The New Lease Accounting Standards

4 CPE Hours

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THE NEW LEASE ACCOUNTING STANDARDS

Course Abstract

This course provides an in-depth overview of the new lease accounting standards issued by the Financial Accounting Standards Board (FASB) in February 2016. This includes a discussion of the primary reasons for the change as well as how to identify a lease within a contract. This course also provides an in-depth review of lease classification, initial measurement, subsequent measurement, presentation & disclosure, as well as transition requirements. The course concludes with a discussion of some of the significant differences between IFRS 16 (the IASB's new lease accounting standard) as well as private company considerations.

Learning Objectives

Upon completion of this course, you will be able to:

- ❑ Recognize how the new leasing standard has evolved and how the new standard is organized
- ❑ Determine whether an arrangement contains a lease
- ❑ Identify considerations with respect to substitution rights and decision-making rights
- ❑ Identify the criteria for the new finance lease and short-term leases
- ❑ Recognize the new recognition and measurement requirements for both lessees and lessors
- ❑ Identify the recognition criteria for sales-type, direct financing, and operating leases
- ❑ Identify the overall requirements with respect to lease modifications
- ❑ Identify the criteria used for sale and leaseback transactions
- ❑ Identify the considerations with respect to a lessee's involvement in construction of a leased asset
- ❑ Identify the presentation requirements for both lessees and lessors
- ❑ Recognize both qualitative and quantitative disclosure requirements for both lessees and lessors
- ❑ Identify the effective date for the new lease accounting standards
- ❑ Identify the significant differences between ASC 842 and IFRS 16
- ❑ Recognize considerations of and alternatives provided to private companies

Field of Study	Accounting
Level of Knowledge	Overview
Prerequisite:	General understanding of FASB
Advanced Preparation	None
Recommended CPE hours	4
Course Qualification	Qualifies for National Registry of CPE Sponsors QAS Self-Study credit
CPE Sponsor Information	NASBA Registry Sponsor #138298
Publication Date	September 15, 2018
Expiration Date	September 15, 2019
Deadline to Complete the Course	One year from the date of purchase to complete the examination and submit it to our office for grading

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Under the NASBA-AICPA self-study standards, self-study sponsors are required to present review questions intermittently throughout each self-study course. Additionally, feedback must be given to the course participant in the form of answers to the review questions and the reason why answers are correct or incorrect.

To obtain the maximum benefit from this course, we recommend that you complete each of the following questions, and then compare your answers with the solutions that follow at the end of course. *These questions and related suggested solutions are not part of the final examination and will not be graded by the sponsor.*

Introduction

Nearly 10 years ago in 2006, the FASB and the International Accounting Standards Board (IASB) commenced a joint project to improve the financial reporting of lease activities. Nearly 10 years later, on February 25, 2016, the FASB released the final revised accounting standards with respect to leasing activities through the issuance of FASB Accounting Standards Update (ASU) No. 2016-02, Leases. This was only shortly after the IASB released its final version of IFRS 16, Leases, on January 13, 2016.

While the intent of the joint project was to align the GAAP and IFRS versions of the standards, this was not the end result as the two organizations went their separate ways throughout the development process.

What Drove the Change?

Current lease accounting standards do not require that lessees recognize assets and liabilities that arise from operating leases. However, recognition is required as it relates to capital leases. The FASB concluded that based on this disconnect between the different accounting models, coupled with the fact that it is common to structure lease transactions to avoid balance sheet recognition, the previous accounting model did not meet the needs of users of financial statements. As a result, the current lease accounting standards resulted in two significantly different accounting models. One model, reflects a situation where a lessee appropriately reflects an asset and liability resulting from a lease transaction. The other model, results in favorable, off-balance sheet recognition. Herein lies the fundamental goal of the joint project to improve the financial reporting for lease transactions – recognize the lease assets and lease liabilities for operating leases.

Based on the final amended accounting standards now prescribed within ASC Topic No 842, Leases, this goal was accomplished by the FASB. Operating leases, with certain exceptions discussed in this course, are now required to be reflected on a company's balance sheet.

In March 2009, the FASB and the IASB ("the Boards") published a Discussion Paper, Leases: Preliminary Views, which established their views on lessee accounting. Included within this paper was the proposal to implement a right-of-use accounting model. Simply put, this model requires that a lessee recognize both an asset and a liability at the commencement date of a lease. Based on over 300+ comment letters received from various stakeholders, the Boards published an Exposure Draft (ED) in August 2010. This first ED released resulted in the receipt of over 750 comment letters from stakeholders across a range of industries. As a result of the volume of these comment letters and other extensive consultations through various roundtable discussions across the world, the Boards concluded that it was not possible to reflect the views of all the stakeholders in a single uniform lease accounting model.

The Boards published a second joint ED in 2013 which, among other changes reflected based on the significant feedback to the 2010 ED, proposed the use of two different approaches. These two different approaches served to differentiate between a lessee's consumption of the economic benefits embedded in the underlying asset. As a result, the second ED scaled back the more universally applied right-of-use asset proposed in the first ED to accommodate the differing economics among various types of leasing arrangements.

The second ED resulted in the receipt of just over 650 comment letters. Like the first ED, feedback received on the second ED resulted in continued support for the recognition of a right-to-use asset and a lease liability. However, many stakeholders felt that previous lease accounting guidance could be improved with enhanced disclosure requirements instead of significant changes in recognition and measurement requirements. Accordingly, there was not widespread support across the various industries for the significant changes.

The Final Revised Standard

The FASB issued the final lease standards in February 2016. While the project started as a joint project with the IASB, and in the end reached a significant number of the same conclusions, certain differences resulted primarily in the area of the lease accounting model. The FASB included the new guidance within the new ASC 842 instead of modifying the current lease accounting standards within ASC 840.

The ASU affects all companies and other organizations that lease assets such as ships, airplanes, construction equipment, and real estate. For public companies, the ASU is effective for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2018. For other organizations not considered a public company, the guidance is effective one year after. Refer to Exhibit 1-1 below which illustrates some of the key improvements noted by the FASB on account of the new standards.

Exhibit 1-1: Lease Accounting Improvements[1]

- More faithful representation of a lessee's rights and obligations arising from leases;
- Fewer opportunities for organizations to structure leasing transactions to achieve a particular outcome on the balance sheet;
- Improvements in the understanding and comparability of a lessee's financial statements;
- Alignment of lessor accounting and sale & leaseback transactions with comparable revenue guidance in the 2014 revenue recognition standard;
- Additional information about lessors' leasing activities and exposure to credit and asset risk as a result of leasing;
- Clarification of the definition of a lease to address practice issues within current GAAP such the concept of control, used predominantly in standards with respect to revenue recognition and consolidations;

Standards Organization

It is important to ensure that you have a good understanding of the way in which the new lease accounting standards are organized throughout the ASC. ASC 842 is organized under the five primary subtopics as follows:

- 10 – Overall
- 20 – Lessee
- 30 – Lessor
- 40 – Sale and Leaseback Transactions
- 50 – Leveraged Lease Arrangements

The "10-Overall" subtopic above is applicable to all types of leasing transactions, whether a company is a lessee or lessor, and is the only subtopic retained from the previous ASC 840 literature (as far as organization). In other words, this is the overall guidance that should be referred to with respect to all leasing transactions. Entities should also refer to the other subtopics listed above as applicable depending on the particular facts and circumstances of the lease transaction. For example, a lessee should apply the standards included within ASC 842-20.

If you were to review the organization of ASC 840, you will note that the organization of the new leasing standards is different. The previous leasing standards were more transaction focused and lease classification specific, whereas the new leasing standards are more based on the type of participant in the lease transaction.

[1] FASB in Focus, *Accounting Standards Update No. 2016-02, Leases (Topic 842).*

review question...

1. **The new leasing standards prescribed by ASU 2016-02 superseded which of the following ASC Topics?**
   a. ASC 840.
   b. ASC 845.
   c. ASC 605.
   d. ASC 250.

Refer to the Solutions to Review Questions on pages 118-120

Is an Arrangement a Lease?

One of the first considerations with respect to the revised lease accounting standards is whether an arrangement is considered a lease and within the scope of the new standards. The determination of whether an arrangement contains a lease or a service agreement is critical because there are differences in accounting for each type of arrangement.

So what is considered a lease under the new standards? Refer to Exhibit 1-2 below which provides an overview of the new definition of a lease under the new lease accounting standards.

Exhibit 1-2: New Lease Definition

A contract, or part of a contract, that conveys the right to control the use of identified property, plant, or equipment (an identified asset) for a period of time in exchange for consideration.

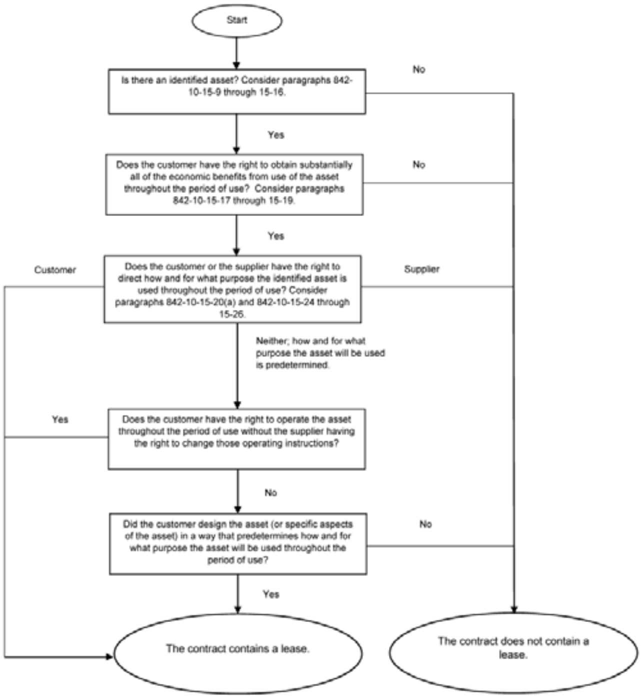
There are distinct differences in the revised definition for a lease. For starters, the definition refers specifically to a contract. Secondly, the definition specifically includes the term "control" within the context of the lease. And finally, the definition includes mention of the fact that a lease requires an "exchange of consideration". All of these characteristics were not found in the previous definition of a lease. Refer to Exhibit 1-2 below for an overview of the previous definition of a lease.

Exhibit 1-3: Existing Lease Definition

An agreement conveying the right to use property, plant, or equipment (land and/or depreciable assets) usually for a stated period of time.

The FASB notes within its Basis for Conclusions (BC) that in most cases, the assessment of whether a contract contains a lease should be straightforward. To this end, a contract either will fail to meet the definition of a lease by failing to meet many of the requirements or will clearly meet the requirements to be a lease without requiring a significant amount of judgment.

Now that you have an understanding of what is considered a lease, it's important to review the steps involved in determining whether a contract a company enters into actually is a lease. To assist in this determination, the FASB has included a flowchart within the implementation guidance section of ASC 842. Refer to this flowchart included below (ASC 842-10-55-1).



Identified Asset

As noted from the flowchart above, the first step in assessing whether a contract is a lease is to determine whether an asset has been identified. This determination of whether an asset has been identified within a contract can either be made explicitly or implicitly. As a result, the key point to note is that when assessing whether there is an identified asset, a company does not have to be able to identify the particular asset in order to conclude that there is an identified asset. A company simply needs to know whether an asset is needed to fulfill the contract to meet this first requirement. Another consideration with respect to determining whether an asset is specified within a contract relates to substitution rights. Simply put, a company cannot conclude that it has the right to use an identified asset if the supplier has the substantive right to substitute the asset throughout the period of use (ASC 842-10-15-10). So the next obvious question is what is considered substantive substitution rights? To this question, two specific conditions must exist within the contract in order for a supplier's substitution rights to be considered substantive. This includes the following (ASC 842-10-15-10):

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

The overall principle with respect to substitution rights is that they should be evaluated based on the facts and circumstances at the inception of the contract and should not take into account certain future events that are not likely to occur. The FASB provides examples of these future events that should not be taken into account include (ASC 842-10-15-11):

- An agreement by a future customer to pay an above-market rate for use of the asset
- The introduction of new technology that is not substantially developed at inception of the contract
- A substantial difference between the customer's use of the asset, or the performance of the asset and the use or performance considered likely at inception of the contract
- A substantial difference between the market price of the asset during the period of use and the market price considered likely at inception of the contract

As you can likely note from above, the determination of whether the rights are substantive requires professional judgment. Furthermore, there may be instances when a company is not able to make a determination of whether the supplier's substitution rights are substantive.

Right to Control Use of the Asset

The next question after concluding that a contract involves the use of an identified asset is to determine whether a company has the right to control the use of that asset. This assessment is two-fold and comprises the consideration of both power and benefits regarding use of the asset.

In the previous leasing standards, the assessment of whether a company had the right to control the use of the asset was based solely on the amount of the output a company would receive from that asset. Said another way, determining how much of the benefits of the asset a company would receive was the primary consideration for determining control and whether the arrangement resulted in the determination that it was in fact a lease. With the new leasing standards, a company is now required to both assess the benefits received from the asset and assess whether they have the ability to direct the use of the asset. As a result, a company has control of an asset if it has both the power to direct the use and receives substantially all of the economic benefits from the use of the asset.

A company has the right to direct the use of the asset throughout the period of use in either of the following situations (ASC 842-10-15-20):

- The entity has the right to direct how and for what purpose the asset is used throughout the period of use
- The decisions about how and for what purpose the

asset will be used are predetermined and at least one of the following conditions exist

- The entity has the right to operate the asset (or direct others to operate) throughout the period of use without the supplier having the right to change those operating instructions
- The customer designed the asset (or specific aspects of it) in a way that predetermines how and for what purpose the asset will be used throughout the period of use

When assessing whether a company has the right to direct the use of an asset, the assessment should only take into account the rights to make decisions about the use of the asset during the period of use. As a result, a company should not consider decisions that are predetermined before the period of use (ASC 842-10-15-22).

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

So how does a company make the determination that its decision-making rights are in fact relevant? In short, decision-making rights are relevant when they affect the economic benefits to be derived from the use of the asset (ASC 842-10-15-24). Obviously, decision-making rights are very likely to be different from contract to contract and industry to industry. The FASB does include some practical examples of these decision-making rights that would suggest that a company has the power to direct the use of an asset. These include rights such as the right to change the type of output, the right to change when the output is produced, the right to change where the output is produced, and the right to change whether the output is produced.

Illustrative Examples – Determining Whether a Contract Contains a Lease

The following exhibits summarize and provide illustrative examples of the application guidance prescribed within ASC 842 (subtopic 55). These examples illustrate situations that do and do not contain a lease across various industries and different types of contracts. Refer to the following exhibits below.

Exhibit 1-4: Rail Cars – Illustrative Example (ASC 842-10-55-42 thru 51)

Case A – Contract Contains a Lease

A contract between a customer and a freight carrier (the Supplier) provides the customer with the use of 10 rail cars of a particular type for 5 years. The contract specifies the rail cars and the cars are owned by the Supplier. However, the 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 the customer's premises and the customer can use the cars for another purpose (for example, storage) if it so chooses. However, the contract specifies that the customer cannot transport particular types of cargo (for example, explosives).

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

Lease Analysis

The contract contains a leases of rail cars. There are 10 identified cars explicitly specified in the contract. Once delivered to the 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.

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

Exhibit 1-4 (continued)

Case B – Contract Does Not Contain a Lease

The contract between Customer and Supplier requires Supplier to transport a specified quantity of goods by using a specified type of rail car in accordance with a stated timetable for a period of five years. The timetable and quantity of goods specified are equivalent to Customer having the use of 10 rail cars for 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.

Lease Analysis

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

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

Accordingly, the 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.

Exhibit 1-5: Ship – Illustrative Example (ASC 842-10-55-79 thru 91)

Case A – Contract Contains a Lease

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

Lease Analysis

The contract does not contain a lease. There is an identified asset and the Supplier does not have the right to substitute. Additionally, the customer has the right to obtain substantially all of the economic benefits from use of the ship over the period of use. Finally, 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.

However, the Customer does not have the right to control the use of the ship because it does not have the right to direct its use. In other words, the 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. The customer has no right to change how and for what purpose the ship is used during the period of use. Additionally, the customer has no other decision-making rights about the use of the ship during the period of use (for example, it does not have the right to operate the ship) and did not design the ship. As a result, the 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 Does Not Contain a Lease

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

Exhibit 1-5 (continued)

Lease Analysis

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

Exhibit 1-6: Contract for Energy – Illustrative Example (ASC 842-10-55-108 thru 123)

Case A – Contract Contains a Lease (1st Example)

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.).

Exhibit 1-6 (continued)

Lease Analysis

The contract contains a lease. Customer has the right to use the solar farm for 20 years and there is an identified asset because the solar farm is explicitly specified in the contract, and Supplier does not have the right to substitute the specified solar farm. Additionally, Customer has the right to control the use of the solar farm throughout the 20-year period of use because Customer has the right to obtain substantially all of the economic benefits from use of the solar farm over the 20-year period of use. Additionally, Customer has exclusive use of the solar farm; it takes all 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.

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

Case B – Contract Contains a Lease (2nd Example)

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). Customer issues instructions to Supplier about the quantity and timing of the delivery of power. If the plant is not producing power for Customer, it does not operate. Supplier operates and maintains the plant on a daily basis in accordance with industry-approved operating practices.

Lease Analysis

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

Exhibit 1-6 (continued)

Additionally, 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.

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

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

Case C – Contract Does Not Contain a Lease
Customer enters into a contract with Supplier to purchase all 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.

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

Exhibit 1-6 (continued)

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.

As you can note from the previous illustrative examples, the determination of whether an arrangement contains a lease is one of the more important areas with respect to the new leasing standards. In later sections, we will address the accounting considerations for both lessees and lessors when the determination is made that a contract is a lease.

Lessee Lease Classification

The previous lease accounting standards prescribed the use of two different recognition models for a lessee – the operating lease and the capital lease. As a result of the new leasing standards though, no longer is a lessee able to avoid balance sheet recognition of an operating lease (subject to certain exceptions). The capital lease term and its "bright lines" is also a thing of the past with the new lease accounting standards. However, the concepts in principle for that type of recognition are mostly retained within the new lease accounting standards.

The biggest change in the new lease accounting standards is the fact that now a lessee must recognize both a right-of-use asset and an associated lease liability on the balance sheet. While the FASB attempted initially to adopt a single framework for lease accounting, this was problematic given the fact that many stakeholders indicated that a single-approach to lease accounting model may not best reflect the economics of all lease transactions. As a result, the FASB concluded that there should be two different lease models.

The Finance Lease

Based on the previous lease standard, a lease is classified as a capital lease if it meets any of the following conditions (ASC 840-10-25-1):

- The lease transfers ownership of the property to the lessee by the end of the lease term
- The lease contains a bargain purchase option

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

Now, refer to Exhibit 1-7 which provides an overview of the new finance lease classification criteria.

Exhibit 1-7: Finance Lease Criteria (ASC 842-10-25-2)

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

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

While several of the characteristics of the previous capital lease have been incorporated into the new classification criteria for a finance lease, there are several key differences worth mentioning. Firstly, you will note that there are no "bright lines" (i.e. 75 percent or 90 percent) incorporated into the criteria as compared to the previous lease accounting standards. While these two criteria have been retained in principle, they have been replaced with more judgmental terms such as "major part of the remaining economic life" and "substantially all of the fair value of the underlying asset." Also worthy of mention is the fact that the new standards no longer use the term "bargain purchase option". Instead, this has been replaced with terminology that suggests a bargain purchase option if a lessee is reasonably certain to exercise. And finally, you will also note that with the previous capital lease criteria, there were four elements. In the new lease accounting standards, there are now five with the addition of the "specialized nature that it is expected to have no alternative use to the lessor"' criteria.

The New Operating Lease

The new lease accounting standards note that if a lease is not considered a finance lease, it is an operating lease. In fact, the definition of an operating lease within the FASB ASC Master Glossary was changed only to account for the change in the name of a capital lease to a finance lease. As a result, the definition now reads that an operating lease is "from the perspective of a lessee, any lease other than a finance lease." While the term operating lease was only slightly changed, from a measurement and recognition perspective, it's a whole new world of accounting.

Short Term Lease Exception

Recall earlier that we noted that all operating leases will need to be recognized on the balance sheet. Here we discuss one of these exceptions to this rule – the short term lease exception. Based on the Board's 2013 ED, it was proposed that both lessees and lessors would not be required to apply the respective measurements to short-term leases. Said another way, these type of leases could remain off-balance sheet similar to previous operating lease accounting recognition if the company made the election. The FASB also further refined the definition of a short-term lease to take into account a potential bargain purchase option. Refer to the Exhibit 1-8 below for an overview of the final short-term lease definition.

Exhibit 1-8: Short-Term Lease (ASC 842-10-25-2)

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.

review questions...

2. Which of the following identifies the first question to be considered when determining whether an arrangement contains a lease?

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

3. Which of the following is a new criteria for a lease meeting the definition of a finance lease, notwithstanding the elimination of bright lines?

a. Transfer of ownership at the conclusion of the lease term.
b. The lease term is for the major part of the remaining economic life of the underlying asset.
c. The present value of future lease payments equals or exceeds substantially all of the fair value of the asset.
d. The asset is of a specialized nature that it will not have alternative use to the lessor.

Refer to the Solutions to Review Questions on pages 118-120

Recognition and Measurement

In this section of the course we discuss the overall recognition and measurement principles with respect to leases, including lease vs. nonlease components, measurement of lease payments, lease term, measurement of the right-to-use asset & liability, and the discount rate used.

Lease vs. Nonlease Components

The important point to note is that within the new standards, the distinction between lease and nonlease components becomes more important as these components are accounted for differently. Accordingly, after a lessee has made the determination that a contract contains a lease, a company is required to identify the separate lease components within a contract and consider the right to use an underlying asset to be a separate lease component if both of the following conditions are met (ASC 842-20-15-28):

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

When a contract does contain more than one lease component, a company is required to allocate consideration in the contract to each separate lease component and nonlease component. However, an important point here is that only those items or activities that transfer a good or service to the lessee can be considered a component.

Measuring the Lease Payment

At the commencement of a lease, a company should first determine its total lease payments and what is and what is not to be included in lease payments. Said another way, the company must know what its total lease payments are so that it can use this payment stream over the lease term to determine the present value of future minimum lease payments. As a result, the following should be included in lease payments relating to an underlying asset over its lease term (ASC 842-20-30-5):

- Fixed payments less any lease incentives paid or payable to lessee
- Variable lease payments
- Exercise price of a reasonably certain option to purchase the underlying asset
- Payments for penalties for terminating the lease if the lease term reflects the lessee exercising an option to terminate the lease
- Amounts being owed under a residual value guarantee

While the above should be included in lease payments, it's also important to identify that which should not be included in lease payments. This includes the following (ASC 842-20-30-6):

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

The Lease Term

The determination of the lease term as it relates to the new lease accounting standards is crucial. At the end of the day (after the multiple exposure drafts and redeliberations), the final lease accounting standards prescribe that a lease term should be the sum of the noncancellable period of the lease along with any periods covered by an option to extend the lease if the lessee is reasonably certain to exercise that option as well as any options to extend that would be controlled by a lessor. In addition, there are also certain instances that may occur during a lease where a lessee is required to reassess the lease term. This includes the following (ASC 842-10-35-1):

- 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
- 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
- The lessee elects to exercise an option even though the entity had previously determined that the lessee was not reasonably certain to do so
- The lessee elects not to exercise an option even though the entity had previously determined that the lessee was reasonably certain to do so

Measuring the Right-of-Use Asset & Lease Liability

Once a company has determined the lease payments to be included in the calculation, the company should record the lease liability and corresponding right-of-use asset. The lessee is required to measure and record both of the following (ASC 842-20-30-1 & 30-5):

- The lease liability at the present value of the lease payments not yet paid, discounted using the discount rate for the lease

- The right-of-use asset which consists of the following:
    - The amount of the measurement of the initial lease liability
    - Any lease payments made to the lessor at or before the commencement date, minus any lease incentives received
    - Any initial direct costs incurred by the lessee

Discount Rate

The discount rate that a company uses to calculate discounted future lease payments should be the rate implicit in the lease if it is readily determinable. If this rate is not determinable, the a company should use its incremental borrowing rate (ASC 842-20-30-3). It's also important to note that a lessee that is not a public business entity is permitted to use a risk-free discount rate for a comparable lease term, however, the company must make this election for all of its leases (ASC 842-20-30-3).

Subsequent Measurement

Finance Lease

The right-of-use asset in a finance lease is economically similar to other nonfinancial assets. As a result, the new lease accounting standards require that the asset be measured at cost, net of accumualted amortization, and be amortized on a straight-line basis from the commencement date to the end of the lease term. Regarding the subsequent measurement of the lease liability, a company should recognize interest on the lease liability such that at all points during the lease, the lease liability reflects the present value of all remaining lease payments.

Both the amortization of the right-to-use asset along with interest on interest liability are reflected in a company's income statement. From a balance sheet perspective, the liability should be increased to reflect the interest on the lease liability and should be reduced to reflect lease payments made during the period. The total periodic expense (the sum of interest expense and amortization) will generally be higher in the earlier periods of a finance lease. Think of this similar to the interest component of a home mortgage.

Operating Lease

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

A lessee is required to recognize in its income statement, a single lease cost calculated so that the remaining cost of the lease is allocated over the remaining lease term on a straight-line basis (ASC 842-20-25-6). Specifically, a company subsequently measures the asset at the amount of the remeasured lease liability adjusted for the following:

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

Illustrative Example – Lessee Accounting

Exhibit 1-9 below helps to tie everything discussed previously together and illustrates the accounting for both a finance lease and a operating lease for a company. Like the other illustrative examples presented previously, this information is derived from the implementation guidance within ASC 842.

Exhibit 1-9: Initial and Subsequent Measurement (ASC 842-20-55-22 thru 30)

Facts

A lessee enters into a 10-year lease of an asset, with an option to extend for an additional 5 years. The lease payments are $50,000 per year during the initial term and $55,000 per year during the optional period, all payable at the beginning of each year. The lessee incurs initial direct costs of $15,000. At the commencement date, the lessee concludes that it is not reasonably certain to exercise the option to extend the lease and, therefore, determines the lease term to be 10 years. The rate implicit in the lease is not readily determinable. The lessee's incremental borrowing rate is 5.87 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. At the commencement date, the lessee makes the lease payment for the first year, incurs initial direct costs, and measures the lease liability at the present value of the remaining 9 payments of $50,000, discounted at the rate of 5.87 percent, which is $342,017. The lessee also measures a right-of-use asset of $407,017 (the initial measurement of the lease liability plus the initial direct costs and the lease payment for the first year). During the first year of the lease, the lessee recognizes lease expense depending on how the lease is classified below.

Exhibit 1-9 (continued)

Lease Classified as a Finance Lease

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

Lease Classified as an Operating Lease

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

Lessor Accounting

The FASB noted based on feedback received from its two exposure drafts as well as other outreach activities, the lessor accounting model did not need comprehensive improvements. On account of this conclusion, the FASB concluded that changing the model in any significant way would not have produced benefits significant enough to justify the added costs. As a result, the accounting requirements for lessors was largely left unchanged. Accordingly, the majority of operating leases should remain classified as operating leases and lessors will continue to recognize lease income for those leases on a generally straight-line basis over the lease term.

Lease Classification

A lessor's lease can be classified as either a sales-type, direct financing, or operating lease. The requirements for a lessor's lease to be classified as a sale-type is the same as that of a lessee's classifying a lease as a finance lease. To reiterate, a lease should be classified as a sales-type lease if it meets any one of the following criteria (ASC 842-10-25-2):

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

When a lease does not meet any of the criteria above, it is classified as either a direct financing lease or an operating lease. If a lease is determined to not be that of a direct financing lease, then by default, it is considered an operating lease by the lessor. As a result, it's important to understand the criteria used for determining whether a lessor's lease is a direct financing lease.

A lessor is required to classify a lease as a direct financing lease when both of the following conditions are met (ASC 842-10-25-3b):

- 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 and/or any other third party unrelated to the lessor equals or exceeds substantially all of the fair value of the underlying asset
- It is probable that the lessor will collect the lease payments plus any amounts necessary to satisfy a residual value guarantee

Initial Measurement

As a reminder, the commencement date of a lease is the date where a lessor makes an underlying asset available for use by a lessee. Simply put, depending on the type of lease (i.e. sales-type, direct financing, or operating lease), the accounting recognition requirements vary.

Given that a sale-type lease is similar to a finance lease from a lessee's perspective where the lessee would reflect the asset on its balance sheet, a lessor is required to derecognize the underlying asset at the commencement date of the lease (ASC 842-30-25-1). The important point to note here though is that the derecognition should only happen if collectability of the lease payments is probable. In addition to this derecognition, a lessor is required to recognize each of the following (ASC 842-30-25-1):

- A net investment in the lease
- Selling profit or selling loss arising from the lease

- Initial direct costs as an expense if, at the commencement date, the fair value of the underlying asset is different from its carrying amount. If it is the same, these costs are deferred

Turning now to direct financing leases, a company is required to derecognize the underlying asset at the lease commencement date of a direct financing lease (ASC 842-30-25-7). In addition, a company is also required to recognize both of the following:

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

Note the subtle distinction between the initial recognition requirements of the sales-type lease vs. the direct financing lease above. The sales-type lease recognized both selling profit, if applicable, and any initial direct costs up front at the lease commencement date. However, this is not the case for the direct financing lease. In fact, both selling profit, if applicable, and initial direct costs are required to be deferred at the commencement date and included in the measurement of the net investment in the lease (ASC 842-30-25-8).

Finally, for an operating lease, this type of lease results in the least amount of requirements at the lease commencement date. No underlying asset is derecognized as compared to the sales-type and direct financing lease. The only recognition at the lease commencement date is the deferral of initial direct costs (ASC 842-30-25-10).

Subsequent Measurement

Once a sales-type lease or a direct financing lease has been initially recorded and the underlying asset has been derecognized from the lessor's balance sheet, a lessor is required to recognize all of the following subsequent to that lease commence date (ASC 842-30-25-2 (Sales-Type) 25-9 (Direct Financing):

- Interest income on the net investment in the lease
- Variable lease payments that are not included in the net investment in the lease as income in profit or loss in the period when the changes in facts and circumstances on which the variable lease payments are based occur
- Impairment of the net investment in the lease

A lessor should increase the carrying amount to reflect the interest income on the net investment in the lease. In other words, a lessor should determine the interest income on the net investment in the lease in each period during the lease term as the amount that produces a constant periodic discount rate on the remaining balance of the net investment in the lease. Alternatively, the net investment in the lease should be reduced to reflect the lease payments collected during the period (ASC 842-30-25-1). This recognition of interest income over the lease term, together with the reduction of the receivable through each recurring lease payment is similar in form to the interest expense incurred by a lessee.

With respect to operating leases, the subsequent measurement for this type of lease is different compared to the sales-type and direct financing leases noted above. For an operating lease, a lessor is required to recognize the following after the lease commencement date (ASC 842-30-25-11):

- The lease payments as income in profit or loss over the lease term on a straight basis unless another systematic and rational basis is more representative of the pattern in which benefit is expected to be derived from the use of the asset
- 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
- Initial indirect costs as an expense over the lease term on the same basis as lease income

review questions...

4. Which of the following time periods is required to be included in the lease term to determine the associated asset and liability?

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

5. Which of the following leases from a lessor standpoint uses the same criteria as that of a finance lease of a lessee?

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

Refer to the Solutions to Review Questions on pages 118-120

Lease Modifications

The FASB ASC Master Glossary defines a lease modification as "a change to the terms and conditions of a contract that results in a change in the scope of or the consideration for a lease." As an example, a lease modification could be 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. Further to this point, in situations when a lease modification occurs, a company has to determine whether the lease modification will be accounted for as a separate contract or as a change to the existing contract.

Specifically, a company is required to account for a modification to a lease contract as a separate contract when both of the following conditions are present (ASC 842-10-25-8):

- The modification grants the lessee an additional right-of-use not included in the original lease
- The lease payments increase commensurate with the standalone price for the additional right-of-use, adjusted for the circumstances of the particular contract

If the lease modification is not accounted for as a separate contract, then a company is required to reassess the classification of the lease as of the effective date of the modification based on the modified terms and conditions (ASC 842-10-25-9). Refer to Exhibit 1-10 which provides an example of a lease modification that results in a separate contract.

Exhibit 1-10: Example Lease Modification (ASC 842-10-55-160 thru .161)

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.

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.

Lessee Lease Modifications

With the FASB's BC173, the following is noted with respect to lessee lease modifications:

"When a modification does not meet the criteria to be accounted for as a separate contract, the lessee remeasures the lease liability for the modified, existing lease as of the effective date of the modification as if the modified lease were a new lease that commences on that date. Because the Board decided that a modified lease is accounted for as if it were a new lease at the effective date of the modification, the lessee reassesses the classification of the lease and remeasures the right-of-use asset and the lease liability based on the changed terms and conditions of the modified contract (including the changed lease payments)."

Furthermore, the FASB prescribed examples of four different situations where remeasurement by the lessee is required. These include the following situations where the modification (ASC 842-10-25-11):

- Grants the lessee an additional right-of-use not included in the original contract
- Extends or reduces the terms of an existing lease other than through the exercise of a contractual option to extend or terminate the lease
- Changes the consideration in the contract only
- Fully or partially terminates an existing lease

In the first three situations above, the lessee is required to recognize the amount of the remeasurement of the lease liability for the modified lease as an adjustment to the corresponding right-of-use asset (ASC 842-10-25-12). The last situation above, the lessee should decrease the carrying amount of the right-to-use asset on a basis proportionate to the full or partial termination of the existing lease. Furthermore, any difference between the reduction in the lease liability and the proportionate reduction in the right-of-use asset should be recognized as either a gain or loss at the effective date of the modification (ASC 842-10-25-13).

Lessor Lease Modifications

The accounting requirements with respect to lease modifications for lessors varies depending on whether the modification relates to a sales-type, direct financing, or operating lease. If an operating lease is modified and is not accounted for as a separate contract, the lessor is required to 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 (ASC 842-10-25-15). Furthermore, depending on the classification of the new lease, the accounting recognition will also vary. If the new lease is considered an operating lease, the lessor should consider any prepaid or accrued lease rentals relating the original lease as part of the lease payments for the modified lease. However, if the modified lease results in a sales-type or direct financing classification, the lessor is required to derecognize any deferred rent liability or accrued rent asset and adjust the selling profit or loss accordingly (ASC 842-10-25-15).

If a direct financing lease is modified and is not accounted for as a separate contract and continues to be a direct financing lease, the lessor should 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 (ASC 842-10-25-16). However, if the modified lease is classified as a sales-type lease, the lessor should account for the modified lease in accordance with overall lease guidance applicable to sales-type leases and utilize the effective date of the modification as the commencement date. To this end, the lessor should calculate the selling profit or selling loss on the lease, the fair value of the underlying asset as is its fair value at the effective date of the modification, and its carrying amount as the carrying amount of the net investment in the original lease immediately before the effective date of the modification (ASC 842-10-25-16). Finally, if the modified direct financing lease is in turn 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 (ASC 842-10-25-16).

If a sales-type lease is modified and does not result in a separate contract, like the previous discussions, the resulting accounting depends on the modified lease classification as well. If the modified lease results in either a sales-type or direct financing lease classification, the lessor is required to 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 (ASC 842-10- 25-17). However, if the modified lease results in an operating lease classification, the carrying amount of the underlying asset equals the net investment in the original lease immediately before the effective date of the modification (ASC 842-10-25-17).

Lease Modifications – Illustrative Examples

One of the best ways to better understand how the lease modification guidance is applied is to review several examples. Fortunately, the FASB includes several of these examples within its implementation guidance. While this course will not provide an overview of all the examples, a few of them have been provided in the following exhibits to help illustrate how the guidance is applied.

Exhibit 1-11: Increase in Lease Term (ASC 842-10-55-162 thru .167)

Case A – No Change in Lease Classification

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.

Lease Modification

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).

Conclusion

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. 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) 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

Assume the same facts as above, 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 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).

Exhibit 1-11 (continued)

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.

Exhibit 1-12: Additional Rights of Use (ASC 842-10-55-168 thru .176)

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.

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.

Lease Modification

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.

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. 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).

Exhibit 1-12 (continued)

Conclusion

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 remaining lease term of 5 years
- Annual allocated lease payments of $77,778 in Years 6 through 10
- Lessee's incremental borrowing rate at the effective date of the modification of 7 percent.

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. 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.

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

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). 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.

Exhibit 1-13: Example Lease Modification (ASC 842-10-55-160 thru .161)

Case A – Direct Financing Lease to Direct Financing Lease
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.

The Lessor concludes that the lease is not a sales-type lease. 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.

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).

Conclusion
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. 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.

Exhibit 1-13 (continued)

Accounting for the Modification
In accounting for the modification, 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

Change in Lease Classification
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.

Accounting for the Modification
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.

Case C –Direct Financing Lease to Operating Lease

Change in Lease Classification
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.

Exhibit 1-13 (continued)

Accounting for the Modification

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.

Sale and Leaseback Transactions

The primary requirement of the new lease accounting standards for sale and leaseback transactions is that in order for a transaction to be accounted for as a sale and leaseback transaction, a sale of the asset must occur in accordance with certain requirements of ASC 606. In determining whether a sale has occurred, ASC 842 prescribes that a company consider both of the following from ASC 606:

- The guidance on identifying the contract
- The guidance on when an entity satisfies a performance obligation by transferring control of an asset

As a result of the above, in order for a transaction to have an identifiable contract, it must have all of the following characteristics (ASC 606-10-25-1):

- The parties to the contract have approved the contract (in writing, orally, or in accordance with other customary business practices) and are committed to perform their respective obligations
- The entity can identify each party's rights regarding the goods or services to be transferred
- The entity can identify the payment terms for the goods or services to be transferred
- The contract has commercial substance (that is, the risk, timing, or amount of the entity's future cash flows is expected to change as a result of the contract)
- It is probable that the entity will collect the consideration to which it will be entitled in exchange for the goods or services that will be transferred to the customer

Simply put, if a sale and leaseback transaction does not have an associated contract, no sale has occurred. Assuming that a company can conclude that a contract has been identified, the next assessment relates to the satisfaction of a performance obligation. With respect to the performance obligation, sale and leaseback transactions are limited to the assessment of whether the performance obligation is satisfied regarding transferring control of the asset. Said another way, there are additional performance obligation considerations for revenue recognition in general as it applies to contracts with customers, but only the regard of transfer of control of the asset is addressed within the new sale and leaseback accounting standards.

Sale and Leaseback – Illustrative Examples

Similar to the previous discussion on lease modifications, ASC 842 also includes examples of sale and leaseback transactions within its implementation guidance. In this section, we provide two examples to help illustrate the sale and leaseback guidance. One of the examples describes a situation where a sale does occur (Exhibit 1-14) and the other exhibit describes a situation when a sale does not occur (Exhibit 1-15). Each of these examples are referenced to the respective paragraphs within the implementation guidance subtopic of ASC 842.

Exhibit 1-14: Sale Occurs (ASC 842-40-55-23 thru .30)

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:

- Seller has a present right to payment of the sales price of $2 million.
- Buyer obtains legal title to the land.
- 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.

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.

Lessee Classification Conclusion

The leaseback is classified as an operating lease.

Initial Recognition

After initial recognition and measurement, at each period of the lease term, Seller will do both of the following:

- 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).

- Recognize the interest expense on the financing obligation (for example, $36,000 in Year 1) and $38,479 in operating lease expense.

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.

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:

- 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).

- Recognize the interest income on the financing obligation (for example, $33,269 in Year 2) and $38,479 in operating lease income.

End of the Lease

The financing obligation and the lease liability equal $0. The carrying amount of the financial asset is $0, and Buyer continues to recognize the land.

Exhibit 1-15: Sales Does Not Occur (ASC 842-40-55-31 thru .38)

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.

Conclusion

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.

Subsequent Recognition

At the commencement date, Seller accounts for the proceeds of $2 million as a financial liability and continues to account for the asset (it is not derecognized). 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.

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.

Exhibit 1-15 (continued)

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).

Purchase Option Expiration

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.

Classification and Measurement

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).

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.

review questions...

6. Which of the following terms define the total of the lease receivable and the unguaranteed residual asset?

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

7. If a lease modification is not accounted for as a separate contract, then a lessor is required to assess which of the following?

a. The classification of the lease.
b. The contractual option periods.
c. Initial direct costs.
d. Nonlease components of the modification.

8. In order for a sale and leaseback transaction to be accounted for as a sale, the transaction must meet certain requirements prescribed within which of the following ASC Topics?

a. ASC 505.
b. ASC 330.
c. ASC 606.
d. ASC 610.

9. If a sale and leaseback transaction is not able to be accounted for as a sale, then any amounts received should be accounted for as which of the following?

a. Lease income.
b. A financial liability.
c. A prepaid asset.
d. Contingent revenue.

Refer to the Solutions to Review Questions on pages 118-120

Assets under Construction

The previous lease accounting standards had extensive requirements relating to situations when a lessee was involved in the construction of an asset that it will in turn lease at the completion of the construction (i.e. a built-to-suit lease). The evaluation of these arrangements included determining whether the lessee was the owner of the asset during the construction period. If the lessee was considered to be the owner, it was required to recognize the asset on its balance sheet (i.e. it defeated the intent of structuring it as an operating lease at completion).

The FASB noted in (BC398) that these requirements were "initially written to address situations in which a lessee might attempt to keep assets "off balance sheet" by leasing an asset that it had constructed and avoiding applying the sale and leaseback requirements that would typically require the lessee to recognize the asset. In such transactions, the lessor sometimes would be a variable interest entity." Simply put, the FASB elected to not carry forward these requirements.

While these requirements were not carried forward, the FASB did prescribe limited guidance primarily around control over the asset. To this end, when a lessee actually controls an asset before the lease commencement, the transaction should be accounted for as a sale and leaseback. In other words, if the lessee controls the asset as it is being constructed, the lessee should recognize that asset just as it would any other asset it controls (BC400).

So herein lies the next obvious follow up question – when is control obtained? While control over an asset can be judgmental, the FASB included criteria to assist entities to assessing whether control over an asset has been obtained. This includes the following situations (ASC 842-40-55-5):

- The lessee has the right to obtain the partially constructed underlying asset at any point during the construction period
- The lessor has an enforceable right to payment for its performance to date and the asset does not have an alternative use to the owner-lessor
- The lessee legally owns either both the land and the property improvements that are under construction or the non-real-estate asset that is under construction
- The lessee controls the land that property improvements will be constructed upon 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
- 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

Similar to other areas within ASC 842, the FASB provides implementation guidance in this area as well. Refer to Exhibit 1-16 which presents a situation where a lessee controls an asset during construction and Exhibit 1-17, where a lessee does not control an asset under construction.

Exhibit 1-16: Lessee Does Have Control under Construction (ASC 842-20-55-40, 43-45)

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.

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. 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.

Lessee controls the building during the construction period and, therefore, the arrangement is within the scope of sale and leaseback guidance. Lessee and Lessor will apply the guidance in that guidance 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 it 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).

Exhibit 1-17: Lessee Does Not Have Control under Construction (ASC 842-20-55-40 thru 42)

Same facts as presented in the Exhibit 1-16, except that 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.

None of the control circumstances 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. 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.

Presentation Requirements

Balance Sheet

From a lessee's perspective, the FASB concluded that a lessee should either present separately in the statement of financial position, or disclose separately in the notes, both finance lease right-of-use assets and operating lease right-of-use assets, separately from other assets (ASC 842-20-45-1). The requirement holds true for both finance lease liabilities and operating lease liabilities. To that end, these liabilities should be presented separate from other liabilities and can either be presented in the statement of financial position or disclosed within the notes. Furthermore, a company is prohibited from presenting finance lease and operating lease assets and liabilities within the same line items (ASC 842-20-45-3). Said another way, a company must ensure that the distinction between a finance lease and an operating lease is clear.

Switching gears to a lessor, the lessor accounting presentation requirements have remained largely unchanged compared to previous lease accounting standards. Specifically for the statement of financial position, a lessor is required to present lease assets separately from other assets, subject to the same current vs. noncurrent classification (ASC 842-30-45-1 thru .02). In addition, the lessors should present a single net investment in both sales-type and direct financing leases instead of separately presenting the respective components.

Statement of Comprehensive Income

From a lessee's perspective, operating leases should be included in income from continuing operations as a single lease cost (ASC 842-20-45-4), which is no different than the previous lease accounting standards. However, a company should present the components of a finance lease (amortization of the right-of-use asset and interest on the lease liability) in a manner consistent with how the entity presents depreciation and amortization of similar assets and other interest expense (ASC 842-20-45-4).

From a lessor's perspective, a lessor has the option of presenting lease income (for all types of lease) separately or disclosing in the notes which line items in the statement include lease income (ASC 842-30-45-3). Generally speaking, a lessor should present profit or loss from leases in a manner that best reflects the lessor's business model. Refer to Exhibit 1-18 below which provides additional insight on the FASB's conclusions on the presentation for lessors.

Exhibit 1-18: Lessor Presentation (BC334)

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

Statement of Cash Flows

The presentation requirements with respect to cash outflows are consistent with the presentation of expenses arising from a lease in the statement of comprehensive income discussed above. The FASB noted in its BCs (BC269) that "it would be inconsistent to present payments in one manner in the statement of comprehensive income and in another manner in the statement of cash flows." Within ASC 842-20-45-5, the classification of four different are prescribed. This includes the following:

- Payments arising from operating leases (Operating)
- Repayment of the principal portion of the lease liability (Financing)

- Payments to bring another asset to the condition and location necessary for its intended use (Investing)
- Variable lease payments and short-term lease payments not included in the lease liability (Operating)

From the lessor perspective, the presentation requirements of cash inflows for a lessor couldn't be simpler. Whether the lessor has a sale-type lease, a direct financing lease, or an operating lease, all cash receipts from a lease should be classified as operating activities (ASC 842-30-45-5 & 7). This single presentation format for the statement of cash flows for a lessor results from the fact that leasing is generally part of the lessor's revenue-generating activities.

Disclosure Requirements

When determining the disclosure requirements for both lessees and lessors, the FASB considered the requirements prescribed within previous lease accounting standards and decisions from the FASB's disclosure framework project. Included within the final lease accounting standards, the FASB prescribed that companies should consider the level of detail necessary to satisfy the disclosure objective as well as how much emphasis to place on various requirements (BC274). To summarize, the objective of the disclosure requirements for both lessees and lessors is to enable users of financial statements to assess the amount, timing, and uncertainty of cash flows arising from leases (ASC 842-20-50-1 & 30-50-1).

As you can imagine, there are disclosures that are applicable to both lessees and lessors, disclosures specific to lessees, as well as disclosures specific to lessors. To start, let's address those disclosures that are applicable to both lessees and lessors. For starters, both lessees and lessors are required to present both qualitative and quantitative information about their leases, the significant judgments made, as well as the amounts recognized in the financial statements relating to those leases (ASC 842-20-50-1 & 30-50-1). Additionally, both lessees and lessors should consider the level of detail necessary to satisfy disclosure objectives and appropriately aggregate and disaggregate disclosures in order to ensure the information is useful to investors. Specifically, the following are required disclosures that are applicable to both lessees and lessors (ASC 842-20-50-3 & 30-50-3):

- Information about the nature of the company's leases to include:
  - A general description of those leases
  - The basis and terms and conditions on which variable lease payments are determined
  - The existence and terms and conditions of operations to extend or terminate the lease
- Information about significant assumptions and judgments to include the following:
  - The determination of whether a contract contains a lease
  - The allocation of consideration in a contract between lease and nonlease components
- Any lease transactions between related parties

Lessee Specific Disclosures

Now that we have addressed those disclosures applicable to both lessees and lessors, let's address those disclosures applicable only for lessees. It's important to note that there are both qualitative and quantitative disclosure requirements. First, let's look at the qualitative disclosures requirements for lessees: This includes the following (ASC 842-20-50-3 & 50-9):

- Narrative disclosures about the options recognized and not recognized as part of its right-of-use assets and lease liabilities
- Existence of any residual value guarantees along with the related terms and conditions
- Restrictions or covenants imposed by leases
- Significant leases that have not yet commenced to include any construction or design involvement
- Determination of the discount rate
- Election of the practical expedient for not separating lease components from nonlease components

In addition to the qualitative disclosures discussed above, the following quantitative disclosures, if applicable, are also required to be presented by a lessee (ASC 842-30-50-4 & 50-6):

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

- Weighted average remaining lease term and discount rate

- Maturity analysis separately for both finance and operating leases

One of the issues the FASB considered when developing these disclosure requirements was understanding how users of financial statements evaluated a company's leasing activities. In other words, a single user may conduct multiple analysis of a company for varying purposes. In light of this, the FASB conducted extensive user outreach to best assess the principal communication needs of users.

To assist lessees in meeting the extensive quantitative disclosure requirements as noted above, the FASB included an illustrative example within ASC 842-20-55-53. This exhibit can be found below.

	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 leases	X.X%	X.X%

Lessor Specific Disclosures

Moving now to the disclosures specifically required by lessors, similar to the lessee specific disclosures, there are both qualitative and quantitative disclosures requirements. On the qualitative front, the following disclosures are required (ASC 842-30-50-3, 50-7, 50-9 thru 10, 50-12):

- Options for a lessee to purchase the leased asset including terms and conditions

- Determination of the amount the entity expects to derive from the leased asset following the end of the lease term

- Information about how it manages its risk associated with the residual value of its leased assets including:
  - Risk management strategy
  - Carrying amount of residual assets covered by residual value guarantees
  - Other means by which it reduces its residual asset risk

- For sales-type leases and direct financing leases only:
  - Significant changes in the balance of its unguaranteed residual assets and deferred selling profit on direct financing leases
  - Maturity analysis of its lease receivables

- For operating leases only:
  - Maturity analysis of lease payments

Now focusing in on the quantitative disclosures, the following information is required to be disclosed by lessors (ASC 842-30-5-5 thru 6):

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

- Components of its aggregate net investment in sales-type and direct financing leases

review questions...

10. Which of the following lessee cash outflows should be classified within financing activities?

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

11. Which of the following disclosures is required by both lessees and lessors?

a. Restrictions or covenants imposed by leases.
b. Determination of the discount rate.
c. Lease transactions between related parties.
d. Maturity analysis of lease receivables.

Refer to the Solutions to Review Questions on pages 118-120

Transition Requirements

The new lease accounting standards are effective for public business entities and certain not-for-profit and employee benefit plans for fiscal years beginning after December 15, 2018, including interim periods within those periods. For all other entities, the new standards are effective for fiscal years beginning after December 15, 2019, and interim periods within fiscal years beginning after December 15, 2020. For all entities, early application is permitted. Transition guidance for all lease transactions, whether it be for lessees or lessors, is included within ASC 842-10-65-1.

Lessees and lessors are required to recognize and measure leases at the beginning of the earliest period presented in its financial statements using a modified retrospective approach. Refer to Exhibit 1-19 below which provides information from the FASB with respect to this transition method determination.

Exhibit 1-19: The Modified Retrospective Approach (BC389 & BC395)

The Board decided to mandate the modified retrospective transition method in Topic 842, with the option to elect a package of practical expedients. The Board decided on this rather than a more onerous transition approach (for example, a full retrospective approach), to reduce the cost of transition for preparers, while still reflecting the primary improvement of the lessee accounting guidance at each reporting date presented in the entity's comparative financial statements.

During the course of the leases project, some stakeholders suggested that the Board should adopt a prospective transition method (that is, applying Topic 842 only to leases that begin on or after the effective date). Although the approach would have been the least costly for preparers of financial statements to apply, the Board rejected this transition approach because information provided would not have been beneficial to users of financial statements, particularly for entities that enter into long-term operating leases (for example, a lessee with a 10-year lease, a 20-year lease, or even longer-term leases might not reflect a significant portion of its lease assets and lease liabilities in its statement of financial position until decades after the effective date of Topic 842).

Given the modified retrospective approach, entities will essentially run off those leases existing at the beginning of the earliest comparative period presented. However, for operating leases, a lessee will present a lease liability on the balance sheet at each reporting date equal to the present value of the remaining minimum rental payments and a right-of-use asset that is derived from the lease liability.

Specific to lessees, the FASB also provided additional transition guidance. The transition requirements vary based on whether the former lease is considered an operating lease versus a capital lease and also whether the new lease is classified as either an operating lease or a finance lease. Given the fact that the primary changes in the new lease accounting standards relate to operating leases now being reflected on the balance sheet of a lessee, this section focuses specifically on this transition requirement. To that end, it should be noted that other transition guidance outside of this type of transition can be found within the applicable transition guidance within ASC 842-10-65-1.

In general, a lessee should recognize a right-of-use asset at the later of the beginning of the earliest period presented in the financial statements and the commencement date of the lease. The lessee is required to measure the lease liability at the present value of the sum of the following using an appropriate discount rate:

- The remaining minimum rental payments
- Any amounts probable of being owed by the lessee under a residual value guarantee

In addition, a lessee is required to measure a right-of-use asset using the calculated lease liability, adjusted for the following items:

- Prepaid or accrued lease payments
- Remaining balance of any lease incentives received
- Unamortized initial direct costs
- Impairment of the right-of-use asset, if applicable

Similar to previous sections of this course, we have presented application guidance with respect to the new lease accounting standards. In the following two exhibits, we provide some illustrative examples of the transition guidance from a lessee's perspective. In Exhibit 1-20, transition of an existing operating lease is illustrated whereas in Exhibit 1-21, the transition of an existing capital lease is reflected.

Exhibit 1-20: Transition of Operating Lease (ASC 842-10-55-249 thru .254)

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.

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 and the Lessee has elected the package of practical expedients. 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. Lessee also does not reassess whether the unamortized initial direct costs on January 1, 20X2, would have met the definition of initial direct costs at lease commencement.

Transition Requirements

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. 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).

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 and the right-of-use asset. Beginning on the effective date of January 1, 20X4, Lessee applies the subsequent measurement guidance in ASC 842, including the reassessment requirements.

Exhibit 1-21: Transition of Capital Lease (ASC 842-10-55-244 thru .247)

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.

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. 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.

Transition Requirements

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 until the effective date.

Beginning on the effective date, Lessee applies the subsequent measurement guidance, 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)

Practical Expedients

The FASB included two practical expedients as part of the transition requirements. The important point to note is that for the first practical expedient discussed below, a company is required to elect it as a package and apply it consistently to all of its leases. The second practical expedient may be elected separately.

The first practical expedient notes that a company need not reassess each of the following:

- Whether any expired or existing contracts are or contain leases
- The lease classification for any expired or existing leases
- Initial direct costs for any existing leases

The second practical expedient prescribes that a company may use hindsight in determining the lease term and in assessing impairment of a company's right-of-use assets.

IFRS Differences

The FASB noted in BC418 that ASC 842 and IFRS 16 are consistent in many areas, including, of most importance, the conclusion that all leases create assets and liabilities that should be recognized by lessees in the statement of financial position, there are a number of differences between them. One of the most important differences between ASC 842 and IFRS 16 is the lessee accounting model.

As you recall, ASC 842 utilizes two different lease classifications, operating leases and finance leases. The classification requirements for that of a finance lease (based primarily on the former capital lease) have been discussed previously in this course and an operating lease, similar to that of the former operating lease in the previous lease accounting standards, is a lease that results when a lease is concluded to not be a finance lease. Given the differing classifications, each lease type carries different initial measurement, recognition, and subsequent measurement requirements, as well as key differences in presentation and disclosure.

In contrast, IFRS 16 prescribed the use of only a single lease classification. As a result, IFRS 16 prescribed that all leases be accounted for as a finance lease. Accordingly, the term operating lease, and related accounting recognition thereof, is not present within IFRS 16. Given this significance divergence in the final lessee lease accounting model, leases classified as operating leases under ASC 842 will be accounted for differently under GAAP than under IFRS. Furthermore, this will result in differences on the statement of comprehensive income and the statement of cash flows under IFRS 16.

While the joint project was undertaken initially to align GAAP and IFRS, two separate paths were taken by the standards setters. The FASB provided additional clarification of specific aspects that influenced its views of maintaining two different lease classifications within the new lease accounting standards. Refer to Exhibit 1-22 below which provides some additional discussion from the FASB with respect to this end result.

Exhibit 1-22: ASC 842 vs IFRS 16 (BC420)

Determining lease classification, in a manner substantially similar to previous GAAP, would not be difficult and was not a significant area of cost or complexity in previous GAAP. Retaining lease classification criteria substantially similar to that in previous GAAP, as well as recognition provisions of the nature included in Topic 842, would significantly reduce costs for U.S. preparers as compared with the previous proposals because it would preserve the alignment that existed in previous GAAP between GAAP and tax/regulatory reporting. Many U.S. stakeholders communicated that the Boards' earlier proposals would have broken that alignment and, therefore, required them to maintain multiple sets of books and records when they previously only maintained a single set.

The most significant cost of adopting new leases guidance on the basis of the Boards' previous proposals would be implementing new accounting systems (for example, to track and account for a significant number of new financial liabilities) and processes. Many U.S. stakeholders communicated that a lessee accounting model of the nature included in Topic 842 would significantly reduce or eliminate those costs because lessees would be able to substantially retain their existing systems for tracking finance and operating leases (even if unsophisticated) and processes (that is, because the lease classification guidance is substantially the same and the effect of leases in the statement of comprehensive income and the statement of cash flows would be minimal).

While the above exhibit provides insight into why the FASB elected its dual lessee lease accounting model, it's also important to understand the IASB's rationale for adopting a single lease classification approach. Refer to Exhibit 1-23 below for this expanded reasoning for this approach by the IASB.

Exhibit 1-23: ASC 842 vs IFRS 16 (BC420)

IFRS stakeholders generally communicated that eliminating lease classification would simplify the accounting for leases because it would remove a key area of judgment and eliminate the need to have a process for determining lease classification.

Many IFRS stakeholders stated that rather than retain a lease classification assessment, the concerns about implementing new systems and processes would be best addressed by exempting high volume, low-dollar leases from the new recognition and measurement requirements. In this way, all significant leases would be accounted for in the same manner, but a lessee's systems and processes would, in effect, not need to be able to capture all of the lessee's leases. A lessee would continue to account for high-volume, low-dollar leases in the same manner as operating leases were accounted for in previous IFRS.

IFRS stakeholders generally did not comment on the effect of the leases proposals on tax or regulatory reporting. That is largely because IFRS stakeholders understand that IFRS is applied in numerous jurisdictions with different tax and regulatory reporting requirements such that it would be impossible to align IFRS with those disparate requirements.

In addition to the differences noted above, the IASB also provided a low value lease exemption within IFRS 16. In short, entities who apply IFRS are not required to account for leases in accordance with IFRS 16 if the underlying asset is less than $5,000 in value. Included within the IFRS January 2016 Project Summary and Feedback Statement (Page 9) is a detailed overview of how the IASB arrived at this exemption. Refer to Exhibit 1-24 for an overview of this justification.

Exhibit 1-24: IASB <$5,000 Exemption

The IASB performed outreach to assess the effects of the exemption for leases of low-value assets. The IASB selected a global sample of 31 lessees from different industries and 21 lessors—lessors were included in the sample to obtain information about their customers. The IASB requested information about leases of low value assets such as the classes of assets leased, contract volumes, lease amounts, lease classification applying IAS 17 and lease term. At the request of some companies included in the sample, the IASB provided a threshold of US$5,000 in terms of the value of the underlying asset (when new) to help those companies identify the leased assets that might be captured by the exemption.

The IASB estimated leases of low-value assets as a percentage of total non-current assets and non-current liabilities based on information provided by 17 lessee respondents together with their reported financial information. The IASB concluded that almost all companies that provided quantifiable responses, leases of low-value assets represent less than 1 per cent of the total noncurrent assets and non-current liabilities.

Approximately half of the 25 lessee respondents explicitly mentioned that all of their identified low-value assets would be considered to be immaterial in the aggregate. Consequently, the exemption is not expected to have any effect on their reported figures. Several of these lessees were those that did not provide any quantitative data because they considered all leases that could potentially be captured by the exemption to be immaterial. These respondents were typically large companies for which materiality is likely to be assessed at a significantly higher level than the low-value asset exemption. Some other respondents noted, however, that, without the exemption, they would be required to demonstrate that these leases are not material in the aggregate. Consequently those respondents expressed the view that the exemption would provide cost relief even if leases of low-value assets were not material to the company.

Additional differences in ASC 842 and IFRS 16 also occurred in the measurement of the right-to-use asset. Recall from previous sections in the course that per ASC 842, a right-to-use asset is measured based on the following (ASC 842-20-30-5):

- The amount of the measurement of the initial lease liability
- Any initial direct costs incurred by the lessee
- Any lease payments made to the lessor at or before the commencement date, minus any lease incentives received

Within IFRS 16 however, additional flexibility is provided to entities when measuring the right-of-use asset on a company's balance sheet. While a single approach is prescribed above with respect to ASC 842, IFRS 16 allows an alternative measurement bases in accordance with either of IAS 40, *Investment Property* or IAS 16, *Property, Plant and Equipment.*

Sale and leaseback transactions are another area in which there was divergence between the FASB and IASB in their final standards. While many of the general principles are aligned between the standards, there are two key differences the FASB and IASB versions. This includes the following (ASU 2016, Section A, Summary):

- IFRS lacks application guidance with respect to determining if a transfer of an asset represents a sale
- IFRS limits the gain recognized by a seller-lessee to the amount of the gain that relates to the buyer's residual interest in the underlying asset at the end of the leaseback

IFRS 16 prescribes that if a seller-lessee has a substantive repurchase option regarding the underlying asset, then no sale can occur. This is very different than ASC 842. ASC 842 prescribes that a company consider a seller-lessee's option to repurchase an underlying asset, but it does not require in all situations that sale treatment is precluded on account of the repurchase option. To the second point above with respect to the limitation of gain recognition, refer to Exhibit 1-25 below for a discussion on the FASB's view of this difference between IFRS 16.

Exhibit 1-25: Gain Recognition Differences (BC430)

In a sale and leaseback transaction, Topic 842 requires a seller-lessee to account for any gain or loss on the sale of the asset consistently with the guidance that would apply to any other sale of the underlying asset. That is consistent with the Board's view that the right-of-use asset conveyed to a lessee in a lease is separate and distinct from the underlying asset itself (that is, the seller-lessee sells the entire underlying asset and then obtains a separate and distinct right-of-use asset as a result of the lease).

In contrast, IFRS 16 requires a seller-lessee to recognize only the amount of any gain on sale that relates to the rights retained in the underlying asset at the end of the leaseback. The IASB concluded that from an economic standpoint, the seller-lessee has sold only a portion of the underlying asset (that is, its interest in the residual value of the underlying asset at the end of the leaseback); it has retained that portion of the underlying asset embodied in the right to use the asset for the duration of the leaseback.

In addition to sale and leaseback differences (as well as others mentioned previously), there are also notable differences as it relates to financial statement disclosures. This is primarily a consequence of the differences that resulted in the final standards between the FASB and the IASB.

Private Company Considerations

Refer to Exhibit 1-26 below which provides an overview of the FASB's overall considerations with respect to private companies. This exhibit will help frame up the following discussions as it relates to certain limited modifications and reliefs provided to private companies.

Exhibit 1-26: FASB Views on Private Company Issues (BC29 through 30)

During the leases project, the FASB carefully considered the potentially different needs of private companies in deciding to modify some of the requirements. In making those decisions, the Board considered the Private Company Decision-Making Framework: A Guide for Evaluating Financial Accounting and Reporting for Private Companies; the Conceptual Framework; input from preparers, auditors, and users of private company financial statements (that is, lenders to private companies); the potentially different needs of users of private company financial statements compared with users of public business entity financial statements; and the feedback and recommendations of the PCC (as well as its predecessor, the Private Company Financial Reporting Committee [PCFRC], which was the Board's private company advisory body during most of the period of the project—that is, from 2007 through 2012), the NAC, and the SBAC. The Board observed the recommendations of the PCC, the PCFRC, and others that the accounting should be consistent for public business entities and private companies with respect to leases.

The Board also considered the generally more limited resources of private companies in considering the costs and benefits of the requirements in Topic 842. The Board observed that the lease accounting requirements in previous GAAP were identical for public business entities and private companies; therefore, the Board's views of the initial and ongoing costs to apply the new requirements (see paragraphs BC9–BC11) apply equally to public business entities and private companies. That is, for most entities, including most private companies, the ongoing costs of applying the requirements in Topic 842 should not be significantly greater than the costs of applying previous GAAP, and a significant portion of private companies will be able to apply the requirements in Topic 842 using similar systems and processes to what they used in previous GAAP to meet those reporting and disclosure requirements.

In the development of the final lease accounting standards, the FASB considered certain private company modification with respect to the following five areas (BC31):

- Recognition
- Measurement
- Presentation
- Disclosures
- Transition

With respect to recognition issues, the FASB considered feedback from multiple stakeholders as it related to private company financial statements. The principle consideration was whether private companies should also reflect lease assets and lease liabilities consistent with public business entities. In the end, the FASB concluded that the benefit to financial statement users to recognize lease assets and lease liabilities on the balance sheet for all entities justifies the costs to preparers to provide this information. As a result, the FASB required that private companies appropriately recognize lease assets and lease liabilities consistent with public business entities.

Regarding measurement, ASC 842 includes a practical expedient for private companies with respect to the discount rate used to measure a company's lease liability, however, a private company must make this election for all of its leases and disclose the election of the practical expedient. The risk-free rate alternative was generally supported when it was first proposed within the 2013 ED due to the fact that some private companies would incur additional costs to identify an incremental borrowing rate.

With respect to presentation, disclosures, and transition issues, no specific private company alternatives were prescribed by the FASB. As a result, private companies are required to apply the same requirements as that of public companies.

review question...

12. Compared to the FASB lessee accounting model, IFRS 16 requires that all leases be classified as which of the following type?

a. Sales-type lease.
b. Operating lease.
c. Capital lease.
d. Finance lease.

Refer to the Solutions to Review Questions on pages 118-120

Glossary

Commencement Date

The date on which a lessor makes an underlying asset available for use by a lessee.

Consideration in the Contract

Lease payments plus any other fixed or variable payments related to the contract.

Direct Financing Lease

From the perspective of a lessor, a lease that meets none of the criteria as a sales-type lease but meets other specific criteria

Discount Rate

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.

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 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 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 plus periods covered by an option to extend the lease if the lessee is reasonably certain to exercise that option, periods covered by an option to terminate the lease if the lessee is reasonably certain not to exercise that option, and periods covered by an option to extend (or not to terminate) the lease in which exercise of the option is controlled by the lessor.

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.

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.

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.

SOLUTIONS TO REVIEW QUESTIONS

1. The new leasing standards prescribed by ASU 2016-02 superseded which of the following ASC Topics?

a. **ASC 840.**
Correct. As a result of the release of ASU 2016-02, the previous lease accounting standards prescribed within ASC 840 were superseded, with the new lease standards included within ASC 842.

b. ASC 845.
Incorrect. ASC 845 relates to the accounting for nonmonetary transactions. While the issuance of the new lease standards through ASU 2016-02 did make certain conforming amendments to ASC 845, the topic was not superseded. These conforming amendments can be found within Section B of the ASU 2016-02.

c. ASC 605.
Incorrect. ASC 605 relates to revenue recognition. The release of the new leasing standard did not supersede requirements within this topic.

d. ASC 250.
Incorrect. ASC 250 relates to the accounting for accounting changes and error corrections. The release of the new leasing standard did not included any amendments to this topic.

2. Which of the following identifies the first question to be considered when determining whether an arrangement contains a lease?

a. Does the customer have rights to operate the asset?
Incorrect. Determining whether the customer has rights to operate the asset is not the first determination to be made when determining if a contract contains a lease. However, this is an important consideration that must be assessed when concluding whether a contract does in fact contain a lease.

b. Did the customer design the asset?
Incorrect. Determining whether the customer designed the asset is not the first determination to be made when determining if a contract contains a lease. However, this is an important consideration that must be assessed when concluding whether a contract does in fact contain a lease.

c. Is there an asset identified in the contract?
Correct. Determining whether there is an identified asset is the first determination to be made when determining if a contract contains a lease. It is important to note that identification of an asset within a contract can be either made explicitly or implicitly.

d. Does the customer obtain substantially all of the economic benefits from the arrangement?
Incorrect. Determining whether the customer obtains substantially all of the economic benefits is not the first determination to be made when determining if a contract contains a lease. However, this is an important consideration that must be assessed when concluding whether a contract does in fact contain a lease.

3. Which of the following is a new criteria for a lease meeting the definition of a finance lease, notwithstanding the elimination of bright lines?

a. Transfer of ownership at the conclusion of the lease term.
Incorrect. The criteria of a transfer of ownership to the lessee at the conclusion of the lease term is not a new criteria for that of a finance lease.

b. The lease term is for the major part of the remaining economic life of the underlying asset.
Incorrect. The lease term accounting for a major part of the remaining economic life of the underlying asset is not a new criteria for that of a finance lease. In the previous capital lease criteria though, a 75% bright line test was included in this analysis.

c. The present value of future lease payments equals or exceeds substantially all of the fair value of the asset.
Incorrect. The present value of future lease payments equaling or exceeding substantially all of the fair value of the asset is not a new criteria for that of a finance lease. In the previous capital lease criteria though, a 90% bright line test was included in this analysis.

d. The asset is of a specialized nature that it will not have alternative use to the lessor.
Correct. The criteria relating to the fact that the underlying assets is of such a specialized nature that when it is returned to the lessor it has not alternative use is a new criteria for a finance lease under the lease accounting standards.

4. Which of the following time periods is required to be included in the lease term to determine the associated asset and liability?

a. Options to extend that are controlled by the lessee.
Incorrect. Any options controlled by the lessee should not be included in the lease term. Only those option period that meet certain criteria should be included in the lease term.

b. Cancellable periods where the penalty is material.
Incorrect. Noncancellable periods, not cancellable periods, should be included in the lease term.

c. Any options to extend controlled by the lessor.
Correct. Any options that are controlled by lessor, not the lessee, should be included in the lease term.

d. Options that are more than remotely likely to be exercise.
Correct. Only options that a lessee is reasonably certain, not more than remotely likely, to exercise should be included in the lease term.

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

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

7. **If a lease modification is not accounted for as a separate contract, then a lessor is required to assess which of the following?**
    a. **The classification of the lease.**
    Correct. When a lease modification does not result in the accounting for the lease as a separate contract, an entity is required to reassess the classification of the lease. Said another way, has it changed from a sales-type lease to a direct financing lease, or operating lease, etc.?
    b. The contractual option periods.
    Incorrect. A company is not required to reassess the contractual options periods when a lease modification is not accounted for as a separate contract.
    c. Initial direct costs.
    Incorrect. A company is not required to reassess the initial direct costs when a lease modification is not accounted for as a separate contract.
    d. Nonlease components of the modification.
    Incorrect. A company is not required to reassess nonlease components of the modification when a lease modification is not accounted for as a separate contract.

8. **In order for a sale and leaseback transaction to be accounted for as a sale, the transaction must meet certain requirements prescribed within which of the following ASC Topics?**
    a. ASC 505.
    Incorrect. ASC 505 relates to equity and is not considered when determining whether a sale and leaseback should be accounted for as a sale.
    b. ASC 330.
    Incorrect. ASC 330 relates to inventory and is not considered when determining whether a sale and leaseback should be accounted for as a sale.
    c. **ASC 606.**
    Correct. If a sale and leaseback transaction does not meet the definition of sale, the asset should continue to be recognized, but amounts received should not be accounted for as lease income.
    d. ASC 610.
    Incorrect. ASC 610 relates to other income and is not considered when determining whether a sale and leaseback should be accounted for as a sale.

9. **If a sale and leaseback transaction is not able to be accounted for as a sale, then any amounts received should be accounted for as which of the following?**
   a. Lease income.
   Incorrect. If a sale and leaseback transaction does not meet the definition of sale, the asset should continue to be recognized, but amounts received should not be accounted for as lease income.
   b. A financial liability.
   Correct. If a sale and leaseback transaction does not meet the definition of sale, the asset should continue to be recognized (it should not be derecognized), and ay amounts received should be recorded as a financial liability.
   c. A prepaid asset.
   Incorrect. If a sale and leaseback transaction does not meet the definition of sale, the asset should continue to be recognized, but amounts received should not be accounted for as a prepaid asset.
   d. Contingent revenue.
   Incorrect. If a sale and leaseback transaction does not meet the definition of sale, the asset should continue to be recognized, but amounts received should not be accounted for as any form of revenue.

10. **Which of the following lessee cash outflows should be classified within financing activities?**
   a. Payments arising from operating leases.
   Incorrect. This cash outflow should be reported in operating activities.
   b. Payments to bring another asset to a location necessary for its intended use.
   Incorrect. This cash outflow should be reported in investing activities.
   c. Variable lease payments.
   Incorrect. This cash outflow should be reported in operating activities. In addition, short-term lease payment should also be included in operating activities.
   d. Repayments of the principal portion of a lease liability.
   Correct. This cash outflow should be reported in financing activities of the statement of cash flows.

11. **Which of the following disclosures is required by both lessees and lessors?**
   a. Restrictions or covenants imposed by leases.
   Incorrect. Restrictions or covenants imposed by leases is a disclosure that is only applicable to lessees, not lessors.
   b. Determination of the discount rate.
   Incorrect. The determination of the discount rate is a disclosure that is only applicable to lessees, not lessors.
   c. Lease transactions between related parties.
   Correct. Both lessees and lessors are required to disclose lease transactions between related parties. In addition, disclosure of significant assumptions and judgments about whether a contract contains a lease is a required disclosure for both lessees and lessors.
   d. Maturity analysis of lease receivables.
   Incorrect. A maturity analysis of lease receivables is a disclosure that is only applicable to lessors, not lessees.

12. **Compared to the FASB lessee accounting model, IFRS 16 requires that all leases be classified as which of the following type?**
   a. Sales-type lease.
   Incorrect. A sales-type lease is a lease classification for a lessor, not lessee. IFRS 16 does not prescribe that all leases are classified as sales-type leases.
   b. Operating lease.
   Incorrect. IFRS 16 does not prescribe that all leases are classified as operating leases. The term operating lease is not utilized within the IFRS 16.
   c. Capital lease.
   Incorrect. IFRS 16 does not prescribe that all leases are classified as capital leases. The term capital lease is no longer utilized within the IFRS 16 as compared to the previous lease accounting standard.
   d. Finance lease.
   Correct. The IASB concluded that IFRS 16 should contain a single lease classification model. As a result, all leases are required to be classified as finance leases. The IASB noted that this single lease classification model simplifies the accounting for leases because it removes a key area of judgment and eliminates the need to have a process for determining lease classification.

NEW LEASE ACCOUNTING STANDARDS

(4 CE HOURS)

FINAL EXAM

1. Which of the following organizations published a joint discussion paper with the FASB which provided the preliminary views on the future lessee accounting?

a. IASB.
b. AICPA.
c. GASB.
d. SEC.

2. In which of the following years did the FASB and IASB publish the first exposure draft with respect to the new lease accounting model?

a. 2009.
b. 2010.
c. 2011.
d. 2012.

3. Which of the following subtopics within the previous lease accounting guidance was retained within the new lease accounting standards?

a. 10 – Overall.
b. 30 – Capital Leases.
c. 20 – Operating Leases.
d. 958 – Not-for-Profit Entities.

4. If an asset has been identified in a contract, which of the following identifies the next assessment to be performed when determining whether a contract contains a lease?

a. Does the customer have rights to operate the asset?
b. Does the customer obtain substantially all of the economic benefits?
c. Was the asset explicitly or implicitly identified in the contract?
d. Did the customer design the asset?

5. Which of the following is the next consideration to be assessed to determine whether the contract contains a lease if a customer has determined that asset has been identified in a contract, the customer obtains substantially all of the economic benefits, and the customer has the right to direct how and for what purpose the asset is used?

a. Does the customer have the right to operate the asset throughout the period of use without supplier intervention?
b. Did the customer design the asset?
c. Are the rent payments assessed by the supplier determined to be at fair market value?
d. Are the rent payments fixed or variable?

6. If a company determines that a customer does not have the right to operate the asset identified in a contract throughout the period of use, the company should also consider which of the following before concluding that the contract does not contain a lease?

a. Did the customer design the asset?
b. Does the customer have substitution rights?
c. Is the asset implicitly identified in the contract?
d. Does the contract contain a repurchase option?

7. In order for a customer to conclude that a supplier's substitution rights are substantive, the supplier must have a practical ability to substitute alternative assets throughout the period of use along with what other condition?

a. The supplier intends to exercise that right during the period of the contract.
b. The supplier intends to only exercise that right based on certain future events.
c. The supplier has the unilateral ability to terminate the contract without penalty.
d. The supplier would benefit economically from the exercise of its right to substitute the asset.

8. A lessee should classify a lease as a finance lease, if the present value of the sum of the lease payments are

a. 50% of the fair value of the underlying asset.
w. Reasonably certain to increase with the election of future option periods.
x. Equal to or exceed substantially all of the fair value of the underlying asset.
y. At least 75% of the fair value of the underlying asset.

9. **Notwithstanding consideration of purchase options, a short-term lease is defined as a lease that is equal to or less than how many months in duration?**
   a. 12 months.
   b. 18 months.
   c. 24 months.
   d. 36 months.

10. **At the commencement date of a lease, a lessee is required to report which of the following?**
   a. Nonlease components paid in cash.
   b. Prepaid deposit.
   c. Interest expense.
   d. Right-of-use asset.

11. **From a lessee perspective, which of the following types of leases utilizes a single lease cost for income statement recognition?**
   a. Operating lease.
   b. Leveraged leases.
   c. Finance leases.
   d. Sales-type leases.

12. **A lessee is required to account for a lease component as a separate lease if the lease is not highly dependent on the other right-to-use asset(s) in the contract and which of the following other condition?**
   a. It does not have a future alternative use for the lessor.
   b. The lessee can benefit from the right-of-use component on its own.
   c. It represents more than 25% of the net present value of total future minimum lease payments.
   d. It is classified as an operating lease.

13. **Which of the following should be included in lease payments when calculating the total lease liability and right-of-use asset?**
   a. Amounts allocated to nonlease components.
   b. Guarantees by the lessee of the lessor's debt.
   c. Exercise price of a reasonably certain option to purchase.
   d. Initial indirect costs that are material to the arrangement.

14. **Which of the following should not be included when measuring a lessee's right-of-use asset?**
   a. Amount of the initial lease liability.
   b. Lease payments made to the lessor before the commencement date.
   c. Initial direct costs incurred by the lessee.
   d. Termination penalties the lessee will more than likely be required to pay.

15. **Which of the following leases would result in the lessor not derecognizing the underlying asset on its balance sheet from a lessor standpoint?**
   a. Operating lease.
   b. Sales-type lease.
   c. Direct financing lease.
   d. Finance lease.

16. **Which of the following should a lessor recognize after the commencement date of a sale-type lease?**
   a. Selling profit or loss arising from the lease.
   b. Interest income on the net investment in the lease.
   c. Initial direct costs.
   d. Net investment in the lease.

17. **Which of the following types of lease modifications requires a lessee to account for the modification as a separate contract?**
   a. The lessee either fully or partially terminates an existing lease.
   b. The modification grants the lessee additional right-of-use with a commensurate increase in the lease payments.
   c. The lessee extends the term of the lease through the exercise of a contractual option.
   d. The lessor grants the lessee additional right-of-use prescribed by the original contract.

18. **If a lessor's sales-type lease is modified and does not result in a separate contract, then the lessor should do which of the following if the modified lease is accounted for as an operating lease?**
   a. Adjust the discount rate and derecognize any selling profit.
   b. Reverse any previously recognized interest income.
   c. Record the underlying asset based on the net investment in the lease immediately before the effective date of the modification.
   d. Record an impairment to the net investment in the lease.

19. **If a seller-lessee concludes that a transfer of an asset meets the sale recognition criteria in ASC 606, then the seller-lesser should do each of the following, except?**
   a. Recognize the transaction price for the sale at the point in time the buyer-lessor obtains control of the asset.
   b. Derecognize the carrying amount of the underlying asset.
   c. Account for the lease in accordance with the applicable ASC 840 subtopic.
   d. Classify the lease as a finance lease and record a single lease cost on its income statement.

20. A sale and leaseback transaction can be accounted for as a sale, notwithstanding an option by the seller-lessee to repurchase the asset, if there are both alternative assets readily available in the marketplace and the exercise price of the option is equal to which of the following?

a. Fair value of the asset.
b. Carrying value of the asset.
c. Net present value of all residual value guarantees.
d. Net investment in the lease.

21. Which of the following situations would lead a lessee to conclude that it controls an asset during its construction period?

a. The lessee legally owns both the land and the property improvements that are under construction.
b. The lessee has the right to obtain the partially constructed asset only at certain point in time.
c. The lessee leases the land on which the property improvements are being constructed, but intends to enter into a sublease prior to the beginning of construction.
d. The lessor has an enforceable right to payment for its performance to date and the asset has an alternative use to the lessor.

22. Which of the following statements is correct in order for a potential sale and leaseback transaction to be accounted for as a sale?

a. The resulting lease is required to be classified as a finance lease.
b. The lease cannot include a bargain purchase option.
c. The transaction must be subject to a contract.
d. The seller-lessee is required to record a net investment in the lease.

23. Variable lease payments and short-term lease payments not included in a lease liability should be classified within which section of a lessee's statement of cash flows?

a. Financing.
b. Investing.
c. Operating.
d. Non Cash.

24. Which of the following types of cash outflows should be classified within the investing activities section of a lessee's statement of cash flows?

a. Payment arising from operating leases.
b. Payments to bring another asset to the condition and location necessary for its intended use.
c. Repayments of the principal portion of a lease liability.
d. Initial direct costs.

25. Which of the following identifies a quantitative disclosure a lessee is required to disclose on a weighted average basis?

a. Sublease income.
b. Finance lease cost.
c. Lease payments.
d. Discount rate.

26. The new lease accounting standards are effective for public business entities for fiscal years beginning after what date?

a. December 15, 2018.
b. December 15, 2019.
c. December 31, 2018.
d. December 31, 2019.

27. The new lease accounting standards should be applied using which of the following transition methods?

a. Modified prospective.
b. Retrospective.
c. Modified retrospective.
d. Prospective.

28. Based on IFRS 16, a company is allowed is avoid lease accounting treatment of a contract if its value is what amount or less?

a. $5,000.
b. $10,000.
c. $50,000.
d. $100,000.

29. Compared to ASC 842, under IFRS 16, a company is limited in which of the following ways as it relates to sale and leaseback transactions?

a. The repurchase option period.
b. Gain recognized by the seller-lessor.
c. Residual value guarantee assumed by the buyer-lessor.
d. The total lease term used to calculate the lease liability and right-of-use asset.

30. The requirements prescribed by ASU 2016-02 are effective for private companies for fiscal years beginning after what date?

a. December 15, 2017.
b. December 15, 2018.
c. December 15, 2019.
d. December 15, 2020.

31. Private entities under ASC 842 are allowed to use which of the following rates as a discount rate assuming they apply it to all leases and appropriately disclose the election?

a. LIBOR rate.
b. 5-Year Treasury yield rate.
c. Risk free rate.
d. Weighted average cost of capital.

Course Evaluation Form

Program Title: ____

Program Date: ____

Participant Name: ____

Please indicate your agreement with the following statements:	Agree	Disagree	Don't Know
1. Stated Learning Objectives were met	______	______	________
2. Stated prerequisite requirements were appropriate and sufficient	______	______	________
3. Program materials were relevant and contributed to the achievement of the learning objectives	______	______	________
4. Time allotted to the learning activity was appropriate	______	______	________
5. If applicable, individual instructors were effective	______	______	________

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Additional Comments:

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Thank you for your comments!