not yet paid, discounted using the **discount rate for the lease** at lease commencement (as described in paragraphs 842-20-30-2 through 30-4)
b. The **right-of-use asset** as described in paragraph 842-20-30-5.

> Discount Rate for the Lease

842-20-30-2 The **discount rate for the lease** initially used to determine the present value of the **lease payments** for a **lessee** is calculated on the basis of information available at the **commencement date**.

842-20-30-3 A lessee should use the **rate implicit in the lease** whenever that rate is readily determinable. If the rate implicit in the lease is not readily determinable, a lessee uses its **incremental borrowing rate**. A lessee that is not a public business entity is permitted to use a risk-free discount rate for the lease, determined using a period comparable with that of the **lease term**, as an accounting policy election for all leases.

842-20-30-4 See Example 2 (paragraphs 842-20-55-17 through 55-20) for an illustration of the requirements on the discount rate.

> Initial Measurement of the Right-of-Use Asset

842-20-30-5 At the **commencement date**, the cost of the **right-of-use asset** shall consist of all of the following:

a. The amount of the initial measurement of the **lease liability**
b. Any **lease payments** made to the **lessor** at or before the commencement date, minus any lease incentives received
c. Any **initial direct costs** incurred by the **lessee** (as described in paragraphs 842-10-30-9 through 30-10).

842-20-30-6 See Example 3 (paragraphs 842-20-55-21 through 55-39) for an illustration of the requirements on lessee measurement of the **lease term**.

Subsequent Measurement

General

842-20-35-1 After the **commencement date**, for a **finance lease**, a **lessee** shall measure both of the following:

a. The **lease liability** by increasing the carrying amount to reflect interest on the lease liability and reducing the carrying amount to reflect the **lease payments** made during the period. The lessee shall determine the interest on the lease liability in each period during the **lease term** as the amount that produces a constant periodic discount rate on the remaining balance of the liability, taking into consideration the reassessment requirements in paragraphs 842-10-35-1 through 35-5.
b. The **right-of-use asset** at cost less any accumulated amortization and any accumulated impairment losses, taking into consideration the reassessment requirements in paragraphs 842-10-35-1 through 35-5.

842-20-35-2 A lessee shall recognize amortization of the right-of-use asset and interest on the lease liability for a finance lease in accordance with paragraph 842-20-25-5.

842-20-35-3 After the commencement date, for an **operating lease**, a lessee shall measure both of the following:

a. The lease liability at the present value of the lease payments not yet paid discounted using the **discount rate for the lease** established at the commencement date (unless the rate has been updated after the commencement date in accordance with paragraph 842-20-35-5, in which case that updated rate shall be used)
b. The right-of-use asset at the amount of the lease liability, adjusted for the following, unless the right-of-use asset has been previously impaired, in which case the right-of-use asset is measured in accordance with paragraph 842-20-35-10 after the impairment:
    1. Prepaid or accrued lease payments
    2. The remaining balance of any lease incentives received, which is the amount of the gross lease incentives received net of amounts recognized previously as part of the single lease cost described in paragraph 842-20-25-6(a)
    3. Unamortized **initial direct costs**
    4. Impairment of the right-of-use asset.

> Remeasurement of the Lease Liability

842-20-35-4 After the **commencement date**, a **lessee** shall remeasure the **lease liability** to reflect changes to the **lease payments** as described in paragraphs 842-10-35-4 through 35-5. A lessee shall recognize the amount of the remeasurement of the lease liability as an adjustment to the **right-of-use asset**. However, if the carrying amount of the right-of-use asset is reduced to zero, a lessee shall recognize any remaining amount of the remeasurement in profit or loss.

842-20-35-5 If there is a remeasurement of the lease liability in accordance with paragraph 842-20-35-4, the lessee shall update the **discount rate for the lease** at the date of remeasurement on the basis of the remaining **lease term** and the remaining lease payments unless the remeasurement of the lease liability is the result of one of the following:

a. A change in the lease term or the assessment of whether the lessee will exercise an option to purchase the **underlying asset** and the discount rate for the lease already reflects that the lessee has an option to extend or terminate the **lease** or to purchase the underlying asset.
b. A change in amounts **probable** of being owed by the lessee under a **residual value guarantee** (see paragraph 842-10-35-4(c)(3)).
c. A change in the lease payments resulting from the resolution of a contingency upon which some or all of the **variable lease payments** that will be paid over the remainder of the lease term are based (see paragraph 842-10-35-4(b)).

842-20-35-6 See Examples 3 and 4 (paragraphs 842-20-55-21 through 55-46) for an illustration of the requirements on lessee subsequent measurement.

> Amortization of the Right-of-Use Asset for a Finance Lease

842-20-35-7 A **lessee** shall amortize the **right-of-use asset** on a straight-line basis, unless another systematic basis is more representative of the pattern in which the lessee expects to consume the right-of-use asset's future economic benefits. When the **lease liability** is remeasured and the right-of-use asset is adjusted in accordance with paragraph 842-20-35-4, amortization of the right-of-use asset shall be adjusted prospectively from the date of remeasurement.

842-20-35-8 A lessee shall amortize the right-of-use asset from the **commencement date** to the earlier of the end of the **useful life** of the right-of-use asset or the end of the **lease term**. However, if the **lease** transfers ownership of the **underlying asset** to the lessee or the lessee is reasonably certain to exercise an option to purchase the underlying asset, the lessee shall amortize the right-of-use asset to the end of the useful life of the underlying asset.

> Impairment of a Right-of-Use Asset

842-20-35-9 A **lessee** shall determine whether a **right-of-use asset** is impaired and shall recognize any impairment loss in accordance with Section 360-10-35 on impairment or disposal of long-lived assets.

842-20-35-10 If a right-of-use asset is impaired in accordance with paragraph 842-20-35-9, after the impairment, it shall be measured at its carrying amount immediately after the impairment less any accumulated amortization. A lessee shall amortize, in accordance with paragraph 842-20-25-7 (for an **operating lease**) or paragraph 842-20-35-7 (for a **finance lease**), the right-of-use asset from the date of the impairment to the earlier of the end of the **useful life** of the right-of-use asset or the end of the **lease term**.

842-20-35-11 See Example 5 (paragraphs 842-20-55-47 through 55-51) for an illustration of the requirements for impairment of a right-of-use asset.

> Amortization of Leasehold Improvements

842-20-35-12 Leasehold improvements shall be amortized over the shorter of the **useful life** of those leasehold improvements and the remaining **lease term**, unless the **lease** transfers ownership of the **underlying asset** to the **lessee** or the lessee is reasonably certain to exercise an option to purchase the underlying asset, in which case the lessee shall amortize the leasehold improvements to the end of their useful life.

842-20-35-13 Leasehold improvements acquired in a **business combination** or an **acquisition by a not-for-profit entity** shall be amortized over the shorter of the useful life of the assets and the remaining lease term at the date of acquisition.

> Subleases

842-20-35-14 If the nature of a **sublease** is such that the original **lessee** is not relieved of the primary obligation under the original **lease**, the original lessee (as sublessor) shall continue to account for the original lease in one of the following ways:

a. If the sublease is classified as an **operating lease**, the original lessee shall continue to account for the original lease as it did before commencement of the sublease. If the lease cost for the term of the sublease exceeds the anticipated sublease income for that same period, the original lessee shall treat that circumstance as an indicator that the carrying amount of the **right-of-use asset** associated with the original lease may not be recoverable in accordance with paragraph 360-10-35-21.
b. If the original lease is classified as a **finance lease** and the sublease is classified as a **sales-type lease** or a **direct financing lease**, the original lessee shall derecognize the original right-of-use asset in accordance with paragraph 842-30-40-1 and continue to account for the original **lease liability** as it did before commencement of the sublease. The original lessee shall evaluate its investment in the sublease for impairment in accordance with paragraph 842-30-35-3.
c. If the original lease is classified as an operating lease and the sublease is classified as a sales-type lease or a direct financing lease, the original lessee shall derecognize the original right-of-use asset in accordance with paragraph 842-30-40-1 and, from the sublease **commencement date**, account for the original lease liability in accordance with paragraphs 842-20-35-1 through 35-2. The original lessee shall evaluate its

investment in the sublease for impairment in accordance with paragraph 842-30-35-3.

842-20-35-15 The original lessee (as sublessor) in a sublease shall use the **rate implicit in the lease** to determine the classification of the sublease and to measure the net investment in the sublease if the sublease is classified as a sales-type or a direct financing lease unless that rate cannot be readily determined. If the rate implicit in the lease cannot be readily determined, the original lessee may use the **discount rate for the lease** established for the original (or head) lease.

Derecognition

General

> Lease Termination

842-20-40-1 A termination of a **lease** before the expiration of the **lease term** shall be accounted for by the **lessee** by removing the **right-of-use asset** and the **lease liability**, with profit or loss recognized for the difference.

> > Purchase of the Underlying Asset

842-20-40-2 The termination of a **lease** that results from the purchase of an **underlying asset** by the **lessee** is not the type of termination of a lease contemplated by paragraph 842-20-40-1 but, rather, is an integral part of the purchase of the underlying asset. If the lessee purchases the underlying asset, any difference between the purchase price and the carrying amount of the lease liability immediately before the purchase shall be recorded by the lessee as an adjustment of the carrying amount of the asset. However, this paragraph does not apply to underlying assets acquired in a **business combination**, which are initially measured at **fair value** in accordance with paragraph 805-20-30-1.

> Subleases

842-20-40-3 If the nature of a **sublease** is such that the original **lessee** is relieved of the primary obligation under the original **lease**, the transaction shall be considered a termination of the original lease. Paragraph 842-20-35-14 addresses subleases in which the original lessee is not relieved of the primary obligation under the original lease. Any consideration paid or received upon termination that was not already included in the **lease payments** (for example, a termination payment that was not included in the lease payments based on the **lease term**) shall be included in the determination of profit or loss to be recognized in accordance with paragraph 842-20-40-1. If a sublease is a termination of the original lease and the original lessee is secondarily liable, the guarantee obligation shall be recognized by the lessee in accordance with paragraph 405-20-40-2.

Other Presentation Matters

General

> Statement of Financial Position

842-20-45-1 A **lessee** shall either present in the statement of financial position or disclose in the notes all of the following:

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

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

842-20-45-2 If a lessee does not present finance lease and operating lease right-of-use assets and lease liabilities separately in the statement of financial position, the lessee shall disclose which line items in the statement of financial position include those right-of-use assets and lease liabilities.

842-20-45-3 In the statement of financial position, a lessee is prohibited from presenting both of the following:

a. Finance lease right-of-use assets in the same line item as operating lease right-of-use assets
b. Finance lease liabilities in the same line item as operating lease liabilities.

> Statement of Comprehensive Income

842-20-45-4 In the statement of comprehensive income, a **lessee** shall present both of the following:

a. For **finance leases**, the interest expense on the **lease liability** and amortization of the **right-of-use asset** are not required to be presented as separate line items and shall be presented in a manner consistent with how the entity presents other interest expense and depreciation or amortization of similar assets, respectively
b. For **operating leases**, **lease** expense shall be included in the lessee's income from continuing operations.

> Statement of Cash Flows

842-20-45-5 In the statement of cash flows, a **lessee** shall classify all of the following:

a. Repayments of the principal portion of the **lease liability** arising from **finance leases** within financing activities

b. Interest on the lease liability arising from finance leases in accordance with the requirements relating to interest paid in Topic 230 on cash flows
c. Payments arising from **operating leases** within operating activities, except to the extent that those payments represent costs to bring another asset to the condition and location necessary for its intended use, which should be classified within investing activities
d. **Variable lease payments** and **short-term lease** payments not included in the lease liability within operating activities.

Disclosure

General

842-20-50-1 The objective of the disclosure requirements is to enable users of financial statements to assess the amount, timing, and uncertainty of cash flows arising from **leases**. To achieve that objective, a **lessee** shall disclose qualitative and quantitative information about all of the following:

a. Its leases (as described in paragraphs 842-20-50-3(a) through (b) and 842-20-50-7 through 50-8)
b. The significant judgments made in applying the requirements in this Topic to those leases (as described in paragraph 842-20-50-3(c))
c. The amounts recognized in the financial statements relating to those leases (as described in paragraphs 842-20-50-4 and 842-20-50-6).

842-20-50-2 A lessee shall consider the level of detail necessary to satisfy the disclosure objective and how much emphasis to place on each of the various requirements. A lessee shall aggregate or disaggregate disclosures so that useful information is not obscured by including a large amount of insignificant detail or by aggregating items that have different characteristics.

842-20-50-3 A lessee shall disclose all of the following:

a. Information about the nature of its leases, including:
   1. A general description of those leases.
   2. The basis and terms and conditions on which **variable lease payments** are determined.
   3. The existence and terms and conditions of options to extend or terminate the lease. A lessee should provide narrative disclosure about the options that are recognized as part of its **right-of-use assets** and **lease liabilities** and those that are not.
   4. The existence and terms and conditions of **residual value guarantees** provided by the lessee.
   5. The restrictions or covenants imposed by leases, for example, those relating to dividends or incurring additional financial obligations.

   A lessee should identify the information relating to **subleases** included in the disclosures provided in (1) through (5), as applicable.

b. Information about leases that have not yet commenced but that create significant rights and obligations for the lessee, including the nature of any involvement with the construction or design of the **underlying asset**.
c. Information about significant assumptions and judgments made in applying the requirements of this Topic, which may include the following:
   1. The determination of whether a **contract** contains a lease (as described in paragraphs 842-10-15-2 through 15-27)
   2. The allocation of the consideration in a contract between lease and nonlease components (as described in paragraphs 842-10-15-28 through 15-32)
   3. The determination of the **discount rate for the lease** (as described in paragraphs 842-20-30-2 through 30-4).

842-20-50-4 For each period presented in the financial statements, a lessee shall disclose the following amounts relating to a lessee's total lease cost, which includes both amounts recognized in profit or loss during the period and any amounts capitalized as part of the cost of another asset in accordance with other Topics, and the cash flows arising from lease transactions:

a. **Finance lease** cost, segregated between the amortization of the right-of-use assets and interest on the lease liabilities.
b. **Operating lease** cost determined in accordance with paragraphs 842-20-25-6(a) and 842-20-25-7.
c. **Short-term lease** cost, excluding expenses relating to leases with a **lease term** of one month or less, determined in accordance with paragraph 842-20-25-2.
d. Variable lease cost determined in accordance with paragraphs 842-20-25-5(b) and 842-20-25-6(b).
e. Sublease income, disclosed on a gross basis, separate from the finance or operating lease expense.
f. Net gain or loss recognized from sale and leaseback transactions in accordance with paragraph 842-40-25-4.
g. Amounts segregated between those for finance and operating leases for the following items:
   1. Cash paid for amounts included in the measurement of lease liabilities, segregated between operating and financing cash flows
   2. Supplemental noncash information on lease liabilities arising from obtaining right-of-use assets
   3. Weighted-average remaining lease term
   4. Weighted-average discount rate.

842-20-50-5 See paragraphs 842-20-55-11 through 55-12 for implementation guidance on preparing the weighted-average remaining lease term and the weighted-average discount rate disclosures. See Example 6 (paragraphs 842-20-55-52 through 55-53) for an illustration of the lessee quantitative disclosure requirements in paragraph 842-20-50-4.

842-20-50-6 A lessee shall disclose a maturity analysis of its finance lease liabilities and its operating lease liabilities separately, showing the undiscounted cash flows on an annual basis for a minimum of each of the first five years and a total of the amounts for the remaining years. A lessee shall disclose a reconciliation of the undiscounted cash flows to the finance lease liabilities and operating lease liabilities recognized in the statement of financial position.

842-20-50-7 A lessee shall disclose lease transactions between related parties in accordance with paragraphs 850-10-50-1 through 50-6.

842-20-50-8 A lessee that accounts for short-term leases in accordance with paragraph 842-20-25-2 shall disclose that fact. If the short-term lease expense for the period does not reasonably reflect the lessee's short-term lease commitments, a lessee shall disclose that fact and the amount of its short-term lease commitments.

842-20-50-9 A lessee that elects the practical expedient on not separating lease components from nonlease components in paragraph 842-10-15-37 shall disclose its accounting policy election and which class or classes of underlying assets it has elected to apply the practical expedient.

Implementation Guidance and Illustrations

General

> Implementation Guidance

> > Recognition of Costs from Variable Lease Payments

842-20-55-1 A **lessee** should recognize costs from **variable lease payments** (in annual periods as well as in interim periods) before the achievement of the specified target that triggers the variable lease payments, provided the achievement of that target is considered **probable**.

842-20-55-2 Variable lease costs recognized in accordance with paragraph 842-20-55-1 should be reversed at such time that it is probable that the specified target will not be met.

> > Pattern of Benefit from Use of the Underlying Asset

842-20-55-3 This Subtopic considers the right to control the use of the **underlying asset** as the equivalent of physical use. If the **lessee** controls the use of the underlying asset, recognition of **lease** cost in accordance with paragraph 842-20-25-6(a) or amortization of the **right-of-use asset** in accordance with paragraph 842-20-35-7 should not be affected by the extent to which the lessee uses the underlying asset.

> > Maintenance Deposits

842-20-55-4 Under certain **leases** (for example, certain equipment leases), a **lessee** is legally or contractually responsible for repair and maintenance of the **underlying asset** throughout the **lease term**. Additionally, certain lease agreements include provisions requiring the lessee to make deposits to the **lessor** to financially protect the lessor in the event the lessee does not properly maintain the underlying asset. Lease agreements often refer to these deposits as maintenance reserves or supplemental rent. However, the lessor is required to reimburse the deposits to the lessee on the completion of maintenance activities that the lessee is contractually required to perform under the lease agreement.

842-20-55-5 Under a typical arrangement, maintenance deposits are calculated on the basis of a performance measure, such as hours of use of the underlying asset, and are contractually required under the terms of the lease agreement to be used to reimburse the lessee for required maintenance of the underlying asset on the completion of that maintenance. The lessor is contractually required to reimburse the lessee for the maintenance costs paid by the lessee, to the extent of the amounts on deposit.

842-20-55-6 In some cases, the total cost of cumulative maintenance events over the term of the lease is less than the cumulative deposits, which results in excess amounts on deposit at the expiration of the lease. In those cases, some lease agreements provide that the lessor is entitled to retain such excess amounts, whereas other agreements specifically provide that, at the expiration of the lease agreement, such excess amounts are returned to the lessee (refundable maintenance deposit).

842-20-55-7 The guidance in paragraphs 842-20-55-8 through 55-9 does not apply to payments to a lessor that are not substantively and contractually related to maintenance of the leased asset. If at the **commencement date** a lessee determines that it is less than **probable** that the total amount of payments will be returned to the lessee as a reimbursement for maintenance activities, the lessee should consider that when determining the portion of each payment that is not addressed by the guidance in paragraphs 842-20-55-8 through 55-9.

842-20-55-8 Maintenance deposits paid by a lessee under an arrangement accounted for as a lease that are refunded only if the lessee performs specified maintenance activities should be accounted for as a deposit asset.

842-20-55-9 A lessee should evaluate whether it is probable that an amount on deposit recognized under paragraph 842-20-55-8 will be returned to reimburse the costs of the maintenance activities incurred by the lessee. When an amount on deposit is less than probable of being returned, it should be recognized in the same manner as variable lease expense. When the underlying maintenance is performed, the maintenance costs should be expensed or capitalized in accordance with the lessee's maintenance accounting policy.

> > **Leases Denominated in a Foreign Currency**

842-20-55-10 The **right-of-use asset** is a nonmonetary asset while the **lease liability** is a **monetary liability**. Therefore, in accordance with Subtopic 830-10 on foreign currency matters, when accounting for a **lease** that is denominated in a foreign currency, if remeasurement into the **lessee's** functional currency is required, the lease liability is remeasured using the current exchange rate, while the right-of-use asset is remeasured using the exchange rate as of the **commencement date**.

> > **Weighted-Average Remaining Lease Term and Weighted-Average Discount Rate Disclosures**

842-20-55-11 The **lessee** should calculate the weighted-average remaining **lease term** on the basis of the remaining lease term and the **lease liability** balance for each **lease** as of the reporting date.

842-20-55-12 The lessee should calculate the weighted-average discount rate on the basis of both of the following:

a. The **discount rate for the lease** that was used to calculate the lease liability balance for each lease as of the reporting date
b. The remaining balance of the **lease payments** for each lease as of the reporting date.

> **Illustrations**

> > **Illustration of a Short-Term Lease**

842-20-55-13 Example 1 illustrates the assessment of whether a lease is a short-term lease.

> > > **Example 1—Short-Term Lease**

842-20-55-14 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.

842-20-55-15 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.

842-20-55-16 The lease meets the definition of a short-term lease because the lease term is 12 months or less. 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.

> > Illustration of Discount Rate

842-20-55-17 Example 2 illustrates the determination of the discount rate for the lease.

> > > Example 2—Portfolio Approach to Establishing the Discount Rate for the Lease

842-20-55-18 Lessee, a public entity, is the parent of several consolidated subsidiaries. During the current period, 2 subsidiaries entered into a total of 400 individual leases of large computer servers, each with terms ranging between 4 and 5 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.

842-20-55-19 The individual lease contracts do not provide information about the rate implicit in the lease. Lessee is BBB 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 percent. Lessee notes that 5-year zero-coupon U.S. Treasury instruments are currently yielding 1.7 percent (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.

842-20-55-20 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 percent is an appropriate discount rate for each of the 400 leases entered into by Lessee's 2 subsidiaries during the period. Because Lessee is a public entity, it is not permitted to use a risk-free discount rate.

> > Illustrations of Lessee Recognition, Measurement, and Reassessment of the Lease Term

842-20-55-21 Example 3 illustrates how a lessee would initially and subsequently measure right-of-use assets and lease liabilities and how a lessee would account for a change in the lease term.

> > > Example 3—Initial and Subsequent Measurement by a Lessee and Accounting for a Change in the Lease Term

> > > > Case A—Initial and Subsequent Measurement of the Right-of-Use Asset and the Lease Liability

842-20-55-22 Lessee enters into a 10-year lease of an asset, with an option to extend for an additional 5 years. 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. Lessee incurs initial direct costs of $15,000.

842-20-55-23 At the commencement date, 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.

842-20-55-24 The rate implicit in the lease is not readily determinable. Lessee's incremental borrowing rate is 5.87 percent, 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.

842-20-55-25 At the commencement date, 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 9 payments of $50,000, discounted at the rate of 5.87 percent, which is $342,017. 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).

842-20-55-26 During the first year of the lease, Lessee recognizes lease expense depending on how the lease is classified. Paragraphs 842-20-55-27 through 55-30 illustrate the lease expense depending on whether the lease is classified as a finance lease or as an operating lease.

> > > > > If the Lease Is Classified as a Finance Lease

842-20-55-27 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, Lessee recognizes the amortization expense of $40,702 ($407,017 ÷ 10) and the interest expense of $20,076 (5.87% × $342,017).

842-20-55-28 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).

> > > > > If the Lease Is Classified as an Operating Lease

842-20-55-29 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).

842-20-55-30 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).

> > > > Case B—Accounting for a Change in the Lease Term

842-20-55-31 At the end of Year 6 of the lease, Lessee makes significant leasehold improvements. Those improvements are expected to have significant economic value for Lessee at the end of the original lease term of 10 years. The improvements result in the underlying asset having greater utility to Lessee than alternative assets that could be leased for a similar amount and that are expected to have significant economic life beyond the original lease term. Consequently, construction of the leasehold improvements is deemed a significant event or significant change in circumstances that directly affects whether Lessee is reasonably certain to exercise the option to extend the lease and triggers a reassessment of the lease term. Upon reassessing the lease term, at the end of Year 6, Lessee concludes that it is reasonably certain to exercise the option to extend the lease for five years. Taking into consideration the extended remaining lease term, Lessee's incremental borrowing rate at the end of Year 6 is 7.83 percent. As a result of Lessee's remeasuring the remaining lease term to nine years, Lessee also would remeasure any variable lease payments that depend on an index or a rate; however, in this Example, there are no variable lease payments that depend on an index or a rate. In accordance with paragraph 842-10-25-1, Lessee reassesses the lease classification as a result of the change in the lease term. Assume for purposes of this Example that the reassessment does not change the classification of the lease from that determined at the commencement date.

842-20-55-32 At the end of Year 6, before accounting for the change in the lease term, the lease liability is $183,973 (present value of 4 remaining payments of $50,000, discounted at the rate of 5.87 percent). Lessee's right-of-use asset is $162,807 if the lease is classified as a finance lease or $189,973 if the lease is classified as an operating lease (the balance of the remeasured lease liability at the end of Year 6 plus the remaining initial direct costs of $6,000).

842-20-55-33 Lessee remeasures the lease liability, which is now equal to the present value of 4 payments of $50,000 followed by 5 payments of $55,000, all discounted at the rate of 7.83 percent, which is $355,189. Lessee increases the lease liability by $171,216, representing the difference between the remeasured liability and its current carrying amount ($355,189 – $183,973). The corresponding adjustment is made to the right-of-use asset to reflect the cost of the additional rights.

842-20-55-34 Following the adjustment, the carrying amount of Lessee's right-of-use asset is $334,023 if the lease is a finance lease (that is, $162,807 + $171,216) or $361,189 if the lease is an operating lease (that is, $189,973 + $171,216).

842-20-55-35 Lessee then makes the $50,000 lease payment for Year 7, reducing the lease liability to $305,189 ($355,189 – $50,000), regardless of how the lease is classified.

842-20-55-36 Lessee recognizes lease expense in Year 7 as follows, depending on how the lease had been classified at the commencement date.

> > > > > If the Lease Is Classified as a Finance Lease at the Commencement Date

842-20-55-37 Lessee depreciates its owned assets on a straight-line basis. Therefore, the right-of-use asset will be amortized on a straight-line basis over the lease term. The lease liability will be reduced in accordance with the interest method. As such, in Year 7 (the first year following the remeasurement), Lessee recognizes amortization expense of $37,114 ($334,023 ÷ 9) and interest expense of $23,896 (7.83% × $305,189).

> > > > > If the Lease Is Classified as an Operating Lease at the Commencement Date

842-20-55-38 Lessee determines the remaining cost of the lease as the sum of the following:

a. The total lease payments, as adjusted for the remeasurement, which is the sum of $500,000 (10 payments of $50,000 during the initial lease term) and $275,000 (5 payments of $55,000 during the term of the lease extension); plus
b. The total initial direct costs attributable to the lease of $15,000; minus
c. The periodic lease cost recognized in prior periods of $309,000.

842-20-55-39 The amount of the remaining cost of the lease is therefore $481,000 ($775,000 + $15,000 – $309,000). Consequently, Lessee determines that the annual expense to be recognized throughout the remainder of the lease term is $53,444 ($481,000 ÷ the remaining lease term of 9 years).

> > Illustrations of Lessee Recognition and Measurement in an Operating Lease

842-20-55-40 Example 4 illustrates how a lessee would recognize lease cost in an operating lease and initially and subsequently measure right-of-use assets and lease liabilities for that lease.

> > > Example 4—Recognition and Initial and Subsequent Measurement by a Lessee in an Operating Lease

842-20-55-41 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 percent each year during the lease term. Lessee's incremental borrowing rate at lease commencement is 6 percent. Lessee classifies the lease as an operating lease in accordance with paragraphs 842-10-25-2 through 25-3. Lessee incurs initial direct costs of $5,000.

842-20-55-42 At the commencement date, Lessee receives a $10,000 cash payment from Lessor that Lessee accounts for as a lease incentive. Lessee measures the lease liability at the present value of the 10 remaining lease payments ($10,000 in Year 1, increasing by 5 percent each year thereafter), discounted at the rate of 6 percent, which is $90,434. 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).

842-20-55-43 During the first year of the lease, Lessee determines the remaining cost of the lease as the sum of the following:

a. The total lease payments of $115,779 (the sum of the 10 escalating payments to Lessor during the lease term of $125,779 − the lease incentive paid to Lessee at the commencement date of $10,000)
b. The total initial direct costs attributable to the lease of $5,000.

The amount of the remaining lease cost is therefore $120,779 ($115,779 + $5,000). Consequently, 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.

842-20-55-44 At the end of Year 1, the carrying amount of the lease liability is $85,860 (9 remaining lease payments, discounted at the rate of 6 percent), and the carrying amount of the right-of-use asset is the amount of the liability, adjusted for the following:

a. 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 Lessor of $125,779 ÷ 10 years] − the first year's lease payment of $10,000)
b. Unamortized initial direct costs of $4,500 (gross initial direct costs of $5,000 – amounts recognized previously as part of the single lease cost of $500 [total initial direct costs of $5,000 ÷ 10 years])
c. The remaining balance of the lease incentive of $9,000 (gross lease incentive of $10,000 – amounts 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, Lessee measures the right-of-use asset at the amount of $78,782 ($85,860 – $2,578 + $4,500 – $9,000).

842-20-55-45 At the beginning of Year 2, 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.

842-20-55-46 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, 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.

> > Illustration of Impairment of a Right-of-Use Asset

842-20-55-47 Example 5 illustrates impairment of a right-of-use asset.

> > > Example 5—Impairment of a Right-of-Use Asset in an Operating Lease

842-20-55-48 Lessee enters into a 10-year lease of a nonspecialized asset. Lease payments are $10,000 per year, payable in arrears. 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 percent, 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. The lease is classified as an operating lease.

842-20-55-49 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 percent). 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).

842-20-55-50 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 in accordance with Section 360-10-35 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 in accordance with paragraph 360-10-35-28 is $35,000. 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 with paragraphs 842-20-25-6(a) and 842-20-25-7 will equal the sum of the following:

a. Amortization of the right-of-use asset remaining after the impairment ($18,893 ÷ 7 years = $2,699 per year)
b. 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%).

842-20-55-51 Consequently, 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 percent, 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.

> > Illustration of Lessee Quantitative Disclosure Requirements

842-20-55-52 Example 6 illustrates how a lessee may meet the quantitative disclosure requirements in paragraph 842-20-50-4.

> > > Example 6—Lessee Quantitative Disclosure Requirements in Paragraph 842-20-50-4

842-20-55-53 The following Example illustrates how a lessee may meet the quantitative disclosure requirements in paragraph 842-20-50-4.

	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	$XXX
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	X.X%	X.X%

5. Add Subtopic 842-30, with a link to transition paragraph 842-10-65-1, as follows:

[For ease of readability, the new Subtopic is not underlined.]

Leases—Lessor

Overview and Background

General

842-30-05-1 This Subtopic addresses accounting by **lessors** for **leases** that have been classified as **sales-type leases**, **direct financing leases**, or **operating leases** in accordance with the requirements in Subtopic 842-10. Lessors should follow the requirements in this Subtopic as well as those in Subtopic 842-10.

Scope and Scope Exceptions

General

842-30-15-1 This Subtopic follows the same Scope and Scope Exceptions as outlined in the Overall Subtopic; see Section 842-10-15.

Glossary

Commencement Date of the Lease (Commencement Date)

The date on which a **lessor** makes an **underlying asset** available for use by a **lessee**. See paragraphs 842-10-55-19 through 55-21 for implementation guidance on the commencement date.

Contract

An agreement between two or more parties that creates enforceable rights and obligations.

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).

Fair Value (second definition)

The price that would be received to sell an asset or paid to transfer a liability in an **orderly transaction** between **market participants** at the measurement date.

Finance Lease

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

Initial Direct Costs

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

Lease

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.

Lease Payments

See paragraph 842-10-30-5 for what constitutes lease payments from the perspective of a **lessee** and a **lessor**.

Lease Receivable

A **lessor's** right to receive **lease payments** arising from a **sales-type lease** or a **direct financing lease** plus any amount that a lessor expects to derive from the underlying asset following the end of the **lease term** to the extent that it is guaranteed by the **lessee** or any other third party unrelated to the lessor, measured on a discounted basis.

Lease Term

The noncancellable period for which a **lessee** has the right to use an **underlying asset**, together with all of the following:

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

Lessee

An entity that enters into a **contract** to obtain the right to use an **underlying asset** for a period of time in exchange for consideration.

Lessor

An entity that enters into a **contract** to provide the right to use an **underlying asset** for a period of time in exchange for consideration.

Market Participants

Buyers and sellers in the principal (or most advantageous) market for the asset or liability that have all of the following characteristics:

a. They are independent of each other, that is, they are not **related parties**, although the price in a related-party transaction may be used as an input to a fair value measurement if the reporting entity has evidence that the transaction was entered into at market terms
b. They are knowledgeable, having a reasonable understanding about the asset or liability and the transaction using all available information, including information that might be obtained through due diligence efforts that are usual and customary
c. They are able to enter into a transaction for the asset or liability
d. They are willing to enter into a transaction for the asset or liability, that is, they are motivated but not forced or otherwise compelled to do so.

Net Investment in the Lease

For a **sales-type lease**, the sum of the **lease receivable** and the **unguaranteed residual asset**.

For a **direct financing lease**, the sum of the **lease receivable** and the **unguaranteed residual asset**, net of any deferred selling profit.

Operating Lease

From the perspective of a **lessee**, any **lease** other than a **finance lease**.

From the perspective of a **lessor**, any lease other than a **sales-type lease** or a **direct financing lease**.

Orderly Transaction

A transaction that assumes exposure to the market for a period before the measurement date to allow for marketing activities that are usual and customary for transactions involving such assets or liabilities; it is not a forced transaction (for example, a forced liquidation or distress sale).

Probable (second definition)

The future event or events are likely to occur.

Rate Implicit in the Lease

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

Related Parties

Related parties include:

a. Affiliates of the entity
b. Entities for which investments in their equity securities would be required, absent the election of the fair value option under the Fair Value Option Subsection of Section 825-10-15, to be accounted for by the equity method by the investing entity
c. Trusts for the benefit of employees, such as pension and profit-sharing trusts that are managed by or under the trusteeship of management
d. Principal owners of the entity and members of their immediate families
e. Management of the entity and members of their immediate families
f. Other parties with which the entity may deal if one party controls or can significantly influence the management or operating policies of the other to an extent that one of the transacting parties might be prevented from fully pursuing its own separate interests
g. Other parties that can significantly influence the management or operating policies of the transacting parties or that have an ownership interest in one of the transacting parties and can significantly influence the other to an extent that one or more of the transacting parties might be prevented from fully pursuing its own separate interests.

Residual Value Guarantee

A guarantee made to a **lessor** that the value of an **underlying asset** returned to the lessor at the end of a **lease** will be at least a specified amount.

Sales-Type Lease

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

Selling Profit or Selling Loss

At the **commencement date**, selling profit or selling loss equals:

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

Sublease

A transaction in which an **underlying asset** is re-leased by the **lessee** (or intermediate **lessor**) to a third party (the sublessee) and the original (or head) **lease** between the lessor and the lessee remains in effect.

Underlying Asset

An asset that is the subject of a **lease** for which a right to use that asset has been conveyed to a **lessee**. The underlying asset could be a physically distinct portion of a single asset.

Unguaranteed Residual Asset

The amount that a **lessor** expects to derive from the **underlying asset** following the end of the **lease term** that is not guaranteed by the **lessee** or any other third party unrelated to the lessor, measured on a discounted basis.

Useful Life

The period over which an asset is expected to contribute directly or indirectly to future cash flows.

Variable Lease Payments

Payments made by a **lessee** to a **lessor** for the right to use an **underlying asset** that vary because of changes in facts or circumstances occurring after the **commencement date**, other than the passage of time.

Recognition

General

> Sales-Type Leases

842-30-25-1 At the **commencement date**, a **lessor** shall recognize each of the following and derecognize the **underlying asset** in accordance with paragraph 842-30-40-1:

a. A **net investment in the lease**, measured in accordance with paragraph 842-30-30-1
b. **Selling profit or selling loss** arising from the **lease**
c. **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 the fair value of the underlying asset equals its carrying amount, initial direct costs (see paragraphs 842-10-30-9 through 30-10) are deferred at the commencement date and included in the measurement of the net investment in the lease. The **rate implicit in the lease** is defined in such a way that those initial direct costs eligible for deferral are included

automatically in the net investment in the lease; there is no need to add them separately.

842-30-25-2 After the commencement date, a lessor shall recognize all of the following:

a. Interest income on the net investment in the lease, measured in accordance with paragraph 842-30-35-1(a)
b. **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
c. Impairment of the net investment in the lease (as described in paragraph 842-30-35-3).

842-30-25-3 The guidance in paragraphs 842-30-25-1 through 25-2 notwithstanding, if collectibility of the **lease payments**, plus any amount necessary to satisfy a **residual value guarantee** provided by the **lessee**, is not **probable** at the commencement date, the lessor shall not derecognize the underlying asset but shall recognize lease payments received—including variable lease payments—as a deposit liability until the earlier of either of the following:

a. Collectibility of the lease payments, plus any amount necessary to satisfy a residual value guarantee provided by the lessee, becomes probable. If collectibility is not probable at the commencement date, a lessor shall continue to assess collectibility to determine whether the lease payments and any amount necessary to satisfy a residual value guarantee are probable of collection.
b. Either of the following events occurs:
    1. The **contract** has been terminated, and the lease payments received from the lessee are nonrefundable.
    2. The lessor has repossessed the underlying asset, it has no further obligation under the contract to the lessee, and the lease payments received from the lessee are nonrefundable.

842-30-25-4 When collectibility is not probable at the commencement date, at the date the criterion in paragraph 842-30-25-3(a) is met (that is, the date at which collectibility of the lease payments plus any amount necessary to satisfy a residual value guarantee provided by the lessee is assessed as probable), the lessor shall do all of the following:

a. Derecognize the carrying amount of the underlying asset
b. Derecognize the carrying amount of any deposit liability recognized in accordance with paragraph 842-30-25-3
c. Recognize a net investment in the lease on the basis of the remaining lease payments and remaining **lease term**, using the rate implicit in the lease determined at the commencement date
d. Recognize selling profit or selling loss calculated as:

1. The **lease receivable**; plus
2. The carrying amount of the deposit liability; minus
3. The carrying amount of the underlying asset, net of the **unguaranteed residual asset**.

842-30-25-5 When collectibility is not probable at the commencement date, at the date the criterion in paragraph 842-30-25-3(b) is met, the lessor shall derecognize the carrying amount of any deposit liability recognized in accordance with paragraph 842-30-25-3, with the corresponding amount recognized as lease income.

842-30-25-6 If collectibility is probable at the commencement date for a **sales-type lease** or for a **direct financing lease**, a lessor shall not reassess whether collectibility is probable. Subsequent changes in the credit risk of the lessee shall be accounted for in accordance with the impairment guidance applicable to the net investment in the lease in paragraph 842-30-35-3.

> Direct Financing Leases

842-30-25-7 At the **commencement date**, a **lessor** shall recognize both of the following and derecognize the **underlying asset** in accordance with paragraph 842-30-40-1:

a. A **net investment in the lease**, measured in accordance with paragraph 842-30-30-2
b. Selling loss arising from the **lease**, if applicable.

842-30-25-8 Selling profit and **initial direct costs** (see paragraphs 842-10-30-9 through 30-10) are deferred at the commencement date and included in the measurement of the net investment in the lease. The **rate implicit in the lease** is defined in such a way that initial direct costs deferred in accordance with this paragraph are included automatically in the net investment in the lease; there is no need to add them separately.

842-30-25-9 After the commencement date, a lessor shall recognize all of the following:

a. Interest income on the net investment in the lease, measured in accordance with paragraph 842-30-35-1(a)
b. **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
c. Impairment of the net investment in the lease (as described in paragraph 842-30-35-3).

> Operating Leases

842-30-25-10 At the **commencement date**, a **lessor** shall defer **initial direct costs**.

842-30-25-11 After the commencement date, a lessor shall recognize all of the following:

a. The **lease payments** as income in profit or loss over the **lease term** on a straight-line 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 **underlying asset**, subject to paragraph 842-30-25-12
b. **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
c. Initial direct costs as an expense over the lease term on the same basis as lease income (as described in (a)).

842-30-25-12 If collectibility of the lease payments plus any amount necessary to satisfy a **residual value guarantee** (provided by the **lessee** or any other unrelated third party) is not **probable** at the commencement date, lease income shall be limited to the lesser of the income that would be recognized in accordance with paragraph 842-30-25-11(a) through (b) or the lease payments, including variable lease payments, that have been collected from the lessee.

842-30-25-13 If the assessment of collectibility changes after the commencement date, any difference between the lease income that would have been recognized in accordance with paragraph 842-30-25-11(a) through (b) and the lease payments, including variable lease payments, that have been collected from the lessee shall be recognized as a current-period adjustment to lease income.

842-30-25-14 See Example 1 (paragraphs 842-30-55-18 through 55-43) for an illustration of the requirements when collectibility is not probable.

Initial Measurement

General

> Sales-Type and Direct Financing Leases

842-30-30-1 At the **commencement date**, for a **sales-type lease**, a **lessor** shall measure the **net investment in the lease** to include both of the following:

a. The **lease receivable**, which is measured at the present value, discounted using the **rate implicit in the lease**, of:
   1. The **lease payments** (as described in paragraph 842-10-30-5) not yet received by the lessor
   2. The amount the lessor expects to derive from the **underlying asset** following the end of the **lease term** that is guaranteed by the **lessee** or any other third party unrelated to the lessor
b. The **unguaranteed residual asset** at the present value of the amount the lessor expects to derive from the underlying asset following the end

of the lease term that is not guaranteed by the lessee or any other third party unrelated to the lessor, discounted using the rate implicit in the lease.

842-30-30-2 At the commencement date, for a **direct financing lease**, a lessor shall measure the net investment in the lease to include the items in paragraph 842-30-30-1(a) through (b), reduced by the amount of any selling profit.

842-30-30-3 See Example 1 (paragraphs 842-30-55-18 through 55-43) for an illustration of the requirements for sales-type and direct financing leases.

> Operating Leases

842-30-30-4 A **lessor** shall continue to measure the **underlying asset** subject to an **operating lease** in accordance with other Topics.

Subsequent Measurement

General

> Sales-Type and Direct Financing Leases

842-30-35-1 After the **commencement date**, a **lessor** shall measure the **net investment in the lease** by doing both of the following:

a. Increasing the carrying amount to reflect the interest income on the net investment in the lease. A lessor shall 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.
b. Reducing the carrying amount to reflect the **lease payments** collected during the period.

842-30-35-2 After the commencement date, a lessor shall not remeasure the net investment in the lease unless the **lease** is modified and that modification is not accounted for as a separate **contract** in accordance with paragraph 842-10-25-8.

> > Impairment of the Net Investment in the Lease

842-30-35-3 A **lessor** shall determine impairment related to the **net investment in the lease** and shall recognize any impairment in accordance with Topic 310 on receivables (as described in paragraphs 310-10-35-16 through 35-30). When determining the loss allowance for a net investment in the lease, a lessor shall take into consideration the collateral relating to the net investment in the lease. The collateral relating to the net investment in the lease represents the cash flows that the lessor would expect to derive from the **underlying asset** during the remaining **lease term** (for example, from sale of the asset or release of the asset for the remainder of the lease term), which excludes the cash flows that the lessor would expect to derive from the underlying asset following the end of the lease term (for example, cash flows from leasing the asset after the end of the lease term).

> > Sale of the Lease Receivable

842-30-35-4 If a **lessor** sells the **lease receivable** associated with a **sales-type lease** or a **direct financing lease** and retains an interest in the **unguaranteed residual asset**, the lessor shall not continue to accrete the unguaranteed residual asset to its estimated value over the remaining **lease term**. The lessor shall report any remaining unguaranteed residual asset thereafter at its carrying amount at the date of the sale of the lease receivable and apply Topic 360 on property, plant, and equipment to determine whether the unguaranteed residual asset is impaired.

> > Accounting for the Underlying Asset at the End of the Lease Term

842-30-35-5 At the end of the **lease term**, a **lessor** shall reclassify the **net investment in the lease** to the appropriate category of asset (for example, property, plant, and equipment) in accordance with other Topics, measured at the carrying amount of the net investment in the lease. The lessor shall account for the **underlying asset** that was the subject of a **lease** in accordance with other Topics.

> Operating Leases

842-30-35-6 A **lessor** shall continue to measure, including testing for impairment in accordance with Section 360-10-35 on impairment or disposal of long-lived assets, the **underlying asset** subject to an **operating lease** in accordance with other Topics.

> Subleases

842-30-35-7 If the original **lessee** enters into a **sublease** or the original **lease** agreement is sold or transferred by the original lessee to a third party, the original **lessor** shall continue to account for the lease as it did before.

Derecognition

General

> Sales-Type and Direct Financing Leases

842-30-40-1 At the **commencement date**, a **lessor** shall derecognize the carrying amount of the **underlying asset** (if previously recognized) unless the **lease** is a **sales-type lease** and collectibility of the **lease payments** is not **probable** (see paragraph 842-30-25-3).

> > Lease Termination

842-30-40-2 If a **sales-type lease** or a **direct financing lease** is terminated before the end of the **lease term**, a **lessor** shall do all of the following:

a. Test the **net investment in the lease** for impairment in accordance with Topic 310 on receivables and recognize any impairment loss identified
b. Reclassify the net investment in the lease to the appropriate category of asset in accordance with other Topics, measured at the sum of the carrying amounts of the **lease receivable** (less any amounts still expected to be received by the lessor) and the residual asset
c. Account for the **underlying asset** that was the subject of the **lease** in accordance with other Topics.

> > Subleases

842-30-40-3 If the original **lease** agreement is replaced by a new agreement with a new **lessee**, the **lessor** shall account for the termination of the original lease as provided in paragraph 842-30-40-2 and shall classify and account for the new lease as a separate transaction.

842-30-40-4 For guidance on the acquisition of the residual value of an **underlying asset** by a third party, see paragraph 360-10-25-2.

Other Presentation Matters

General

> Sales-Type and Direct Financing Leases

> > Statement of Financial Position

842-30-45-1 A **lessor** shall present lease assets (that is, the aggregate of the lessor's net investment in **sales-type leases** and **direct financing leases**) separately from other assets in the statement of financial position.

842-30-45-2 Lease assets shall be subject to the same considerations as other assets in classification as current or noncurrent assets in a classified balance sheet.

> > Statement of Comprehensive Income

842-30-45-3 A **lessor** shall either present in the statement of comprehensive income or disclose in the notes income arising from **leases**. If a lessor does not separately present lease income in the statement of comprehensive income, the lessor shall disclose which line items include lease income in the statement of comprehensive income.

842-30-45-4 A lessor shall present any profit or loss on the lease recognized at the **commencement date** in a manner that best reflects the lessor's business model(s). Examples of presentation include the following:

a. If a lessor uses leases as an alternative means of realizing value from the goods that it would otherwise sell, the lessor shall 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:
    1. The **fair value** of the **underlying asset** at the commencement date
    2. 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**.
b. If a lessor uses leases for the purposes of providing finance, the lessor shall present the profit or loss in a single line item.

> > Statement of Cash Flows

842-30-45-5 In the statement of cash flows, a **lessor** shall classify cash receipts from **leases** within operating activities.

> Operating Leases

> > Statement of Financial Position

842-30-45-6 A **lessor** shall present the **underlying asset** subject to an **operating lease** in accordance with other Topics.

> > Statement of Cash Flows

842-30-45-7 In the statement of cash flows, a **lessor** shall classify cash receipts from **leases** within operating activities.

Disclosure

General

842-30-50-1 The objective of the disclosure requirements is to enable users of financial statements to assess the amount, timing, and uncertainty of cash flows arising from **leases**. To achieve that objective, a **lessor** shall disclose qualitative and quantitative information about all of the following:

a. Its leases (as described in paragraphs 842-30-50-3(a), 842-30-50-4, and 842-30-50-7)
b. The significant judgments made in applying the requirements in this Topic to those leases (as described in paragraph 842-30-50-3(b))

c. The amounts recognized in the financial statements relating to those leases (as described in paragraphs 842-30-50-5 through 50-6 and 842-30-50-8 through 50-13).

842-30-50-2 A lessor shall consider the level of detail necessary to satisfy the disclosure objective and how much emphasis to place on each of the various requirements. A lessor shall aggregate or disaggregate disclosures so that useful information is not obscured by including a large amount of insignificant detail or by aggregating items that have different characteristics.

842-30-50-3 A lessor shall disclose both of the following:

a. Information about the nature of its leases, including:
   1. A general description of those leases
   2. The basis and terms and conditions on which **variable lease payments** are determined
   3. The existence and terms and conditions of options to extend or terminate the lease
   4. The existence and terms and conditions of options for a **lessee** to purchase the **underlying asset**.
b. Information about significant assumptions and judgments made in applying the requirements of this Topic, which may include the following:
   1. The determination of whether a **contract** contains a lease (as described in paragraphs 842-10-15-2 through 15-27)
   2. The allocation of the consideration in a contract between lease and nonlease components (as described in paragraphs 842-10-15-28 through 15-32)
   3. The determination of the amount the lessor expects to derive from the underlying asset following the end of the **lease term**.

842-30-50-4 A lessor shall disclose any lease transactions between related parties (see Topic 850 on related party disclosures).

842-30-50-5 A lessor shall disclose lease income recognized in each annual and interim reporting period, in a tabular format, to include the following:

a. For **sales-type leases** and **direct financing leases**:
   1. Profit or loss recognized at the **commencement date** (disclosed on a gross basis or a net basis consistent with paragraph 842-30-45-4)
   2. Interest income either in aggregate or separated by components of the **net investment in the lease**.
b. For **operating leases**, lease income relating to **lease payments**.
c. Lease income relating to variable lease payments not included in the measurement of the **lease receivable**.

842-30-50-6 A lessor shall disclose in the notes the components of its aggregate net investment in sales-type and direct financing leases (that is, the carrying amount of its lease receivables, its **unguaranteed residual assets**, and any deferred selling profit on direct financing leases).

842-30-50-7 A lessor shall disclose information about how it manages its risk associated with the residual value of its leased assets. In particular, a lessor should disclose all of the following:

a. Its risk management strategy for residual assets
b. The carrying amount of residual assets covered by **residual value guarantees** (excluding guarantees considered to be lease payments for the lessor, as described in paragraph 842-30-30-1(a)(2))
c. Any other means by which the lessor reduces its residual asset risk (for example, buyback agreements or variable lease payments for use in excess of specified limits).

> Sales-Type and Direct Financing Leases

842-30-50-8 In addition to the disclosures required by paragraphs 842-30-50-3 through 50-7, a **lessor** also shall provide the disclosures in paragraphs 842-30-50-9 through 50-10 for **sales-type leases** and **direct financing leases**.

842-30-50-9 A lessor shall explain significant changes in the balance of its **unguaranteed residual assets** and deferred selling profit on direct financing leases.

842-30-50-10 A lessor shall disclose a maturity analysis of its **lease receivables**, showing the undiscounted cash flows to be received on an annual basis for a minimum of each of the first five years and a total of the amounts for the remaining years. A lessor shall disclose a reconciliation of the undiscounted cash flows to the lease receivables recognized in the statement of financial position (or disclosed separately in the notes).

> Operating Leases

842-30-50-11 In addition to the disclosures required by paragraphs 842-30-50-3 through 50-7, a **lessor** also shall provide the disclosures in paragraphs 842-30-50-12 through 50-13 for **operating leases**.

842-30-50-12 A lessor shall disclose a maturity analysis of **lease payments**, showing the undiscounted cash flows to be received on an annual basis for a minimum of each of the first five years and a total of the amounts for the remaining years. A lessor shall present that maturity analysis separately from the maturity analysis required by paragraph 842-30-50-10 for **sales-type leases** and **direct financing leases**.

842-30-50-13 A lessor shall provide disclosures required by Topic 360 on property, plant, and equipment separately for **underlying assets** under operating leases from owned assets.

Implementation Guidance and Illustrations

General

> Implementation Guidance

> > Sales of Equipment with Guaranteed Minimum Resale Amount

842-30-55-1 This implementation guidance addresses the application of the provisions of this Subtopic in the following circumstances. A manufacturer sells equipment with an expected **useful life** of several years to end users (purchasers) utilizing various sales incentive programs. Under one such sales incentive program, the manufacturer contractually guarantees that the purchaser will receive a minimum resale amount at the time the equipment is disposed of, contingent on certain requirements.

842-30-55-2 The manufacturer provides the guarantee by agreeing to do either of the following:

a. Reacquire the equipment at a guaranteed price at specified time periods as a means to facilitate its resale
b. Pay the purchaser for the deficiency, if any, between the sales proceeds received for the equipment and the guaranteed minimum resale value.

There may be dealer involvement in these types of transactions, but the minimum resale guarantee is the responsibility of the manufacturer.

842-30-55-3 A sales incentive program in which an entity (for example, a manufacturer) contractually guarantees that it has either a right or an obligation to reacquire the equipment at a guaranteed price (or prices) at a specified time (or specified time periods) as a means to facilitate its resale should be evaluated in accordance with the guidance on satisfaction of performance obligations in paragraph 606-10-25-30 and the guidance on repurchase agreements in paragraphs 606-10-55-66 through 55-78. If that evaluation results in a **lease**, the manufacturer should account for the transaction as a lease using the principles of lease accounting in Subtopic 842-10 and in this Subtopic.

842-30-55-4 A sales incentive program in which an entity (for example, a manufacturer) contractually guarantees that it will pay a purchaser for the deficiency, if any, between the sales proceeds received for the equipment and the guaranteed minimum resale value should be accounted for in accordance with Topic 460 on guarantees and Topic 606 on revenue from **contracts** with customers.

842-30-55-5 The **lease payments** used as part of the determination of whether the transaction should be classified as an **operating lease**, a **direct financing lease**, or a **sales-type lease** generally will be the difference between the proceeds upon the equipment's initial transfer and the amount of the **residual value guarantee** to the purchaser as of the first exercise date of the guarantee.

842-30-55-6 If the transaction qualifies as an operating lease, the net proceeds upon the equipment's initial transfer should be recorded as a liability in the manufacturer's balance sheet.

842-30-55-7 The liability is then subsequently reduced on a pro rata basis over the period to the first exercise date of the guarantee to the amount of the guaranteed residual value at that date with corresponding credits to revenue in the manufacturer's income statement. Any further reduction in the guaranteed residual value resulting from the purchaser's decision to continue to use the equipment should be recognized in a similar manner.

842-30-55-8 The equipment should be included in the manufacturer's balance sheet and depreciated following the manufacturer's normal depreciation policy.

842-30-55-9 The Impairment or Disposal of Long-Lived Assets Subsections of Subtopic 360-10 on property, plant, and equipment provide guidance on the accounting for any potential impairment of the equipment.

842-30-55-10 At the time the purchaser elects to exercise the residual value guarantee by selling the equipment to another party, the liability should be reduced by the amount, if any, paid to the purchaser. The remaining undepreciated carrying amount of the equipment and any remaining liability should be removed from the balance sheet and included in the determination of income of the period of the equipment's sale.

842-30-55-11 Alternatively, if the purchaser exercises the residual value guarantee by selling the equipment to the manufacturer at the guaranteed price, the liability should be reduced by the amount paid to the purchaser. Any remaining liability should be included in the determination of income of the period of the exercise of the guarantee.

842-30-55-12 The accounting for a guaranteed minimum resale value is not in the scope of Topic 815 on derivatives and hedging. In the transaction described, the embedded guarantee feature is not an embedded derivative instrument that must be accounted for separately from the lease because it does not meet the criterion in paragraph 815-15-25-1(c).

842-30-55-13 Specifically, if freestanding, the guarantee feature would be excluded from the scope of paragraph 815-10-15-59(b) because of both of the following conditions:

a. It is not exchange traded.
b. The underlying on which settlement is based is the price of a nonfinancial asset of one of the parties, and that asset is not readily convertible to cash. It is assumed that the equipment is not readily convertible to cash, as that phrase is used in Topic 815.

842-30-55-14 Paragraph 815-10-15-59(b)(2) states that the related exception applies only if the nonfinancial asset related to the underlying is owned by the party that would not benefit under the contract from an increase in the price or value of the nonfinancial asset. (In some circumstances, the exclusion in paragraph 815-10-15-63 also would apply.)

842-30-55-15 Lastly, Topic 460 on guarantees does not affect the guarantor's accounting for the guarantee because that Topic does not apply to a guarantee for which the underlying is related to an asset of the guarantor. Because the manufacturer continues to recognize the residual value of the equipment guaranteed by the manufacturer as an asset (included in the seller-lessor's **net investment in the lease**) if recording a sales-type lease, that guarantee does not meet the characteristics in paragraph 460-10-15-4 and is, therefore, not subject to the guidance in Topic 460. Additionally, if the lease is classified as an operating lease, the manufacturer does not remove the asset from its books, and its guarantee would be a market value guarantee of its own asset. A market value guarantee of the guarantor's own asset is not within the scope of Topic 460, and the guidance in paragraphs 842-10-55-32 through 55-33 for an operating lease is not affected. As a result, the guarantor's accounting for the guarantee is unaffected by Topic 460.

> > Guarantee Payments Received

842-30-55-16 Indemnification payments related to tax effects other than the investment tax credit should be reflected by the **lessor** in income consistent with the classification of the **lease**. That is, the payments should be accounted for as an adjustment of the lessor's **net investment in the lease** if the lease is a **sales-type lease** or a **direct financing lease** or recognized ratably over the **lease term** if the lease is an **operating lease**.

> > Pattern of Benefit from Use of the Underlying Asset

842-30-55-17 This Subtopic considers the right to control the use of the **underlying asset** as the equivalent of physical use. If the **lessee** controls the use of the underlying asset, recognition of **lease** income in accordance with paragraph 842-30-25-11(a) should not be affected by the extent to which the lessee uses the underlying asset.

> Illustrations

> > Illustration of Lessor Accounting

842-30-55-18 Example 1 illustrates how a lessor would account for sales-type leases and direct financing leases.

> > > Example 1—Lessor Accounting Example

> > > > Case A—Lessor Accounting—Sales-Type Lease

842-30-55-19 Lessor enters into a 6-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 9-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 6-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 percent.

842-30-55-20 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.

842-30-55-21 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 6 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 on the basis of the guidance in paragraph 842-30-25-1(c) (that is, because the fair value of the underlying asset is different from its carrying amount at the commencement date).

842-30-55-22 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.

842-30-55-23 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%).

842-30-55-24 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.

> > > > Case B—Lessor Accounting—Sales-Type Lease—Collectibility of the Lease Payments Is Not Probable

842-30-55-25 Assume the same facts and circumstances as in Case A (paragraphs 842-30-55-19 through 55-24), except that it is not probable Lessor will collect the lease payments and any amount necessary to satisfy the residual value guarantee provided by Lessee. In reaching this conclusion, the entity observes that Lessee's ability and intention to pay may be in doubt because of the following factors:

a. Lessee intends to make the lease payments primarily from income derived from its business in which the equipment will be used (which is a business facing significant risks because of high competition in the industry and Lessee's limited experience)
b. Lessee has limited credit history and no significant other income or assets with which to make the payments if the business is not successful.

842-30-55-26 In accordance with paragraph 842-30-25-3, 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 Case A, Lessor pays and recognizes the initial direct costs of $2,000 as an expense at the commencement date.

842-30-55-27 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 ÷ 7-year useful life).

842-30-55-28 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.

842-30-55-29 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 2 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 percent 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).

842-30-55-30 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 Case A, 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.

> > > > Case C—Lessor Accounting—Direct Financing Lease

842-30-55-31 Assume the same facts and circumstances as in Case A (paragraphs 842-30-55-19 through 55-24), except that the $13,000 residual value guarantee is provided by a third party, not by Lessee. Collectibility of the lease payments and any amount necessary to satisfy the third party residual value guarantee is probable.

842-30-55-32 None of the criteria in paragraph 842-10-25-2 to be classified as a sales-type lease are met. Lessor classifies the lease as a direct financing lease because the sum of the present value of the lease payments and the present value of the residual value guaranteed by the third party amounts to substantially all of the fair value of the equipment. In accordance with paragraph 842-10-25-4, the discount rate used to determine the present value of the lease payments and the guaranteed residual value (5.4839 percent) assumes that no initial direct costs will be deferred because, at the commencement date, the fair value of the equipment is different from its carrying amount.

842-30-55-33 At the commencement date, Lessor derecognizes the equipment and recognizes a net investment in the lease of $56,000, which is equal to the carrying amount of the underlying asset of $54,000 plus the initial direct costs of $2,000 that are included in the measurement of the net investment in the lease in accordance with paragraph 842-30-25-8 (that is, because the lease is classified as a direct financing lease). The net investment in the lease includes a lease receivable of $58,669 (the present value of the 6 annual lease payments of $9,500 and the third-party residual value guarantee of $13,000, discounted at the rate implicit in the lease of 4.646 percent), an unguaranteed residual asset of $5,331 (the present value of the difference between the estimated residual value of

$20,000 and the third-party residual value guarantee of $13,000, discounted at 4.646 percent), and deferred selling profit of $8,000.

842-30-55-34 Lessor calculates the deferred selling profit of $8,000 in this Example as follows:

a. The lease receivable ($58,669); minus
b. The carrying amount of the equipment ($54,000), net of the unguaranteed residual asset ($5,331), which equals $48,669; minus
c. The initial direct costs included in the measurement of the net investment in the lease ($2,000).

842-30-55-35 At the end of Year 1, Lessor recognizes the receipt of the lease payment of $9,500 and interest on the net investment in the lease of $4,624 (the beginning balance of the net investment in the lease of $56,000 × the discount rate that, at the commencement date, would have resulted in the sum of the lease receivable and the unguaranteed residual asset equaling $56,000, which is 8.258 percent), resulting in a balance in the net investment of the lease of $51,124.

842-30-55-36 Also at the end of Year 1, Lessor calculates, for disclosure purposes, the separate components of the net investment in the lease: the lease receivable, the unguaranteed residual asset, and the deferred selling profit. The lease receivable equals $51,895 (the beginning balance of the lease receivable of $58,669 – the annual lease payment received of $9,500 + the amount of interest income on the lease receivable during Year 1 of $2,726, which is $58,669 × 4.646%). The unguaranteed residual asset equals $5,578 (the beginning balance of the unguaranteed residual asset of $5,331 + the interest income on the unguaranteed residual asset during Year 1 of $247, which is $5,331 × 4.646%). The deferred selling profit equals $6,349 (the initial deferred selling profit of $8,000 – $1,651 recognized during Year 1 [the $1,651 is the difference between the interest income recognized on the net investment in the lease during Year 1 of $4,624 calculated in paragraph 842-30-55-35 and the sum of the interest income earned on the lease receivable and the unguaranteed residual asset during Year 1]).

842-30-55-37 At the end of Year 2, Lessor recognizes the receipt of the lease payment of $9,500 and interest on the net investment in the lease (the beginning of Year 2 balance of the net investment in the lease of $51,124 × 8.258%, which is $4,222), resulting in a carrying amount of the net investment in the lease of $45,846.

842-30-55-38 Also at the end of Year 2, Lessor calculates the separate components of the net investment in the lease. The lease receivable equals $44,806 (the beginning of Year 2 balance of $51,895 – the annual lease payment received of $9,500 + the interest income earned on the lease receivable during Year 2 of $2,411, which is $51,895 × 4.646%). The unguaranteed residual asset equals $5,837 (the beginning of Year 2 balance of the unguaranteed residual asset of $5,578 + the interest income earned on the unguaranteed residual asset during

Year 2 of $259, which is $5,578 × 4.646%). The deferred selling profit equals $4,797 (the beginning of Year 2 balance of deferred selling profit of $6,349 – $1,552 recognized during Year 2 [the $1,552 is the difference between the interest income recognized on the net investment in the lease during Year 2 of $4,222 and the sum of the interest income earned on the lease receivable and the unguaranteed residual asset during Year 2]).

842-30-55-39 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.

> > > > Case D—Lessor Accounting—Collectibility Is Not Probable

842-30-55-40 Assume the same facts and circumstances as Case C (paragraphs 842-30-55-31 through 55-39), except that 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. 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 in accordance with paragraph 842-10-25-3, Lessor classifies the lease as an operating lease.

842-30-55-41 Lessor continues to measure the equipment in accordance with Topic 360 on property, plant, and equipment.

842-30-55-42 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 only recognizes lease income of $7,000 at the point in time Lessee makes the end of Year 1 payment for that amount.

842-30-55-43 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, 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 ÷ 6 years = $9,500 per year × 2 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.

6. Add Subtopic 842-40, with a link to transition paragraph 842-10-65-1, as follows:

[For ease of readability, the new Subtopic is not underlined.]

Leases—Sale and Leaseback Transactions

Overview and Background

General

842-40-05-1 This Subtopic addresses accounting for sale and leaseback transactions when a **lease** has been accounted for in accordance with Subtopic 842-10 and either Subtopic 842-20 or Subtopic 842-30.

Scope and Scope Exceptions

General

842-40-15-1 This Subtopic follows the same Scope and Scope Exceptions as outlined in the Overall Subtopic; see Section 842-10-15.

842-40-15-2 If an entity (the seller-lessee) transfers an asset to another entity (the buyer-lessor) and leases that asset back from the buyer-lessor, both the seller-lessee and the buyer-lessor shall account for the transfer **contract** and the **lease** in accordance with Sections 842-40-25, 842-40-30, and 842-40-50.

842-40-15-3 See paragraphs 842-40-55-1 through 55-21 for implementation guidance on the scope of this Subtopic. See Example 3 (paragraphs 842-40-55-39 through 55-44) for an illustration of the scope of this Subtopic.

Glossary

Commencement Date of the Lease (Commencement Date)

The date on which a **lessor** makes an **underlying asset** available for use by a **lessee**. See paragraphs 842-10-55-19 through 55-21 for implementation guidance on the commencement date.

Contract

An agreement between two or more parties that creates enforceable rights and obligations.

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).

Fair Value (second definition)

The price that would be received to sell an asset or paid to transfer a liability in an **orderly transaction** between **market participants** at the measurement date.

Finance Lease

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

Lease

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.

Lease Payments

See paragraph 842-10-30-5 for what constitutes lease payments from the perspective of a **lessee** and a **lessor**.

Lease Term

The noncancellable period for which a **lessee** has the right to use an **underlying asset**, together with all of the following:

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

Lessee

An entity that enters into a **contract** to obtain the right to use an **underlying asset** for a period of time in exchange for consideration.

Lessor

An entity that enters into a **contract** to provide the right to use an **underlying asset** for a period of time in exchange for consideration.

Market Participants

Buyers and sellers in the principal (or most advantageous) market for the asset or liability that have all of the following characteristics:

a. They are independent of each other, that is, they are not **related parties**, although the price in a related-party transaction may be used as an input to a fair value measurement if the reporting entity has evidence that the transaction was entered into at market terms
b. They are knowledgeable, having a reasonable understanding about the asset or liability and the transaction using all available information,

including information that might be obtained through due diligence efforts that are usual and customary
c. They are able to enter into a transaction for the asset or liability
d. They are willing to enter into a transaction for the asset or liability, that is, they are motivated but not forced or otherwise compelled to do so.

Operating Lease

From the perspective of a **lessee**, any **lease** other than a **finance lease**.

From the perspective of a **lessor**, any lease other than a **sales-type lease** or a **direct financing lease**.

Orderly Transaction

A transaction that assumes exposure to the market for a period before the measurement date to allow for marketing activities that are usual and customary for transactions involving such assets or liabilities; it is not a forced transaction (for example, a forced liquidation or distress sale).

Related Parties

Related parties include:

a. Affiliates of the entity
b. Entities for which investments in their equity securities would be required, absent the election of the fair value option under the Fair Value Option Subsection of Section 825-10-15, to be accounted for by the equity method by the investing entity
c. Trusts for the benefit of employees, such as pension and profit-sharing trusts that are managed by or under the trusteeship of management
d. Principal owners of the entity and members of their immediate families
e. Management of the entity and members of their immediate families
f. Other parties with which the entity may deal if one party controls or can significantly influence the management or operating policies of the other to an extent that one of the transacting parties might be prevented from fully pursuing its own separate interests
g. Other parties that can significantly influence the management or operating policies of the transacting parties or that have an ownership interest in one of the transacting parties and can significantly influence the other to an extent that one or more of the transacting parties might be prevented from fully pursuing its own separate interests.

Residual Value Guarantee

A guarantee made to a **lessor** that the value of an **underlying asset** returned to the lessor at the end of a **lease** will be at least a specified amount.

Sales-Type Lease

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

Sublease

A transaction in which an **underlying asset** is re-leased by the **lessee** (or intermediate **lessor**) to a third party (the sublessee) and the original (or head) **lease** between the lessor and the lessee remains in effect.

Underlying Asset

An asset that is the subject of a **lease** for which a right to use that asset has been conveyed to a **lessee**. The underlying asset could be a physically distinct portion of a single asset.

Recognition

General

> Determining Whether the Transfer of the Asset Is a Sale

842-40-25-1 An entity shall apply the following requirements in Topic 606 on revenue from **contracts** with customers when determining whether the transfer of an asset shall be accounted for as a sale of the asset:

a. Paragraphs 606-10-25-1 through 25-8 on the existence of a contract
b. Paragraph 606-10-25-30 on when an entity satisfies a performance obligation by transferring control of an asset.

842-40-25-2 The existence of a leaseback (that is, a seller-lessee's right to use the **underlying asset** for a period of time) does not, in isolation, prevent the buyer-lessor from obtaining control of the asset. However, the buyer-lessor is not considered to have obtained control of the asset in accordance with the guidance on when an entity satisfies a performance obligation by transferring control of an asset in Topic 606 if the leaseback would be classified as a **finance lease** or a **sales-type lease**.

842-40-25-3 An option for the seller-lessee to repurchase the asset would preclude accounting for the transfer of the asset as a sale of the asset unless both of the following criteria are met:

a. The exercise price of the option is the **fair value** of the asset at the time the option is exercised.
b. There are alternative assets, substantially the same as the transferred asset, readily available in the marketplace.

> Transfer of the Asset Is a Sale

842-40-25-4 If the transfer of the asset is a sale in accordance with paragraphs 842-40-25-1 through 25-3, both of the following apply:

a. The seller-lessee shall:
   1. Recognize the transaction price for the sale at the point in time the buyer-lessor obtains control of the asset in accordance with paragraph 606-10-25-30 in accordance with the guidance on determining the transaction price in paragraphs 606-10-32-2 through 32-27
   2. Derecognize the carrying amount of the **underlying asset**
   3. Account for the **lease** in accordance with Subtopic 842-20.
b. The buyer-lessor shall account for the purchase in accordance with other Topics and for the lease in accordance with Subtopic 842-30.

> Transfer of the Asset Is Not a Sale

842-40-25-5 If the transfer of the asset is not a sale in accordance with paragraphs 842-40-25-1 through 25-3, both of the following apply:

a. The seller-lessee shall not derecognize the transferred asset and shall account for any amounts received as a financial liability in accordance with other Topics.
b. The buyer-lessor shall not recognize the transferred asset and shall account for the amounts paid as a receivable in accordance with other Topics.

Initial Measurement

General

> Transfer of the Asset Is a Sale

842-40-30-1 An entity shall determine whether a sale and leaseback transaction is at **fair value** on the basis of the difference between either of the following, whichever is more readily determinable:

a. The sale price of the asset and the fair value of the asset
b. The present value of the **lease payments** and the present value of market rental payments.

842-40-30-2 If the sale and leaseback transaction is not at fair value, the entity shall adjust the sale price of the asset on the same basis the entity used to determine that the transaction was not at fair value in accordance with paragraph 842-40-30-1. The entity shall account for both of the following:

a. Any increase to the sale price of the asset as a prepayment of rent
b. Any reduction of the sale price of the asset as additional financing provided by the buyer-lessor to the seller-lessee. The seller-lessee and

the buyer-lessor shall account for the additional financing in accordance with other Topics.

842-40-30-3 A sale and leaseback transaction is not off market solely because the sale price or the lease payments include a variable component. In determining whether the sale and leaseback transaction is at fair value, the entity should consider those variable payments it reasonably expects to be entitled to (or to make) on the basis of all of the information (historical, current, and forecast) that is reasonably available to the entity. For a seller-lessee, this would include estimating any variable consideration to which it expects to be entitled in accordance with paragraphs 606-10-32-5 through 32-9.

842-40-30-4 If the transaction is a related party **lease**, an entity shall not make the adjustments required in paragraph 842-40-30-2, but shall provide the required disclosures as discussed in paragraphs 842-20-50-7 and 842-30-50-4.

842-40-30-5 See Examples 1 and 2 (paragraphs 842-40-55-22 through 55-38) for illustrations of the requirements for a sale and leaseback transaction.

> Transfer of the Asset Is Not a Sale

842-40-30-6 The guidance in paragraph 842-40-25-5 notwithstanding, the seller-lessee shall adjust the interest rate on its financial liability as necessary to ensure that both of the following apply:

a. Interest on the financial liability is not greater than the principal payments on the financial liability over the shorter of the **lease term** and the term of the financing. The term of the financing may be shorter than the lease term because the transfer of an asset that does not qualify as a sale initially may qualify as a sale at a point in time before the end of the lease term.
b. The carrying amount of the asset does not exceed the carrying amount of the financial liability at the earlier of the end of the lease term or the date at which control of the asset will transfer to the buyer-lessor (for example, the date at which a repurchase option expires if that date is earlier than the end of the lease term).

Disclosure

General

842-40-50-1 If a seller-lessee or a buyer-lessor enters into a sale and leaseback transaction that is accounted for in accordance with paragraphs 842-40-25-4 and 842-40-30-1 through 30-3, it shall provide the disclosures required in paragraphs 842-20-50-1 through 50-9 for a seller-lessee or paragraphs 842-30-50-1 through 50-13 for a buyer-lessor.

842-40-50-2 In addition to the disclosures required by paragraphs 842-20-50-1 through 50-9, a seller-lessee that enters into a sale and leaseback transaction shall disclose both of the following:

a. The main terms and conditions of that transaction
b. Any gains or losses arising from the transaction separately from gains or losses on disposal of other assets.

Implementation Guidance and Illustrations

General

> Implementation Guidance

> > Control of the Underlying Asset before the Commencement Date

842-40-55-1 A **lessee** may obtain legal title to the **underlying asset** before that legal title is transferred to the **lessor** and the asset is leased to the lessee. If the lessee controls the underlying asset (that is, it can direct its use and obtain substantially all of its remaining benefits) before the asset is transferred to the lessor, the transaction is a sale and leaseback transaction that is accounted for in accordance with this Subtopic.

842-40-55-2 If the lessee obtains legal title, but does not obtain control of the underlying asset before the asset is transferred to the lessor, the transaction is not a sale and leaseback transaction. For example, this may be the case if a manufacturer, a lessor, and a lessee negotiate a transaction for the purchase of an asset from the manufacturer by the lessor, which in turn is leased to the lessee. For tax or other reasons, the lessee might obtain legal title to the underlying asset momentarily before legal title transfers to the lessor. In this case, if the lessee obtains legal title to the asset but does not control the asset before it is transferred to the lessor, the transaction is accounted for as a purchase of the asset by the lessor and a **lease** between the lessor and the lessee.

> > Costs of the Lessee Relating to the Construction or Design of an Underlying Asset

842-40-55-3 An entity may negotiate a **lease** before the **underlying asset** is available for use by the **lessee**. For some leases, the underlying asset may need to be constructed or redesigned for use by the lessee. Depending on the terms and conditions of the **contract**, a lessee may be required to make payments relating to the construction or design of the asset.

842-40-55-4 If a lessee incurs costs relating to the construction or design of an underlying asset before the **commencement date**, the lessee should account for those costs in accordance with other Topics, for example, Topic 330 on inventory or Topic 360 on property, plant, and equipment. Costs relating to the construction or design of an underlying asset do not include payments made by the lessee for the right to use the underlying asset. Payments for the right to use the underlying asset are **lease payments**, regardless of the timing of those payments or the form of those payments (for example, a lessee might contribute construction materials for the asset under construction).

842-40-55-5 If the lessee controls the underlying asset being constructed before the commencement date, the transaction is accounted for in accordance with this Subtopic. Any one (or more) of the following would demonstrate that the lessee controls an underlying asset that is under construction before the commencement date:

a. The lessee has the right to obtain the partially constructed underlying asset at any point during the construction period (for example, by making a payment to the **lessor**).
b. The lessor has an enforceable right to payment for its performance to date, and the asset does not have an alternative use (see paragraph 842-10-55-7) to the owner-lessor. In evaluating whether the asset has an alternative use to the owner-lessor, an entity should consider the characteristics of the asset that will ultimately be leased.
c. The lessee legally owns either:
    1. Both the land and the property improvements (for example, a building) that are under construction
    2. The non-real-estate asset (for example, a ship or an airplane) that is under construction.
d. The lessee controls the land that property improvements will be constructed upon (this includes where the lessee enters into a transaction to transfer the land to the lessor, but the transfer does not qualify as a sale in accordance with paragraphs 842-40-25-1 through 25-3) and does not enter into a lease of the land before the beginning of construction that, together with renewal options, permits the lessor or another unrelated third party to lease the land for substantially all of the economic life of the property improvements.
e. The lessee is leasing the land that property improvements will be constructed upon, the term of which, together with lessee renewal options, is for substantially all of the economic life of the property improvements, and does not enter into a **sublease** of the land before the beginning of construction that, together with renewal options, permits the lessor or another unrelated third party to sublease the land for substantially all of the economic life of the property improvements.

The list of circumstances above in which a lessee controls an underlying asset that is under construction before the commencement date is not all inclusive. There may be other circumstances that individually or in combination demonstrate that a lessee controls an underlying asset that is under construction before the commencement date.

842-40-55-6 See Example 3 (paragraphs 842-40-55-39 through 55-44) for an illustration of the scope of this Subtopic.

> > Lessee Indemnification for Environmental Contamination

842-40-55-7 A provision that requires **lessee** indemnifications for preexisting environmental contamination does not, on its own, mean that the lessee controlled the **underlying asset** before the **lease** commenced regardless of the likelihood of loss resulting from the indemnity. Consequently, the presence of such a provision does not mean the transaction is in the scope of this Subtopic.

> > Sale Subject to a Preexisting Lease

842-40-55-8 An entity owns an interest in an **underlying asset** and also is a **lessee** under an **operating lease** for all or a portion of the underlying asset. Acquisition of an ownership interest in the underlying asset and consummation of the **lease** occurred at or near the same time. This owner-lessee relationship can occur, for example, when the entity has an investment in a partnership that owns the underlying asset (or a larger asset of which the underlying asset is a distinct portion). The entity subsequently sells its interest or the partnership sells the underlying asset to an independent third party, and the entity continues to lease the underlying asset under the preexisting operating lease.

842-40-55-9 A transaction should be subject to the guidance in this Subtopic if the scope or price of the preexisting lease is modified in connection with the sale. If the scope or the price of the preexisting lease is not modified in conjunction with the sale, the sale should be accounted for in accordance with other Topics.

842-40-55-10 A lease between parties under common control should not be considered a preexisting lease. Accordingly, the guidance in this Subtopic should be applied to transactions that include nonfinancial assets within its scope, except if Topic 980 on regulated operations applies. That is, if one of the parties under common control is a regulated entity with a lease that has been approved by the appropriate regulatory agency, that lease should be considered a preexisting lease.

> > Transfer of Tax Benefits

842-40-55-11 A U.S. entity purchases an asset and enters into a **contract** with a foreign investor that provides that foreign investor with an ownership right in, but not necessarily title to, the asset. That ownership right enables the foreign investor to claim certain benefits of ownership of the asset for tax purposes in the foreign tax jurisdiction.

842-40-55-12 The U.S. entity also enters into a contract in the form of a leaseback for the ownership right with the foreign investor. The contract contains a purchase option for the U.S. entity to acquire the foreign investor’s ownership right in the asset at the end of the **lease term**.

842-40-55-13 The foreign investor pays the U.S. entity an amount of cash on the basis of an appraised value of the asset. The U.S. entity immediately transfers a portion of that cash to a third party, and that third party assumes the U.S. entity's obligation to make the future **lease payments**, including the purchase option payment. The cash retained by the U.S. entity is consideration for the tax benefits to be obtained by the foreign investor in the foreign tax jurisdiction. The U.S. entity may agree to indemnify the foreign investor against certain future events that would reduce the availability of tax benefits to the foreign investor. The U.S. entity also may agree to indemnify the third-party trustee against certain future events.

842-40-55-14 The result of the transaction is that both the U.S. entity and the foreign investor have a tax basis in the same depreciable asset.

842-40-55-15 An entity should determine whether the transfer of the ownership right is a sale based on the guidance in paragraphs 842-40-25-1 through 25-3. Consistent with paragraphs 842-40-25-2 through 25-3, if the leaseback for the ownership right is a **finance lease** or if the U.S. entity has an option to repurchase the ownership right at any exercise price other than the **fair value** of that right on the exercise date, there is no sale. If the transfer of the ownership right is not a sale, consistent with the guidance in paragraph 842-40-25-5, the entity should account for the cash received from the foreign investor as a financial liability in accordance with other Topics.

842-40-55-16 If the transfer of the ownership right is a sale, income recognition for the cash received should be determined on the basis of individual facts and circumstances. Immediate income recognition is not appropriate if there is more than a remote possibility of loss of the cash consideration received because of indemnification or other contingencies.

842-40-55-17 The total consideration received by the U.S. entity is compensation for both the tax benefits and the indemnification of the foreign investor or other third-party trustee. The recognition of a liability for the indemnification agreement at inception in accordance with the guidance in Topic 460 on guarantees would reduce the amount of income related to the tax benefits that the seller-lessee would recognize immediately when the possibility of loss is remote.

> > Sale-Leaseback-Sublease Transactions

842-40-55-18 An entity enters into a sale and leaseback of an asset that meets either of the following criteria:

a. The asset is subject to an **operating lease.**
b. The asset is subleased or intended to be subleased by the seller-lessee to another party under an operating lease.

842-40-55-19 A sale-leaseback-sublease transaction is within the scope of this Subtopic. The existence of the **sublease** (that is, the operating lease in paragraph 842-40-55-18(a) or (b)) does not, in isolation, prevent the buyer-lessor from obtaining control of the asset in accordance with paragraphs 842-40-25-1 through 25-3, nor does it prevent the seller-lessee from controlling the asset before its transfer to the buyer-lessor (that is, the seller-lessee is subject to the same requirements for determining whether the transfer of the asset is a sale as it would be without the sublease). All facts and circumstances should be considered in determining whether the buyer-lessor obtains control of the **underlying asset** from the seller-lessee in a sale-leaseback-sublease transaction.

> > Seller-Lessee Guarantee of the Residual Value

842-40-55-20 The seller-lessee may guarantee to the **lessor** that the residual value will be a stipulated amount at the end of the **lease term**. If the transfer of the asset is a sale in accordance with paragraphs 842-40-25-1 through 25-3, the seller-lessee **residual value guarantee** should be accounted for in the same manner as any other residual value guarantee provided by a **lessee**.

842-40-55-21 The residual value guarantee does not, on its own, preclude accounting for the transaction as a sale and leaseback, but should be considered in evaluating whether control of the asset has transferred to the buyer-lessor in accordance with paragraph 606-10-25-30. For example, a significant residual value guarantee by the seller-lessee may affect an entity's consideration of the transfer of control indicator in paragraph 606-10-25-30(d).

> Illustrations

> > Illustration of Sale and Leaseback Transaction

842-40-55-22 Examples 1 and 2 illustrate the accounting for sale and leaseback transactions.

> > > Example 1—Sale and Leaseback Transaction

842-40-55-23 An entity (Seller) sells a piece of land to an unrelated entity (Buyer) for cash of $2 million. Immediately before the transaction, the land has a carrying amount of $1 million. At the same time, Seller enters into a contract with Buyer for the right to use the land for 10 years (the leaseback), with annual payments of $120,000 payable in arrears. This Example ignores any initial direct costs associated with the transaction. The terms and conditions of the transaction are such that Buyer obtains substantially all the remaining benefits of the land on the basis of the combination of the cash flows it will receive from Seller during the leaseback and the benefits that will be derived from the land at the end of the lease term. In determining that a sale occurs at commencement of the leaseback, Seller considers that, at that date, all of the following apply:

a. Seller has a present right to payment of the sales price of $2 million.
b. Buyer obtains legal title to the land.
c. Buyer has the significant risks and rewards of ownership of the land because, for example, Buyer has the ability to sell the land if the property

value increases and also must absorb any losses, realized or unrealized, if the property value declines.

842-40-55-24 The observable fair value of the land at the date of sale is $1.4 million. Because the fair value of the land is observable, both Seller and Buyer utilize that benchmark in evaluating whether the sale is at market term. Because the sale is not at fair value (that is, the sales price is significantly in excess of the fair value of the land), both Seller and Buyer adjust for the off-market terms in accounting for the transaction. Seller recognizes a gain of $400,000 ($1.4 million – $1 million) on the sale of the land. The amount of the excess sale price of $600,000 ($2 million – $1.4 million) is recognized as additional financing from Buyer to Seller (that is, Seller is receiving the additional benefit of financing from Buyer). Seller's incremental borrowing rate is 6 percent. The leaseback is classified as an operating lease.

842-40-55-25 At the commencement date, Seller derecognizes the land with a carrying amount of $1 million. Seller recognizes the cash received of $2 million, a financial liability for the additional financing obtained from Buyer of $600,000, and a gain on sale of the land of $400,000. Seller also recognizes a lease liability for the leaseback at the present value of the portion of the 10 contractual leaseback payments attributable to the lease of $38,479 ($120,000 contractual lease payment – $81,521 of that lease payment that is attributable to the additional Buyer financing), discounted at the rate of 6 percent, which is $283,210, and a corresponding right-of-use asset of $283,210. The amount of $81,521 is the amount of each $120,000 annual payment that must be attributed to repayment of the principal of the financial liability for that financial liability to reduce to zero by the end of the lease term.

842-40-55-26 After initial recognition and measurement, at each period of the lease term, Seller will do both of the following:

a. Decrease the financing obligation for the amount of each lease payment allocated to that obligation (that is, $81,521) and increase the carrying amount of the obligation for interest accrued using Seller's incremental borrowing rate of 6 percent. For example, at the end of Year 1, the balance of the financial obligation is $554,479 ($600,000 – $81,521 + $36,000).
b. Recognize the interest expense on the financing obligation (for example, $36,000 in Year 1) and $38,479 in operating lease expense.

842-40-55-27 At the end of the lease term, the financing obligation and the lease liability equal $0.

842-40-55-28 Also, at the commencement date, Buyer recognizes the land at a cost of $1.4 million and a financial asset for the additional financing provided to Seller of $600,000. Because the lease is an operating lease, at the date of sale Buyer does not do any accounting for the lease.

842-40-55-29 In accounting for the additional financing to Seller, Buyer uses 6 percent as the applicable discount rate, which it determined in accordance with paragraphs 835-30-25-12 through 25-13. Therefore, Buyer will allocate $81,521 of each lease payment to Buyer's financial asset and allocate the remaining $38,479 to lease income. After initial recognition and measurement at each period of the lease term, Buyer will do both of the following:

a. Decrease the financial asset for the amount of each lease payment received that is allocated to that obligation (that is, $81,521) and increase the carrying amount of the obligation for interest accrued on the financial asset using Seller's incremental borrowing rate of 6 percent. Consistent with Seller's accounting, at the end of Year 1, the carrying amount of the financial asset is $554,479 ($600,000 – $81,521 + $36,000).
b. Recognize the interest income on the financing obligation (for example, $33,269 in Year 2) and $38,479 in operating lease income.

842-40-55-30 At the end of the lease term, the carrying amount of the financial asset is $0, and Buyer continues to recognize the land.

> > > Example 2—Accounting for a Failed Sale and Leaseback Transaction

842-40-55-31 An entity (Seller) sells an asset to an unrelated entity (Buyer) for cash of $2 million. Immediately before the transaction, the asset has a carrying amount of $1.8 million and has a remaining useful life of 21 years. At the same time, Seller enters into a contract with Buyer for the right to use the asset for 8 years with annual payments of $200,000 payable at the end of each year and no renewal options. Seller's incremental borrowing rate at the date of the transaction is 4 percent. The contract includes an option to repurchase the asset at the end of Year 5 for $800,000.

842-40-55-32 The exercise price of the repurchase option is fixed and, therefore, is not the fair value of the asset on the exercise date of the option. Consequently, the repurchase option precludes accounting for the transfer of the asset as a sale. Absent the repurchase option, there are no other factors that would preclude accounting for the transfer of the asset as a sale.

842-40-55-33 Therefore, at the commencement date, Seller accounts for the proceeds of $2 million as a financial liability and continues to account for the asset. Buyer accounts for the payment of $2 million as a financial asset and does not recognize the transferred asset. Seller accounts for its financing obligation, and Buyer accounts for its financial asset in accordance with other Topics, except that, in accordance with paragraph 842-40-30-6, Seller imputes an interest rate (4.23 percent) to ensure that interest on the financial liability is not greater than the principal payments on the financial liability over the shorter of the lease term and the term of the financing and that the carrying amount of the asset will not exceed the financial liability at the point in time the repurchase option expires (that is, at the point in time Buyer will obtain control of the asset in accordance with the guidance on satisfying performance obligations in Topic 606). Paragraph 842-40-

30-6 does not apply to the buyer-lessor; therefore, Buyer recognizes interest income on its financial asset on the basis of the imputed interest rate determined in accordance with paragraphs 835-30-25-12 through 25-13, which in this case Buyer determines to be 4 percent.

842-40-55-34 During Year 1, Seller recognizes interest expense of $84,600 (4.23% × $2 million) and recognizes the payment of $200,000 as a reduction of the financial liability. Seller also recognizes depreciation expense of $85,714 ($1.8 million ÷ 21 years). Buyer recognizes interest income of $80,000 (4% × $2 million) and recognizes the payment of $200,000 as a reduction of its financial asset.

842-40-55-35 At the end of Year 1, the carrying amount of Seller's financial liability is $1,884,600 ($2 million + $84,600 – $200,000), and the carrying amount of the underlying asset is $1,714,286 ($1.8 million – $85,714). The carrying amount of Buyer's financial asset is $1,880,000 ($2 million + $80,000 – $200,000).

842-40-55-36 At the end of Year 5, the option to repurchase the asset expires, unexercised by Seller. The repurchase option was the only feature of the arrangement that precluded accounting for the transfer of the asset as a sale. Therefore, upon expiration of the repurchase option, Seller recognizes the sale of the asset by derecognizing the carrying amount of the financial liability of $1,372,077, derecognizing the carrying amount of the underlying asset of $1,371,429, and recognizing a gain of $648. Buyer recognizes the purchase of the asset by derecognizing the carrying amount of its financial asset of $1,350,041 and recognizes the transferred asset at that same amount. The date of sale also is the commencement date of the leaseback for accounting purposes. The lease term is 3 years (8 year contractual leaseback term – 5 years already passed at the commencement date). Therefore, Seller recognizes a lease liability at the present value of the 3 remaining contractual leaseback payments of $200,000, discounted at Seller's incremental borrowing rate at the contractually stated commencement date of 4 percent, which is $555,018, and a corresponding right-of-use asset of $555,018. Seller uses the incremental borrowing rate as of the contractual commencement date because that rate more closely reflects the interest rate that would have been considered by Buyer in pricing the lease.

842-40-55-37 The lease is classified as an operating lease by both Seller and Buyer. Consequently, in Year 6 and each year thereafter, Seller recognizes a single lease cost of $200,000, while Buyer recognizes lease income of $200,000 and depreciation expense of $84,378 on the underlying asset ($1,350,041 ÷ 16 years remaining useful life).

842-40-55-38 At the end of Year 6 and at each reporting date thereafter, Seller calculates the lease liability at the present value of the remaining lease payments of $200,000, discounted at Seller's incremental borrowing rate of 4 percent. Because Seller does not incur any initial direct costs and there are no prepaid or accrued lease payments, Seller measures the right-of-use asset at an amount equal to the lease liability at each reporting date for the remainder of the lease term.

> > Illustration of Guidance on Application of Costs of the Lessee Relating to the Construction or Design of an Underlying Asset

842-40-55-39 Example 3 illustrates the guidance on determining whether a lessee controls an underlying asset that is under construction before the commencement date.

> > > Example 3—Lessee Control over an Asset under Construction

842-40-55-40 Lessee and Lessor enter into a contract whereby Lessor will construct (whether itself or using subcontractors) a building to Lessee's specifications and lease that building to Lessee for a period of 20 years once construction is completed for an annual lease payment of $1,000,000, increasing by 5 percent per year, plus a percentage of any overruns above the budgeted cost to construct the building. The building is expected to have an economic life of 50 years once it is constructed. Lessee does not legally own the building and does not have a right under the contract to obtain the building while it is under construction (for example, a right to purchase the construction in process from Lessor). In addition, while the building is being developed to Lessee's specifications, those specifications are not so specialized that the asset does not have an alternative use to Lessor.

> > > > Case A—Lessee Does Not Control the Asset under Construction

842-40-55-41 Assume Lessee controls (that is, Lessee is the owner for accounting purposes) the land upon which the building will be constructed and, as part of the contract, Lessee agrees to lease the underlying land to Lessor for an initial period of 25 years. Lessor also is granted a series of six 5-year renewal options for the land lease.

842-40-55-42 None of the circumstances in paragraph 842-40-55-5 exist. Even though Lessee owns the land (whether legally or for accounting purposes only) upon which the building will be constructed, Lessor legally owns the property improvements and has rights to use the underlying land for at least substantially all of the economic life of the building. Lessee does not own the building and does not have a right under the contract to obtain the building (for example, a right to purchase the building from Lessor). In addition, the building has an alternative use to Lessor. Therefore, Lessee does not control the building under construction. Consequently, the arrangement is not within the scope of this Subtopic. Lessee and Lessor will account for the lease of the building in accordance with Subtopics 842-20 and 842-30, respectively. If Lessee incurs costs related to the construction or design of the building (for example, architectural services in developing the specifications of the building), it will account for those costs as lease payments unless the costs are for goods or services provided to Lessee, in which case Lessee will account for those costs in accordance with other Topics.

> > > > Case B—Lessee Controls the Asset under Construction

842-40-55-43 Assume Lessee leases, rather than owns, the land upon which the building will be constructed. Lessee has a 20-year lease of the underlying land and five 10-year renewal options. Therefore, Lessee's lease of the underlying land, together with the renewal options, is for at least substantially all of the economic life of the building under construction. Lessee enters into a sublease with Lessor for the right to use the underlying land for 20 years that commences upon completion of the building. The sublease has a single 10-year renewal option available to Lessor.

842-40-55-44 Lessee controls the building during the construction period and, therefore, the arrangement is within the scope of this Subtopic. Lessee and Lessor will apply the guidance in this Subtopic to determine whether this arrangement qualifies as a sale and a leaseback or whether this arrangement is, instead, a financing arrangement. Lessee controls the building during the construction period because, in accordance with paragraph 842-40-55-5(e), Lessee controls the use of the land upon which the building will be constructed for a period that is at least substantially all of the economic life of the building and the sublease entered into with Lessor does not both (a) grant Lessor the right to use the land before the beginning of construction and (b) permit Lessor to use the land for substantially all the economic life of the building (that is, the sublease, including Lessor renewal options, only is for 30 years as compared with the 50-year economic life of the building).

7. Add Subtopic 842-50, with a link to transition paragraph 842-10-65-1, as follows:

[For ease of readability, the new Subtopic is not underlined.]

Leases—Leveraged Lease Arrangements

Overview and Background

General

842-50-05-1 This Subtopic addresses accounting for **leases** that meet the definition of a **leveraged lease**.

Scope and Scope Exceptions

General

842-50-15-1 This Subtopic addresses accounting for **leases** that meet the criteria in transition paragraph 842-10-65-1(z). If a **lessee** exercises an option to extend a lease that meets the criteria in transition paragraph 842-10-65-1(z) that it was not previously reasonably assured of exercising, the exercise of that option shall be considered a **lease modification** as described in paragraph 842-10-65-1(z).

Glossary

Acquiree

The **business** or **businesses** that the **acquirer** obtains control of in a **business combination**. This term also includes a nonprofit activity or business that a not-for-profit acquirer obtains control of in an **acquisition by a not-for-profit entity**.

Acquirer

The entity that obtains control of the **acquiree**. However, in a **business combination** in which a **variable interest entity** (VIE) is acquired, the primary beneficiary of that entity always is the acquirer.

Acquisition by a Not-for-Profit Entity

A transaction or other event in which a not-for-profit acquirer obtains control of one or more nonprofit activities or businesses and initially recognizes their assets and liabilities in the acquirer's financial statements. When applicable guidance in Topic 805 is applied by a **not-for-profit entity**, the term **business combination** has the same meaning as this term has for a for-profit entity. Likewise, a reference to business combinations in guidance that links to Topic 805 has the same meaning as a reference to acquisitions by not-for-profit entities.

Business

An integrated set of activities and assets that is capable of being conducted and managed for the purpose of providing a return in the form of dividends, lower costs, or other economic benefits directly to investors or other owners, members, or participants. Additional guidance on what a business consists of is presented in paragraphs 805-10-55-4 through 55-9.

Business Combination

A transaction or other event in which an **acquirer** obtains control of one or more **businesses**. Transactions sometimes referred to as true mergers or mergers of equals also are business combinations. See also **Acquisition by a Not-for-Profit Entity**.

Commencement Date of the Lease (Commencement Date)

The date on which a **lessor** makes an **underlying asset** available for use by a **lessee**. See paragraphs 842-10-55-19 through 55-21 for implementation guidance on the commencement date.

Contract

An agreement between two or more parties that creates enforceable rights and obligations.

Delayed Equity Investment

In **leveraged lease** transactions that have been structured with terms such that the **lessee's** rent payments begin one to two years after **lease inception**, equity contributions the **lessor** agrees to make (in the lease agreement or a separate binding **contract**) that are used to service the nonrecourse debt during this brief period. The total amount of the lessor's contributions is specifically limited by the agreements.

Estimated Residual Value

The estimated fair value of the leased property at the end of the **lease term**.

Fair Value (second definition)

The price that would be received to sell an asset or paid to transfer a liability in an **orderly transaction** between **market participants** at the measurement date.

Lease

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.

Lease Inception

The date of the lease agreement or commitment, if earlier. For purposes of this definition, a commitment shall be in writing, signed by the parties in interest to the transaction, and shall specifically set forth the principal provisions of the transaction. If any of the principal provisions are yet to be negotiated, such a preliminary agreement or commitment does not qualify for purposes of this definition.

Lease Modification

A change to the terms and conditions of a **contract** that results in a change in the scope of or the consideration for a **lease** (for example, a change to the terms and conditions of the contract that adds or terminates the right to use one or more underlying assets or extends or shortens the contractual lease term).

Lease Payments

See paragraph 842-10-30-5 for what constitutes lease payments from the perspective of a **lessee** and a **lessor**.

Lease Term

The noncancellable period for which a **lessee** has the right to use an **underlying asset**, together with all of the following:

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

Legal Entity

Any legal structure used to conduct activities or to hold assets. Some examples of such structures are corporations, partnerships, limited liability companies, grantor trusts, and other trusts.

Lessee

An entity that enters into a **contract** to obtain the right to use an **underlying asset** for a period of time in exchange for consideration.

Lessor

An entity that enters into a **contract** to provide the right to use an **underlying asset** for a period of time in exchange for consideration.

Leveraged Lease

From the perspective of a **lessor**, a **lease** that was classified as a leveraged lease in accordance with the leases guidance in effect before the effective date and for which the **commencement date** is before the effective date.

Market Participants

Buyers and sellers in the principal (or most advantageous) market for the asset or liability that have all of the following characteristics:

a. They are independent of each other, that is, they are not **related parties**, although the price in a related-party transaction may be used as an input to a fair value measurement if the reporting entity has evidence that the transaction was entered into at market terms
b. They are knowledgeable, having a reasonable understanding about the asset or liability and the transaction using all available information, including information that might be obtained through due diligence efforts that are usual and customary
c. They are able to enter into a transaction for the asset or liability
d. They are willing to enter into a transaction for the asset or liability, that is, they are motivated but not forced or otherwise compelled to do so.

Minimum Lease Payments

Minimum lease payments comprise the payments that the lessee is obligated to make or can be required to make in connection with the leased property, excluding both of the following:

a. Contingent rentals
b. Any guarantee by the lessee of the lessor's debt and the lessee's obligation to pay (apart from the rental payments) executory costs such as insurance, maintenance, and taxes in connection with the leased property.

If the lease contains a bargain purchase option, only the minimum rental payments over the lease term and the payment called for by the bargain purchase option are required to be included in the minimum lease payments. Otherwise, minimum lease payments include all of the following:

a. The minimum rental payments called for by the lease over the lease term.
b. Any guarantee of the residual value at the expiration of the lease term, whether or not payment of the guarantee constitutes a purchase of the leased property or of rental payments beyond the lease term by the lessee (including a third party related to the lessee) or a third party unrelated to either the lessee or the lessor, provided the third party is financially capable of discharging the obligations that may arise from the guarantee. If the lessor has the right to require the lessee to purchase the property at termination of the lease for a certain or determinable amount, that amount is required to be considered a lessee guarantee of the residual value. If the lessee agrees to make up any deficiency below a stated amount in the lessor's realization of the residual value, the residual value guarantee to be included in the minimum lease payments is required to be the stated amount, rather than an estimate of the deficiency to be made up.
c. Any payment that the lessee must make or can be required to make upon failure to renew or extend the lease at the expiration of the lease term, whether or not the payment would constitute a purchase of the leased property. Note that the definition of lease term includes all periods, if any, for which failure to renew the lease imposes a penalty on the lessee in an amount such that renewal appears, at lease inception, to be reasonably assured. If the lease term has been extended because of that provision, the related penalty is not included in minimum lease payments.
d. Payments made before the beginning of the lease term. The lessee is required to use the same interest rate to accrete payments to be made before the beginning of the lease term that it uses to discount lease payments to be made during the lease term.
e. Fees that are paid by the lessee to the owners of the special-purpose entity for structuring the lease transaction. Such fees are required to be

included as part of minimum lease payments (but not included in the fair value of the leased property).

Lease payments that depend on a factor directly related to the future use of the leased property, such as machine hours of use or sales volume during the lease term, are contingent rentals and, accordingly, are excluded from minimum lease payments in their entirety. However, lease payments that depend on an existing index or rate, such as the Consumer Price Index or the prime interest rate, are required to be included in minimum lease payments based on the index or rate existing at lease inception; any increases or decreases in lease payments that result from subsequent changes in the index or rate are contingent rentals and, thus, affect the determination of income as accruable.

Not-for-Profit Entity

An entity that possesses the following characteristics, in varying degrees, that distinguish it from a business entity:

a. Contributions of significant amounts of resources from resource providers who do not expect commensurate or proportionate pecuniary return
b. Operating purposes other than to provide goods or services at a profit
c. Absence of ownership interests like those of business entities.

Entities that clearly fall outside this definition include the following:

a. All investor-owned entities
b. Entities that provide dividends, lower costs, or other economic benefits directly and proportionately to their owners, members, or participants, such as mutual insurance entities, credit unions, farm and rural electric cooperatives, and employee benefit plans.

Orderly Transaction

A transaction that assumes exposure to the market for a period before the measurement date to allow for marketing activities that are usual and customary for transactions involving such assets or liabilities; it is not a forced transaction (for example, a forced liquidation or distress sale).

Related Parties

Related parties include:

a. Affiliates of the entity
b. Entities for which investments in their equity securities would be required, absent the election of the fair value option under the Fair Value Option Subsection of Section 825-10-15, to be accounted for by the equity method by the investing entity

c. Trusts for the benefit of employees, such as pension and profit-sharing trusts that are managed by or under the trusteeship of management
d. Principal owners of the entity and members of their immediate families
e. Management of the entity and members of their immediate families
f. Other parties with which the entity may deal if one party controls or can significantly influence the management or operating policies of the other to an extent that one of the transacting parties might be prevented from fully pursuing its own separate interests
g. Other parties that can significantly influence the management or operating policies of the transacting parties or that have an ownership interest in one of the transacting parties and can significantly influence the other to an extent that one or more of the transacting parties might be prevented from fully pursuing its own separate interests.

Underlying Asset

An asset that is the subject of a **lease** for which a right to use that asset has been conveyed to a **lessee**. The underlying asset could be a physically distinct portion of a single asset.

Variable Interest Entity

A **legal entity** subject to consolidation according to the provisions of the Variable Interest Entities Subsections of Subtopic 810-10.

Recognition

General

842-50-25-1 A **lessor** shall record its investment in a **leveraged lease**. The net of the balances of the following accounts as measured in accordance with this Subtopic shall represent the lessor's initial and continuing investment in leveraged leases:

a. Rentals receivable
b. Investment-tax-credit receivable
c. **Estimated residual value** of the leased asset
d. Unearned and deferred income.

> Leveraged Lease Acquired in a Business Combination or an Acquisition by a Not-for-Profit Entity

842-50-25-2 In a business combination or an **acquisition by a not-for-profit entity**, the acquiring entity shall retain the classification of the acquired entity's investment as a **lessor** in a **leveraged lease** at the date of the combination. The net investment of the acquired leveraged lease shall be disaggregated into its component parts, namely net rentals receivable, **estimated residual value**, and unearned income including discount to adjust other components to present value.

Initial Measurement

General

842-50-30-1 A **lessor** shall initially measure its investment in a **leveraged lease** net of the nonrecourse debt (as discussed in paragraph 842-50-25-1). The net of the balances of the following accounts shall represent the initial and continuing investment in leveraged leases:

a. Rentals receivable, net of that portion of the rental applicable to principal and interest on the nonrecourse debt.
b. A receivable for the amount of the investment tax credit to be realized on the transaction.
c. The **estimated residual value** of the leased asset. The estimated residual value shall not exceed the amount estimated at **lease inception** except if the **lease** agreement includes a provision to escalate **minimum lease payments** either for increases in construction or acquisition cost of the leased property or for increases in some other measure of cost or value (such as general price levels) during the construction or preacquisition period. In that case, the effect of any increases that have occurred shall be considered in the determination of the estimated residual value of the **underlying asset** at lease inception.
d. Unearned and deferred income consisting of both of the following:
    1. The estimated pretax lease income (or loss), after deducting initial direct costs, remaining to be allocated to income over the **lease term**.
    2. The investment tax credit remaining to be allocated to income over the lease term.

> Leveraged Lease Acquired in a Business Combination or an Acquisition by a Not-for-Profit Entity

842-50-30-2 In a business combination or an **acquisition by a not-for-profit entity**, the acquiring entity shall assign an amount to the acquired net investment in the **leveraged lease** in accordance with the general guidance in Topic 805 on business combinations, based on the remaining future cash flows and giving appropriate recognition to the estimated future tax effects of those cash flows.

Subsequent Measurement

General

> Leveraged Lease Acquired in a Business Combination or an Acquisition by a Not-for-Profit Entity

842-50-35-1 In a business combination or an **acquisition by a not-for-profit entity**, the acquiring entity shall subsequently account for its acquired investment as a **lessor** in a **leveraged lease** in accordance with the guidance in this Subtopic as it would for any other leveraged lease.

> Income Recognition on a Leveraged Lease

842-50-35-2 The investment in **leveraged leases** minus deferred taxes arising from differences between pretax accounting income and taxable income shall represent the **lessor's** net investment in leveraged leases for purposes of computing periodic net income from the leveraged lease. Given the original investment and using the projected cash receipts and disbursements over the term of the **lease**, the rate of return on the net investment in the years in which it is positive shall be computed. The rate is that rate that, when applied to the net investment in the years in which the net investment is positive, will distribute the net income to those years and is distinct from the interest rate implicit in the lease. In each year, whether positive or not, the difference between the net cash flow and the amount of income recognized, if any, shall serve to increase or reduce the net investment balance. The use of the term *years* is not intended to preclude application of the accounting prescribed in this paragraph to shorter accounting periods.

842-50-35-3 The net income (or loss) that a lessor recognizes on a leveraged lease shall be composed of the following three elements:

a. Pretax lease income (or loss)
b. Investment tax credit
c. Tax effect of pretax lease income (or loss).

842-50-35-4 The pretax lease income (or loss) and investment tax credit elements shall be allocated in proportionate amounts from the unearned and deferred income included in the lessor's net investment (as described in paragraph 842-50-30-1(d)). The tax effect of the pretax lease income (or loss) recognized shall be reflected in tax expense for the year. The tax effect of the difference between pretax accounting income (or loss) and taxable income (or loss) for the year shall be charged or credited to deferred taxes.

842-50-35-5 If, at any time during the **lease term** the application of the method prescribed in this Subtopic would result in a loss being allocated to future years, that loss shall be recognized immediately. This situation might arise in circumstances in which one of the important assumptions affecting net income is revised (see paragraphs 842-50-35-6 through 35-15).

> > Changes in Assumptions

842-50-35-6 Any **estimated residual value** and all other important assumptions affecting estimated total net income from the **leveraged lease** shall be reviewed at least annually. The rate of return and the allocation of income to positive investment years shall be recalculated from **lease inception** following the method described in paragraphs 842-50-35-2 through 35-4 and using the revised assumption if, during the **lease term**, any of the following conditions occur:

a. The estimate of the residual value is determined to be excessive, and the decline in the residual value is judged to be other than temporary.
b. The revision of another important assumption changes the estimated total net income from the **lease**.
c. The projected timing of the income tax cash flows is revised.

842-50-35-7 The **lessor** shall update all assumptions used to calculate total and periodic income if the lessor is performing a recalculation of the leveraged lease. That recalculation shall include actual cash flows up to the date of the recalculation and projected cash flows following the date of recalculation.

842-50-35-8 The accounts constituting the net investment balance shall be adjusted to conform to the recalculated balances, and the change in the net investment shall be recognized as a gain or loss in the year in which the assumption is changed. The gain or loss shall be recognized as follows:

a. The pretax gain or loss shall be included in income from continuing operations before income taxes in the same line item in which leveraged lease income is recognized.
b. The tax effect of the gain or loss shall be included in the income tax line item.
c. An upward adjustment of the estimated residual value (including any guaranteed portion) shall not be made.

842-50-35-9 The projected timing of income tax cash flows generated by the leveraged lease is an important assumption and shall be reviewed annually, or more frequently, if events or changes in circumstances indicate that a change in timing has occurred or is projected to occur. The income effect of a change in the income tax rate shall be recognized in the first accounting period ending on or after the date on which the legislation effecting a rate change becomes law.

842-50-35-10 A revision of the projected timing of the income tax cash flows applies only to changes or projected changes in the timing of income taxes that are directly related to the leveraged lease transaction. For example, a change in timing or projected timing of the tax benefits generated by a leveraged lease as a result of any of the following circumstances would require a recalculation because that change in timing is directly related to that lease:

a. An interpretation of the tax law
b. A change in the lessor's assessment of the likelihood of prevailing in a challenge by the taxing authority
c. A change in the lessor's expectations about settlement with the taxing authority.

842-50-35-11 In contrast, as discussed in paragraph 842-50-35-20, a change in timing of income taxes solely as a result of an alternative minimum tax credit or insufficient taxable income of the lessor would not require a recalculation of a leveraged lease because that change in timing is not directly related to that lease. A recalculation would not be required unless there is an indication that the previous assumptions about total after-tax net income from the leveraged lease were no longer valid.

842-50-35-12 Tax positions shall be reflected in the lessor's initial calculation or subsequent recalculation on the recognition, measurement, and derecognition criteria in paragraphs 740-10-25-6, 740-10-30-7, and 740-10-40-2. The determination of when a tax position no longer meets those criteria is a matter of individual facts and circumstances evaluated in light of all available evidence.

842-50-35-13 If the lessor expects to enter into a settlement of a tax position relating to a leveraged lease with a taxing authority, the cash flows following the date of recalculation shall include projected cash flows between the date of the recalculation and the date of any projected settlement and a projected settlement amount at the date of the projected settlement.

842-50-35-14 The recalculation of income from the leveraged lease shall not include interest or penalties in the cash flows from the leveraged lease.

842-50-35-15 Advance payments and deposits made with a taxing authority shall not be considered an actual cash flow of the leveraged lease; rather, those payments and deposits shall be included in the projected settlement amount.

> Effect of Alternative Minimum Tax

842-50-35-16 An entity shall include assumptions about the effect of the alternative minimum tax, considering its consolidated tax position, in **leveraged lease** computations.

842-50-35-17 Any difference between alternative minimum tax depreciation and the tax depreciation assumed in the leveraged lease or between income recognition for financial reporting purposes and alternative minimum tax income could, depending on the **lessor's** overall tax situation, result in alternative minimum tax or the utilization of alternative minimum tax credits.

842-50-35-18 If alternative minimum tax is paid or an alternative minimum tax credit is utilized, the total cash flows from the leveraged lease could be changed and the lessor's net investment in the leveraged lease and income recognition would be affected.

842-50-35-19 If a change to the tax assumptions changes total estimated after-tax net income, the rate of return on the leveraged lease shall be recalculated from inception, the accounts constituting the lessor's net investment shall be adjusted, and a gain or loss shall be recognized in the year in which the assumption is changed.

842-50-35-20 However, an entity whose tax position frequently varies between alternative minimum tax and regular tax shall not be required to recalculate the rate of return on the leveraged lease each year unless there is an indication that the original assumptions regarding total after-tax net income from the **lease** are no longer valid. In that circumstance, the entity shall be required to revise the leveraged lease computations in any period in which total net income from the leveraged lease changes because of the effect of the alternative minimum tax on cash flows for the lease.

> Transfer of Minimum Rental Payments

842-50-35-21 If a **lessor** sells substantially all of the minimum rental payments associated with a **leveraged lease** and retains an interest in the residual value of the leased asset, the lessor shall not recognize increases in the value of the **lease** residual to its estimated value over the remaining **lease term**. The lessor shall report any remaining interest thereafter at its carrying amount at the date of the sale of the **lease payments**. If it is determined subsequently that the **fair value** of the residual value of the leased asset has declined below the carrying amount of the interest retained and that decline is other than temporary, the asset shall be written down to fair value, and the amount of the write-down shall be recognized as a loss. That fair value becomes the asset's new carrying amount, and the asset shall not be increased for any subsequent increase in its fair value before its sale or disposition.

Other Presentation Matters

General

842-50-45-1 For purposes of presenting the investment in a **leveraged lease** in the **lessor's** balance sheet, the amount of related deferred taxes shall be presented separately (from the remainder of the net investment). In the income statement or the notes to that statement, separate presentation (from each other) shall be made of pretax income from the leveraged lease, the tax effect of pretax income, and the amount of investment tax credit recognized as income during the period.

> Income Taxes and Leveraged Leases

842-50-45-2 Integration of the results of income tax accounting for **leveraged leases** with the other results of accounting for income taxes under Topic 740 on income taxes is required if deferred tax credits related to leveraged leases are the only source (see paragraph 740-10-30-18) for recognition of a tax benefit for deductible temporary differences and carryforwards not related to leveraged leases. A valuation allowance is not necessary if deductible temporary differences and carryforwards will offset taxable amounts from future recovery of the net investment in the leveraged lease. However, to the extent that the amount of deferred tax credits for a leveraged lease as determined in accordance with this Subtopic differs from the amount of the deferred tax liability related to the leveraged lease that would otherwise result from applying the guidance in Topic 740, that difference is preserved and is not a source of taxable income for recognition of the tax benefit of deductible temporary differences and operating loss or tax credit carryforwards.

842-50-45-3 This Subtopic requires that the tax effect of any difference between the assigned value and the tax basis of a leveraged lease at the date of a business combination or an **acquisition by a not-for-profit entity** shall not be accounted for as a deferred tax credit. Any tax effects included in unearned and deferred income as required by this Subtopic shall not be offset by the deferred tax consequences of other temporary differences or by the tax benefit of operating loss or tax credit carryforwards. However, deferred tax credits that arise after the date of a combination shall be accounted for in the same manner as for leveraged leases that were not acquired in a combination.

Disclosure

General

842-50-50-1 If leveraged leasing is a significant part of the **lessor's** business activities in terms of revenue, net income, or assets, the components of the net investment balance in **leveraged leases** as set forth in paragraph 842-50-25-1 shall be disclosed in the notes to financial statements.

842-50-50-2 For guidance on disclosures about financing receivables, which include receivables relating to a lessor's rights to payments from leveraged leases, see the guidance beginning in paragraphs 310-10-50-5A, 310-10-50-27, and 310-10-50-31.

842-50-50-3 If accounting for the effect on leveraged leases of the change in tax rates results in a significant variation from the customary relationship between income tax expense and pretax accounting income and the reason for that variation is not otherwise apparent, the lessor shall disclose the reason for that variation.

Implementation Guidance and Illustrations

General

> Implementation Guidance

> > Leveraged Lease Involving an Existing Asset of a Regulated Entity

842-50-55-1 Although the carrying amount of an asset acquired previously may not differ significantly from its **fair value**, it is unlikely that the two will be the same. However, regulated utilities have argued that the carrying amounts of certain of their assets always equal the fair value based on the utility's ability to recover that cost in conjunction with a franchise to sell a related service in a specified area. That argument is not valid when considering the value of the asset to a third-party purchaser that does not own that franchise.

> > Delayed Equity Investment

842-50-55-2 A **delayed equity investment** frequently obligates the **lessor** to make up the shortfall between rent and debt service in the first several years of the transaction. The type of recourse debt resulting from the delayed equity investment does not contradict the notion of nonrecourse and, therefore, does not preclude **leveraged lease** accounting as long as other requirements of leveraged lease accounting are met. The lessor's related obligation should be recorded as a liability at present value at **lease inception**.

842-50-55-3 Recognition of the liability would increase the lessor's net investment on which the lessor bases its pattern of income recognition. While the increase to the net investment results in an increase in income, it may be offset by the accrual of interest on the liability.

> > Income Taxes Related to Leveraged Leases

842-50-55-4 The accounting for income taxes related to **leveraged leases** set forth in this Subtopic is not consistent with the guidance in Topic 740 on income taxes.

842-50-55-5 The integration of the results of accounting for income taxes related to leveraged leases with the other results of accounting for income taxes as required by Topic 740 is an issue if all of the following exist:

a. The accounting for a leveraged lease requires recognition of deferred tax credits.
b. The guidance in Topic 740 limits the recognition of a tax benefit for deductible temporary differences and carryforwards not related to the leveraged lease.
c. Unrecognized tax benefits in this paragraph could offset taxable amounts that result from future recovery of the net investment in the leveraged lease.

> Illustrations

> > Example 1: Lessor's Accounting for a Leveraged Lease

842-50-55-6 This Example illustrates a lessor's accounting for a leveraged lease in accordance with the guidance in this Subtopic. It also illustrates one way of meeting the disclosure requirements in paragraphs 842-50-45-1 and 842-50-50-1 as applied to a leveraged lease. The Example does not encompass all circumstances that may arise about leveraged leases; rather, the Example is based on a single instance of a leveraged lease. The elements of accounting and reporting illustrated for this Example of a leveraged lease are as follows:

a. Cash flow analysis by years (see paragraph 842-50-55-8)
b. Allocation of annual cash flow to investment and income (see paragraph 842-50-55-9)
c. Journal entries for lessor's initial investment and first year of operation (see paragraph 842-50-55-10)
d. Financial statements including notes at end of second year (see paragraph 842-50-55-11)
e. Accounting for a revision in the estimated residual value of the leased asset assumed to occur in the eleventh year of the lease (from $200,000 to $120,000):
    1. Revised allocation of annual cash flow to investment and income (see paragraph 842-50-55-12)
    2. Balances in investment accounts at beginning of the eleventh year before revised estimate (see paragraph 842-50-55-13)
    3. Journal entries (see paragraph 842-50-55-14)
    4. Adjustment of investment accounts (see paragraph 842-50-55-15).

842-50-55-7 This Example has the following terms and assumptions.

Cost of leased asset (equipment)	$1,000,000
Lease term	15 years, dating from January 1, 1975
Lease rental payments	$90,000 per year (payable last day of each year)
Residual value	$200,000 estimated to be realized 1 year after lease termination; in the eleventh year of the lease the estimate is reduced to $120,000
Financing:	
Equity investment by lessor	$400,000
Long-term nonrecourse debt	$600,000, bearing interest at 9% and repayable in annual installments (on last day of each year) of $74,435.30
Depreciation allowable to lessor for income tax purposes	7-year asset depreciation range life using double-declining-balance method for the first 2 years (with the half-year convention election applied in the first year) and sum-of-years digits method for remaining life, depreciated to $100,000 salvage value
Lessor's income tax rate (federal and state)	50.4% (assumed to continue in existence throughout the term of the lease)
Investment tax credit	10% of equipment cost or $100,000 (realized by the lessor on last day of first year of lease)
Initial direct costs	For simplicity, initial direct costs have not been included in the illustration

842-50-55-8 Cash flow analysis by years follows.

	1	2	3	4	5	6	7	8	9
Year	Gross Lease Rentals and Residual Value	Depreciation (for Income Tax Purposes)	Loan Interest Payments	Taxable Income (Loss) (Col. 1– 2– 3)	Income Tax Credits (Charges) (Col. 4 × 50.4%)	Loan Principal Payments	Investment Tax Credit Realized	Annual Cash Flow (Col. 1– 3 + 5 – 6 + 7)	Cumulative Cash Flow
Initial Investment	-	-	-	-	-	-	-	$(400,000)	$ (400,000)
1	$ 90,000	$ 142,857	$ 54,000	$(106,857)	$ 53,856	$ 20,435	$ 100,000	169,421	(230,579)
2	90,000	244,898	52,161	(207,059)	104,358	22,274	-	119,923	(110,656)
3	90,000	187,075	50,156	(147,231)	74,204	24,279	-	89,769	(20,887)
4	90,000	153,061	47,971	(111,032)	55,960	26,464	-	71,525	50,638
5	90,000	119,048	45,589	(74,637)	37,617	28,846	-	53,182	103,820
6	90,000	53,061	42,993	(6,054)	3,051	31,442	-	18,616	122,436
7	90,000	-	40,163	49,837	(25,118)	34,272	-	(9,553)	112,883
8	90,000	-	37,079	52,921	(26,672)	37,357	-	(11,108)	101,775
9	90,000	-	33,717	56,283	(28,367)	40,719	-	(12,803)	88,972
10	90,000	-	30,052	59,948	(30,214)	44,383	-	(14,649)	74,323
11	90,000	-	26,058	63,942	(32,227)	48,378	-	(16,663)	57,660
12	90,000	-	21,704	68,296	(34,421)	52,732	-	(18,857)	38,803
13	90,000	-	16,957	73,043	(36,813)	57,478	-	(21,248)	17,555
14	90,000	-	11,785	78,215	(39,420)	62,651	-	(23,856)	(6,301)
15	90,000	-	6,145	83,855	(42,263)	68,290	-	(26,698)	(32,999)
16	200,000	100,000	-	100,000	(50,400)	-	-	149,600	116,601
Totals	$1,550,000	$ 1,000,000	$516,530	$ 33,470	$ (16,869)	$600,000	$ 100,000	$ 116,601	

842-50-55-9 Allocation of annual cash flow to investment and income follows.

	1	2	3	4	5	6	7
		Annual Cash Flow			Components of Income [(a)]		
Year	Lessor's Net Investment at Beginning of Year	Total (from Col. 8 of Paragraph 842-50-55-8)	Allocated to Investment	Allocated to Income [(b)]	Pretax Income	Tax Effect of Pretax Income	Investment Tax Credit
1	$ 400,000	$ 169,421	$ 134,833	$ 34,588	$ 9,929	$ (5,004)	$ 29,663
2	265,167	119,923	96,994	22,929	6,582	(3,317)	19,664
3	168,173	89,769	75,227	14,542	4,174	(2,104)	12,472
4	92,946	71,525	63,488	8,037	2,307	(1,163)	6,893
5	29,458	53,182	50,635	2,547	731	(368)	2,184
6	(21,177)	18,616	18,616	-	-	-	-
7	(39,793)	(9,553)	(9,553)	-	-	-	-
8	(30,240)	(11,108)	(11,108)	-	-	-	-
9	(19,132)	(12,803)	(12,803)	-	-	-	-
10	(6,329)	(14,649)	(14,649)	-	-	-	-
11	8,320	(16,663)	(17,382)	719	206	(104)	617
12	25,702	(18,857)	(21,079)	2,222	637	(321)	1,906
13	46,781	(21,248)	(25,293)	4,045	1,161	(585)	3,469
14	72,074	(23,856)	(30,088)	6,232	1,789	(902)	5,345
15	102,162	(26,698)	(35,532)	8,834	2,536	(1,278)	7,576
16	137,694	149,600	137,694	11,906	3,418	(1,723)	10,211
Totals		$ 516,601	$ 400,000	$ 116,601	$ 33,470	$ (16,869)	$ 100,000

(a) Lease income is recognized as 8.647% of the unrecovered investment at the beginning of each year in which the net investment is positive. The rate is that rate which, if applied to the net investment in the years in which the net investment is positive, will distribute the net income (net cash flow) to those years.

(b) Each component is allocated among the years of positive net investment in proportion to the allocation of net income in column 4.

842-50-55-10 Illustrative journal entries for the year ending December 31, 1975, follow.

Lessor's Initial Investment		Debit	Credit
Rentals receivable (table in paragraph 842-50-55-8, total of column 1 minus residual value, minus totals of columns 3 and 6)		$ 233,470	
Investment tax credit receivable (table in paragraph 842-50-55-8, column 7)		100,000	
Estimated residual value (paragraph 842-50-55-7)		200,000	
Unearned and deferred income (table in paragraph 842-50-55-9, totals of columns 5 and 7)			$133,470
Cash			400,000
Record lessor's initial investment			
First Year of Operation			
Journal Entry 1			
Cash		15,565	
Rentals receivable (table in paragraph 842-50-55-8, column 1 minus columns 3 and 6)			15,565
Collection of first year's net rental			
Journal Entry 2			
Cash [(a)]		100,000	
Investment tax credit receivable (table in paragraph 842-50-55-8, column 7)			100,000
Receipt of investment tax credit			
Journal Entry 3			
Unearned and deferred income		9,929	
Income from leveraged leases (table in paragraph 842-50-55-9, column 5)			9,929
Recognition of first year's portion of pretax income allocated in the same proportion as the allocation of total income			
(34,588 ÷ 116,601) × 33,470 = 9,929			
Journal Entry 4			
Unearned and deferred income		29,663	
Investment tax credit recognized (table in paragraph 842-50-55-9, column 7)			29,663
Recognition of first year's portion of investment tax credit allocated in the same proportion as the allocation of total income			
(34,588 ÷ 116,601) × 100,000 = 29,663			
Journal Entry 5			
Cash (table in paragraph 842-50-55-8, column 5) [(a)]		53,856	
Income tax expense (table in paragraph 842-50-55-9, column 6)		5,004	
Deferred taxes			58,860
To record receipt of first year's tax credit from lease operation, to charge income tax expense for tax effect of pretax accounting income, and to recognize as deferred taxes the tax effect of the difference between pretax accounting income and the tax loss for the year, calculated as follows:			
Tax loss (table in paragraph 842-50-55-8, column 4)	$(106,857)		
Pretax accounting income	9,929		
Difference	$(116,786)		
Deferred taxes ($116,786 × 50.4%)	$ 58,860		

(a) Receipts of the investment tax credit and other tax benefits are shown as cash receipts for simplicity only. Those receipts probably would not be in the form of immediate cash inflow. Instead, they likely would be in the form of reduced payments of taxes on other income of the lessor or on the combined income of the lessor and other entities whose operations are joined with the lessor's operations in a consolidated tax return.

842-50-55-11 The following are illustrative partial financial statements including notes.

BALANCE SHEET

ASSETS	December 31, 1976	December 31, 1975	LIABILITIES	December 31, 1976	December 31, 1975
Investment in leveraged leases	$334,708	$324,027	Deferred taxes arising from leveraged leases	$166,535	$ 58,860

INCOME STATEMENT

(Ignoring all income and expense items other than those relating to leveraged leasing)

	1976	1975
Income from leveraged leases	$ 6,582	$ 9,929
Income before taxes and investment tax credit	6,582	9,929
Less: Income tax expense [(a)]	(3,317)	(5,004)
	3,265	4,925
Investment tax credit recognized [(a)]	19,664	29,663
Net income	$ 22,929	$ 34,588

(a) These two items may be netted for purposes of presentation in the income statement, provided that the separate amounts are disclosed in a note to financial statements.

The following are notes to the illustrative financial statements included in this Example.

Investment in Leveraged Leases

Entity is the lessor in a leveraged lease agreement entered into in 1975 under which mining equipment having an estimated economic life of 18 years was leased for a term of 15 years. Entity's equity investment represented 40 percent of the purchase price; the remaining 60 percent was furnished by third-party financing in the form of long-term debt that provides for no recourse against Entity and is secured by a first lien on the property. At the end of the lease term, the equipment is turned back to Entity. The residual value at that time is estimated to be 20 percent of cost. For federal income tax purposes, Entity receives the investment tax credit and has the benefit of tax deductions for depreciation on the entire leased asset and for interest on the long-term debt. During the early years of the lease, those deductions exceed the lease rental income, and substantial excess deductions are available to be applied against Entity's other income. In the later years of the lease, rental income will exceed the deductions and taxes will be payable. Deferred taxes are provided to reflect this reversal. Entity's net investment in leveraged leases is composed of the following elements.

	December 31,	
	1976	1975
Rentals receivable (net of principal and interest on the nonrecourse debt)	$ 202,340	$ 217,905
Estimated residual value of leased assets	200,000	200,000
Less: Unearned and deferred income	(67,632)	(93,878)
Investment in leveraged leases	334,708	324,027
Less: Deferred taxes arising from leveraged leases	(166,535)	(58,860)
Net investment in leveraged leases	$ 168,173	$ 265,167

842-50-55-12 Allocation of annual cash flow to investment and income follows, revised to include new residual value estimate.

	1	2	3	4	5	6	7
		Annual Cash Flow			Components of Income		
Year	Lessor's Net Investment at Beginning of Year	Total	Allocated to Investment	Allocated to Income [(a)]	Pretax Loss	Tax Effect of Pretax Loss	Investment Tax Credit
1	$ 400,000	$ 169,421	$ 142,458	$ 26,963	$ (16,309)	$ 8,220	$ 35,052
2	257,542	119,923	102,563	17,360	(10,501)	5,293	22,568
3	154,979	89,769	79,323	10,446	(6,319)	3,184	13,581
4	75,656	71,525	66,425	5,100	(3,085)	1,555	6,630
5	9,231	53,182	52,560	622	(377)	190	809
6	(43,329)	18,616	18,616	-	-	-	-
7	(61,945)	(9,553)	(9,553)	-	-	-	-
8	(52,392)	(11,108)	(11,108)	-	-	-	-
9	(41,284)	(12,803)	(12,803)	-	-	-	-
10	(28,481)	(14,649)	(14,649)	-	-	-	-
11	(13,832)	(16,663)	(16,663)	-	-	-	-
12	2,831	(18,857)	(19,048)	191	(115)	58	248
13	21,879	(21,248)	(22,723)	1,475	(892)	450	1,917
14	44,602	(23,856)	(26,862)	3,006	(1,819)	916	3,909
15	71,464	(26,698)	(31,515)	4,817	(2,914)	1,469	6,262
16	102,979	109,920	102,979	6,941	(4,199)	2,116	9,024
Totals		$ 476,921	$ 400,000	$ 76,921	$ (46,530)	$ 23,451	$ 100,000

(a) The revised allocation rate is 6.741%.

842-50-55-13 Balances in investment accounts before revised estimate of residual value follow.

	1	2	3	4	5	6	7
				Unearned and Deferred Income			
	Rentals Receivable [(a)]	Estimated Residual Value	Investment Tax Credit Receivable	Pretax Income (Loss) [(b)]	Investment Tax Credit [(c)]	Deferred Taxes [(d)]	Net Investment (Col. 1+2+3) less (Col. 4 + 5 + 6)
Initial investment	$ 233,470	$200,000	$ 100,000	$ 33,470	$ 100,000	$ -	$ 400,000
Changes in year of operation							
1	(15,565)	-	(100,000)	(9,929)	(29,663)	58,860	(134,833)
2	(15,565)	-	-	(6,582)	(19,664)	107,675	(96,994)
3	(15,565)	-	-	(4,174)	(12,472)	76,308	(75,227)
4	(15,565)	-	-	(2,307)	(6,893)	57,123	(63,488)
5	(15,565)	-	-	(731)	(2,184)	37,985	(50,635)
6	(15,565)	-	-	-	-	3,051	(18,616)
7	(15,565)	-	-	-	-	(25,118)	9,553
8	(15,564)	-	-	-	-	(26,672)	11,108
9	(15,564)	-	-	-	-	(28,367)	12,803
10	(15,565)	-	-	-	-	(30,214)	14,649
Balances, beginning of eleventh year	$ 77,822	$200,000	$ -	$ 9,747	$ 29,124	$230,631	$ 8,320

(a) Table in paragraph 842-50-55-8, column 1, excluding residual value, minus columns 3 and 6.
(b) Table in paragraph 842-50-55-9, column 5.
(c) Table in paragraph 842-50-55-9, column 7.
(d) 50.4% of difference between taxable income (loss) in column 4 of the table in paragraph 842-50-55-8 and pretax accounting income (loss) in column 5 of the table in paragraph 842-50-55-9.

842-50-55-14 Illustrative journal entries involving a reduction in residual value follow.

		Debit	Credit
Journal Entry 1			
Pretax income (or loss)		$ 60,314	
Unearned and deferred income		27,450	
Pretax income (loss):			
Balance at end of tenth year	$ 9,747 [(a)]		
Revised balance	(9,939) [(b)]		
Adjustment	(19,686)		
Deferred investment tax credit:			
Balance at end of tenth year	29,124 [(c)]		
Revised balance	21,360 [(d)]		
Adjustment	(7,764)		
Investment tax credit recognized			$ 7,764
Estimated residual value			80,000

To record:

a. The cumulative effect on pretax income and the effect on future income resulting from the decrease in estimated residual value:

Reduction in estimated residual value	$80,000
Less portion attributable to future years (unearned and deferred income)	(19,686)
Cumulative effect (charged against current income)	$60,314

b. The cumulative and future effect of the change in allocation of the investment tax credit resulting from the reduction in estimated residual value

		Debit	Credit
Journal Entry 2			
Deferred taxes		30,398	
Income tax expense			30,398

To recognize deferred taxes for the difference between pretax accounting income (or loss) and taxable income (or loss) for the effect of the reduction in estimated residual value:

Pretax accounting loss per Journal Entry 1	$(60,314)
Tax income (or loss)	-
Difference	$(60,314)
Deferred taxes ($60,314 × 50.4%)	$(30,398)

(a) Table in paragraph 842-50-55-13, column 4.

(b) Table in paragraph 842-50-55-12, total of column 5 minus amounts applicable to the first 10 years.

(c) Table in paragraph 842-50-55-13, column 5.

(d) Table in paragraph 842-50-55-12, total of column 7 minus amounts applicable to the first 10 years.

842-50-55-15 Adjustment of investment accounts for revised estimates of residual value follows.

	1	2	3	4	5	6
			Unearned and Deferred Income			Net Investment
	Rentals Receivable	Estimated Residual Value	Pretax Income (Loss)	Investment Tax Credit	Deferred Taxes	(Col. 1 + 2) less (Col. 3 + 4 + 5)
Balances, beginning of eleventh year (table in paragraph 842-50-55-13)	$ 77,822	$200,000	$ 9,747	$ 29,124	$230,631	$ 8,320
Adjustment of estimated residual value and unearned and deferred income (table in paragraph 842-50-55-14, Journal Entry 1)	-	(80,000)	(19,686)	(7,764)	-	(52,550)
Adjustment of deferred taxes for the cumulative effect on pretax accounting income (table in paragraph 842-50-55-14, Journal Entry 2)	-	-	-	-	(30,398)	30,398
Adjusted balances, beginning of eleventh year	$ 77,822	$120,000	$(9,939)	$ 21,360	$200,233	$ (13,832) [(a)]

(a) Table in paragraph 842-50-55-12, column 1.

> > Example 2: Income Taxes Related to a Leveraged Lease

842-50-55-16 This Example illustrates integration of the results of a lessor's income tax accounting for leveraged leases (in accordance with the guidance in this Subtopic) with the other results of accounting for income taxes as required by Topic 740.

842-50-55-17 At the end of Year 1 (the current year), an entity has two temporary differences.

842-50-55-18 The first temporary difference is for a leveraged lease that was entered into in a prior year. During Year 1, the enacted tax rate for Year 2 and thereafter changes from 40 percent to 35 percent.

842-50-55-19 After adjusting for the change in estimated total net income from the lease as a result of the change in tax rates, the components of the investment in the leveraged lease at the end of Year 1 are as follows.

Net rentals receivable plus residual value minus unearned pretax income		$ 150,000
Reduced by:		
Deferred investment tax credit	$9,000	
Deferred tax credits	39,000	48,000
Net investment in leveraged lease for financial reporting		$ 102,000

842-50-55-20 The second temporary difference is a $120,000 estimated liability for warranty expense that will result in a tax deduction in Year 5 when the liability is expected to be paid. Absent consideration of the deferred tax credits attributable to the leveraged lease, the weight of available evidence indicates that a valuation allowance is needed for the entire amount of the deferred tax asset related to that $120,000 deductible temporary difference.

842-50-55-21 The tax basis of the investment in the leveraged lease at the end of Year 1 is $41,000. The amount of the deferred tax liability for that leveraged lease that would otherwise result from the application of guidance in Topic 740 on income taxes is determined as follows.

Net rentals receivable plus residual value minus unearned pretax income	$ 150,000
Temporary difference for deferred investment tax credit	9,000
	141,000
Tax basis of leveraged lease	41,000
Temporary difference	$ 100,000
Deferred tax liability (35 percent)	$ 35,000

842-50-55-22 Loss carryback (to Year 2) and loss carryforward (to Year 20) of the $120,000 tax deduction for warranty expense in Year 5 would offset the $100,000 of taxable amounts resulting from future recovery of the net investment in the leveraged lease over the remainder of the lease term.

842-50-55-23 At the end of Year 1, the entity recognizes a $42,000 ($120,000 at 35 percent) deferred tax asset and a related $7,000 valuation allowance. The effect is to recognize a $35,000 net deferred tax benefit for the reduction in deferred tax credits attributable to the leveraged lease. Deferred tax credits attributable to the leveraged lease determined under the guidance in this Subtopic are $39,000.

However, the deferred tax liability determined is only $35,000. The $4,000 difference is not available for offsetting.

> > Example 3: Effect of Advance Payments and Deposits on Recalculation of a Leveraged Lease

842-50-55-24 This Example illustrates how (in accordance with the guidance in paragraph 842-50-35-13 and other paragraphs) a lessor would include advance payments and deposits in a recalculation of a leveraged lease resulting from a determination by the lessor that it would enter into a settlement of a tax position arising from a leveraged lease.

842-50-55-25 This Example assumes that the lessor has concluded that the position originally taken on the tax return would meet the more-likely-than-not threshold in Subtopic 740-10 on income taxes. It also assumes that the lessor would conclude that the estimate of $50 for the projected lease-in, lease-out settlement is consistent with the measurement guidance in that Subtopic.

842-50-55-26 A lessor makes an advance payment of $25 on July 1, 2007, $10 of which is estimated to be associated with issues arising from a lease-in, lease-out transaction. On July 1, 2007, the lessor changes its assumption about the timing of the tax cash flows and projects a settlement with the Internal Revenue Service on September 1, 2009. The projected settlement would result in a payment to the taxing authority of $125 of which $50 is associated with the lease-in, lease-out transaction. On July 1, 2007, when the lessor recalculates the leveraged lease, the lessor would include a $50 cash flow on September 1, 2009, as a projected outflow in the leveraged lease recalculation.

> > Example 4: Leveraged Lease Acquired in a Business Combination or an Acquisition by a Not-for-Profit Entity

842-50-55-27 This Example illustrates one way that a lessor's investment in a leveraged lease might be valued by the acquiring entity in a business combination or an acquisition by a not-for-profit entity and the subsequent accounting for the investment in accordance with the guidance in this Subtopic. The elements of accounting and reporting illustrated for this Example are as follows:

a. Acquiring entity's cash flow analysis by years (see paragraph 842-50-55-29)
b. Acquiring entity's valuation of investment in the leveraged lease (see paragraph 842-50-55-30)
c. Acquiring entity's allocation of annual cash flow to investment and income (see paragraph 842-50-55-31)
d. Journal entry for recording allocation of purchase price to net investment in the leveraged lease (see paragraph 842-50-55-32)
e. Journal entries for the year ending December 31, 1984 (Year 10 of the lease) (see paragraph 842-50-55-33).

842-50-55-28 This Example has the following terms and assumptions.

Cost of leased asset (equipment)	$1,000,000
Lease term	15 years, dating from January 1, 1975
Lease rental payments	$90,000 per year (payable last day of each year)
Residual value	$200,000 estimated to be realized 1 year after lease termination
Financing:	
Equity investment by lessor	$400,000
Long-term nonrecourse debt	$600,000, bearing interest at 9% and repayable in annual installments (on last day of each year) of $74,435.30
Depreciation allowable to lessor for income tax purposes	7-year asset depreciation range life using double-declining-balance method for the first 2 years (with the half-year convention election applied in the first year) and sum-of-years digits method for remaining life, depreciated to $100,000 salvage value
Lessor's income tax rate (federal and state)	50.4% (assumed to continue in existence throughout the term of the lease)
Investment tax credit	10% of equipment cost or $100,000 (realized by the lessor on last day of first year of lease)
Initial direct costs	For simplicity, initial direct costs have not been included in the illustration
Date of business combination	January 1, 1982
Tax status of business combination	Nontaxable transaction
Appropriate interest rate for valuing net-of-tax return on investment	4½%

842-50-55-29 Acquiring entity's cash flow analysis by years follows.

	1	2	3	4	5	6	7
Year	Gross Lease Rentals and Residual Value	Depreciation (for Income Tax Purposes)	Loan Interest Payments	Taxable Income (Col. 1 – 2 – 3)	Income Tax (Charges) (Col. 4 × 50.4%)	Loan Principal Payments	Annual Cash Flow (Col. 1 – 3 + 5 – 6)
8	$ 90,000	-	$ 37,079	$ 52,921	$ (26,672)	$ 37,357	$ (11,108)
9	90,000	-	33,717	56,283	(28,367)	40,719	(12,803)
10	90,000	-	30,052	59,948	(30,214)	44,383	(14,649)
11	90,000	-	26,058	63,942	(32,227)	48,378	(16,663)
12	90,000	-	21,704	68,296	(34,421)	52,732	(18,857)
13	90,000	-	16,957	73,043	(36,813)	57,478	(21,248)
14	90,000	-	11,785	78,215	(39,420)	62,651	(23,856)
15	90,000	-	6,145	83,855	(42,263)	68,290	(26,698)
16	200,000	$ 100,000	-	100,000	(50,400)	-	149,600
Totals	$ 920,000	$ 100,000	$183,497	$ 636,503	$ (320,797)	$411,988	$ 3,718

842-50-55-30 Acquiring entity's valuation of investment in the leveraged lease follows.

Cash Flow	Present Value at 4½% Net-of-Tax Rate
1. Rentals receivable (net of principal and interest on the nonrecourse debt) ($15,564.70 at the end of each year for 8 years)	$ 102,663
2. Estimated residual value ($200,000 realizable at the end of 9 years)	134,581
3. Future tax payments (various amounts payable over 9 years—see the table in paragraph 842-50-55-29)	(253,489)
Net present value	$ (16,245)

842-50-55-31 Acquiring entity's allocation of annual cash flow to investment and income follows (see footnote (a)).

	1	2	3	4	5	6
		Annual Cash Flow			Components of Income [(b)]	
Year	Net Investment at Beginning of Year	Total from Col. 7 of the Table in Paragraph 842-50-55-29	Allocated to Investment	Allocated to Income [(a)]	Pretax Income	Tax Effect of Pretax Income
8	$ (16,245)	$ (11,108)	$ (11,108)	-	-	-
9	(5,137)	(12,803)	(12,803)	-	-	-
10	7,666	(14,649)	(14,973)	$ 324	$ 5,530	$ (5,206)
11	22,639	(16,663)	(17,621)	958	16,353	(15,395)
12	40,260	(18,857)	(20,561)	1,704	29,087	(27,383)
13	60,821	(21,248)	(23,822)	2,574	43,937	(41,363)
14	84,643	(23,856)	(27,439)	3,583	61,160	(57,577)
15	112,082	(26,698)	(31,443)	4,745	80,995	(76,250)
16	143,525	149,600	143,525	6,075	103,698	(97,623)
Totals		$ 3,718	$ (16,245)	$ 19,963	$ 340,760	$ (320,797)

(a) Lease income is recognized as 4.233% of the unrecovered investment at the beginning of each year in which the net investment is positive. The rate is that rate which, if applied to the net investment in the years in which the net investment is positive, will distribute the net income (net cash flow) to those years.

(b) Each component is allocated among the years of positive net investment in proportion to the allocation of net income in column 4. Journal Entry 2 in the table in paragraph 842-50-55-33 includes an example of this computation.

842-50-55-32 Illustrative journal entry for recording allocation of purchase price to net investment in the leveraged lease follows.

Rentals receivable (table in paragraph 842-50-55-29, total of column 1 minus residual value, minus totals of columns 3 and 6)	$ 124,515	
Estimated residual value (paragraph 842-50-55-28)	200,000	
Purchase price allocation clearing account (paragraph 842-50-55-30, present value)	16,245	
Unearned and deferred income (paragraph 842-50-55-30, present value, minus total of rentals receivable and estimated residual value)		$ 340,760

842-50-55-33 Illustrative journal entries for year ending December 31, 19Y4, follows.

Third Year of Operation after the Business Combination (Year 10 of the Lease)

Journal Entry 1		
Cash	$15,565	
Rentals receivable (table in paragraph 842-50-55-29, column 1 minus columns 3 and 6)		$15,565
Collection of year's net rental		
Journal Entry 2		
Unearned and deferred income	$ 5,530	
Income from leveraged leases (table in paragraph 842-50-55-31, column 5)		$ 5,530
Recognition of pretax income for the year allocated in the same proportion as the allocation of total income computed as follows:		
([$324 ÷ $19,963] × $340,760 = $5,530)		
Journal Entry 3		
Deferred taxes (table in paragraph 842-50-55-29, column 5, minus table in paragraph 842-50-55-31, column 6)	$25,008	
Income tax expense (table in paragraph 842-50-55-31, column 6)	5,206	
Cash (table in paragraph 842-50-55-29, column 5)		$30,214
To record payment of tax for the year		