The Ultimate Lease Accounting Guide:

ASC 842 Simplified with Step-by-Step Examples

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Introduction

ASC 842, *Leases* represents the most sweeping change to accounting in decades. Organizations now must recognize material lease assets and liabilities for both operating and finance/capital leases, which led to average balance sheet lease liabilities increases of 1,475% in 2019 following the adoption by public companies. And the updated guidance requires changes to your lease accounting beyond lease liabilities. It's imperative for accounting teams to work together to champion and communicate the change to ensure synchronicity amongst departments and within the accounting team itself.

This guide covers most of the new guidance in an easy-to-understand format and real-life examples. It can be used to educate accountants on lease accounting or provide a refresher to those who need clarity on a particular topic. The examples, journal entries and disclosures within focus primarily on the lessee side of lease accounting.

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1. Introduction to Lease Accounting

Why Lease Accounting Had To Change

Under ASC 840, *Leases* (ASC 840) only a limited number of leases were recorded on the balance sheet. An operating lease, for instance, was always an off-balance-sheet transaction. However, the payment obligations for an operating lease represent a real liability and should be clearly presented so users of financial statements can assess the amount, timing, and uncertainty of cash flows arising from leases.

Given the widespread prevalence of off-balance-sheet leasing activities, the new lease accounting rules are intended to improve financial reporting and increase transparency and comparability across organizations. Released in February 2016, Accounting Standards Update (ASU) 2016-02, *Leases*, (ASC 842) requires organizations to disclose vital information about leasing arrangements to investors. It also provides management with better insight into the true extent of an organization's lease obligations and leads to improvements in capital allocation, capital budgeting, and lease vs. buy decisions.

What Changed

The primary change to lease accounting under ASC 842 is that organizations must now recognize lease assets and lease liabilities on the balance sheet for most of their lease arrangements. Lessees are required to calculate the present value of future lease payments to establish a lease liability and the related right-of-use (ROU) asset. Another change is the renaming of capital leases to finance leases. The accounting for the lessor is largely unchanged from ASC 840 to ASC 842.

Effective Date

Public and private companies had different effective dates for ASC 842. For public companies, the standard went into effect for reporting periods that began subsequent to December 15, 2018. For calendar year-end public entities, this means the standard was adopted on January 1, 2019.

For private companies, the original effective date was for reporting periods beginning subsequent to December 15, 2019. However, in October of 2019, the FASB delayed the effective date for private companies and nonprofit organizations. This was done in an effort to provide private companies with extra time due to the feedback and experiences of public companies and to allow for effective and efficient implementation of the new standard.

A second delay for private companies was issued in June of 2020, moving the effective date to annual reporting periods beginning after December 15, 2021. This was done to provide these organizations with accounting relief during the start of the COVID-19 global pandemic.

Definition of a Lease

ASC 842 defines leases as contracts, or portions of contracts, granting "control" of an identifiable asset for a specific period of time in exchange for payment. The term "control" carries a distinct meaning in this definition. In order to demonstrate control of an asset, an entity must be able to obtain "substantially all" of the economic benefit from the asset's use and direct its use throughout the period of the contract.

> **Identification**
>
> Explicit identification occurs if the contract specifically describes or defines the physical asset to be utilized in performing the service. If the vendor has the ability and the right to provide the required services by using an alternative asset other than what was specifically described in the contract, known as the "right of substitution," a lease does not exist. However, contract terms that allow or require a supplier to substitute other assets only when the underlying asset is not operating properly (e.g., a normal warranty provision) or when a technical upgrade becomes available would not create a right of substitution.
>
> An asset is implicitly identified in a contract if the only way the vendor can fulfill its obligation under the contract is by utilizing a specific asset. For example, if the vendor is required to provide transportation services to the purchaser, but only has one truck, then that truck is deemed to be identified in the contract, even if it is not mentioned.

Control

To determine whether a contract conveys the right to control the use of an identified asset over a period of time, an entity shall assess whether, throughout the period of use, the customer has both of the following:

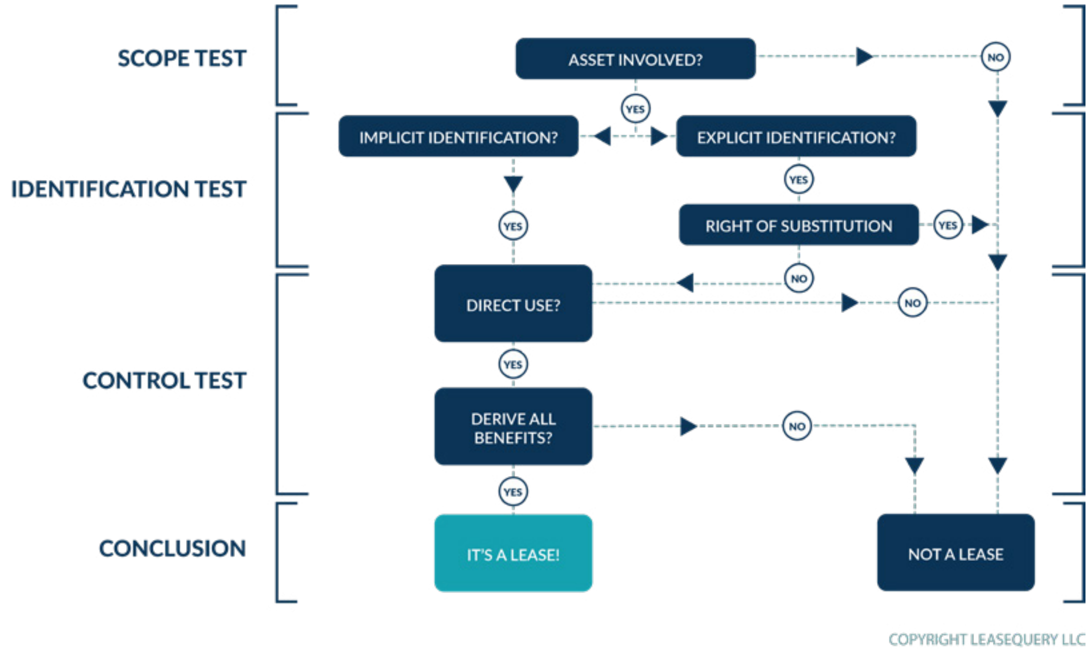
1. The right to obtain substantially all of the economic benefits from use of the identified asset

2. The right to direct the use of the identified asset

Economic Benefits

The economic benefits from use of an asset include its primary output and by-products (including potential cash flows derived from these items) and other economic benefits from using the asset that could be realized from a commercial transaction with a third-party. The economic criterion requires that an entity has the right to obtain substantially all of the economic benefits from the use of that asset.

Lease decision tree



Example 1: How to tell if a contract contains a lease

Is a stadium naming rights contract a leasing agreement?

Start by analyzing the agreement for an identified asset. Most likely, the stadium is specified in the contract. So yes - the identification requirement is met.

Does the purchaser direct the use of the stadium? Do they say "who, what, when, and how?" The answer here is likely "No." The purchaser of the stadium naming right does not direct the use or manage operations of the stadium. They simply pay for the right to have their name displayed. As a result, most stadium naming right contracts do not contain a lease.

Embedded Leases

The identification of embedded leases is a particularly challenging aspect of ASC 842. An embedded lease is a lease agreement that exists within a contract. Because the lease is embedded in another contract, it is fairly common that these arrangements have historically not been accounted for as leases, especially if the management of the contract has been handled within a department other than accounting.

Properly identifying embedded lease agreements can be like a scavenger hunt, and many organizations fail to recognize that service contracts often contain embedded leases. If a contract contains terms that meet the definition of a lease under ASC 842, the contract must be bifurcated into lease and nonlease components and the lease component should be recognized on the balance statement.

See if Your Contracts Contain Embedded Leases

Embedded Lease Test

Example 2: How to identify an embedded lease

Company A has a security services contract with ABC Security. ABC Security provides cameras, monitors, and keypads for Company A's facilities. The contract states that Company A will have full usage of ABC Security's monitoring equipment. The contract lists each item, along with an identification number, to be used for this contract.

Company A will have full control over the monitoring equipment, and will obtain substantially all of the economic benefits of the security equipment. The equipment portion of this contract meets all of the standards required for an embedded lease:

1. The underlying assets are specifically identified: *The cameras, monitors and keypads are listed in the contract along with identification numbers.*

2. Company A has control of the underlying assets: *The contract grants Company A full control over the monitoring equipment.*

3. Company A obtains substantially all of the economic benefits of the underlying assets: *The contract grants Company A substantially all of the economic benefits of the security equipment.*

Scope

ASC 842 applies to most leases and subleases, but exceptions do exist.

Here are the out-of-scope lease types, as detailed in Subtopic 842-10-15-1:

- Leases of intangible assets, such as cloud computing arrangements. The guidance for these agreements can be found in ASC 350, *Intangibles – Goodwill and Other*. Learn more about that guidance **here**.
- Leases for the exploration or use of non-regenerative natural resources such as oil, natural gas, and minerals are covered under ASC 930, *Extractive Activities – Mining*, and ASC 932, *Extractive Activities – Oil and Gas*.
- Leases of biological assets such as plants, animals, and timber. These are addressed in ASC 905, *Agriculture*.
- Leases of inventory, which are covered under ASC 330, *Inventory*.
- Leases of assets that are under construction. These are addressed in ASC 360, *Property, Plant, and Equipment*.

LEASED ASSET	RELEVANT GUIDANCE
Intangible assets	ASC 350, Intangibles - Goodwill and Other
Rights to explore for or use minerals, oil, natural gas, and similar nonregenerative resources	ASC 930, Extractive Activities - Mining, and ASC 932, Extractive Activities - Oil and Gas
Biological assets, including timber	ASC 905, Agriculture
Inventory	ASC 330, Inventory
Assets under construction	ASC 360, Property, Plant and Equipment

2. The Basics

Once a contract has been identified as a lease agreement, it will need to be accounted for in accordance with ASC 842. Below are the definitions and explanations of the major concepts required for lease accounting for both operating and finance leases.

Key Dates

Commencement Date

The lease start date, or commencement date, for accounting purposes is still the date control of the underlying asset is passed from the lessor to the lessee. Under ASC 842, just as under ASC 840, the commencement date specified on the lease document has no bearing on the date the lease is recorded financially.

Sometimes the lease commencement date noted in the contract may align with the date the asset is available to the lessee but other times it may not. For example, if a lease provides access to a tenant prior to the first lease payment or a rent holiday, transfer of control over the underlying asset has occurred for accounting purposes.

Possession Date

The lessee's possession of the underlying asset is the key factor for accounting. As of the possession date, the lessee, or tenant, recognizes a lease liability and a ROU asset even if possession occurs earlier than the "commencement date" specified on the lease. ASC 842 specifies the possession date as the date to determine the discount rate used to calculate the present value of the lease payments for both finance and operating leases and the portion of the finance vs. operating lease classification test which compares useful life of the leased asset to the lease term in total.

Lease End Date

The lease end date is defined as the date when the lessee no longer has control or physical possession of the asset.

Lease Term

A lease term is the period of the agreement between a lessee and lessor when the lessee can use the leased asset owned by the lessor. The lease term for accounting purposes starts from the lease possession date and extends until the end of the lease. Determining the correct lease term is imperative during lease entry as it significantly impacts the classification and measurement of the lease.

Determining the Lease Term

The total lease term is similar to a formula made up of:

- All non-cancelable lease periods,
- Any optional renewal periods the lessee is reasonably certain to exercise,
- Any periods covered by a termination option the lessee is reasonably certain **not** to exercise, and
- Any periods to extend or to not terminate the lease controlled by the lessor.

The graphic below offers a visual representation of the portions of the lease agreement making up the lease term:

Long-Term vs. Short-Term

A short-term lease is a lease with a term of 12 months or less at commencement, in contrast to a long-term lease which has a lease term exceeding 12 months. Key facts to remember about a short-term lease classification are:

- The lease must have a term of 12 months or less at commencement, not at transition or another time
- A lease can not qualify as a short-term lease if it has options that extend the lease beyond 12 months that the lessee is reasonably certain to exercise
- A short-term lease may have a purchase option, if the lessee is reasonably certain not to exercise

Under one of the practical expedients offered by ASC 842, the lessee can elect by class of underlying asset to not recognize their short-term leases on the balance sheet. However, the income statement impact of short-term leases not recorded on the balance sheet is required to be disclosed, so tracking short-term leases by another mechanism is recommended.

If a lessee elects to use the short-term lease expedient, the current accounting treatment will not change and the lessee will recognize lease payments as straight-line expenses for the duration of the lease contract.

Additional Lease Term Considerations

Some lease agreements do not have an easily identifiable lease term, such as leases that offer shorter-term renewals or perpetual leases. As with all other leases, the lessee establishes the lease term by considering whether they are reasonably certain to exercise the options offered by the contract.

For lease agreements offering month-to-month, week-to-week, or even day-to-day renewals, the lessee reviews all of the circumstances related to the contract to make a determination regarding how long they expect to continue renewing the lease. For example, if a piece of equipment leased to support a construction project is being leased weekly or monthly, the lessee may establish the lease end date as the date they expect the project to be completed.

Perpetual leases, sometimes called evergreen leases, generally renew automatically for some period far into the future until the lessee terminates the lease. As with a normal lease, the lessee still reviews the contributing factors to make a reasonably certain judgment as to when they expect to exit the agreement.

One point to consider for a perpetual lease is the renewal timeframe. If a lease renews automatically for the next 40–50 years – or somewhere far into the future, it is highly unlikely the lessee can be reasonably certain they will renew so many years away. However, the lessee could make a case of being reasonably certain to renew for the next five to ten years, in which case they would document their determination of the term length and establish the related lease liability based on that judgment.

Example 3: How to determine the lease term

Background: Tenant Co. is a private company with a calendar year-end that transitioned to ASC 842 on January 1, 2022.

Tenant Co. entered into a lease agreement for a retail store on October 24, 2021. The lease stated a commencement date of January 1, 2022, and Tenant Co. was given the keys to the property on this date. Tenant Co. made some leasehold improvements, painted and updated some fixtures in January and February and moved into the space on March 1, 2022. The lease term is 5 years, with two 5-year renewal options, both of which are reasonably certain to be exercised. Tenant Co. also has a purchase option for $100,000 but they are not reasonably certain they will exercise the option at this time.

The lessor provided a rent holiday for the first month of the initial lease term. After, Tenant Co. will be required to pay base rent of $2,000 monthly and quarterly CAM payments with amounts to be based on actual maintenance activities.

The lease agreement requires annual base rent escalations beginning January 1, 2023 equal to the % increase in CPI for the preceding 12 months. CPI for December 2021 was 0.6%. Tenant Co. will also owe payments equal to 2% of sales, with a minimum required amount of $200 monthly. Sales usually range between $20,000 - $50,000 monthly. After conversations with their auditors, Tenant Co. has decided to use the risk-free rate from the US Treasury website as the discount rate for the lease liability calculation.

To account for their lease agreement, Tenant Co. determines a total lease term based on the following key dates:

- Contract execution date of October 24, 2021 - this is the date the contact was signed and not used for any accounting purposes
- Lease commencement date of January 1, 2022 - this is both the commencement date specified in the lease and the possession date because Tenant Co. was granted access to the property on this date. Tenant Co. will recognize the lease on January 1, 2022. The time taken to complete leasehold improvements has no bearing on the accounting for the lease.
- Initial lease end date of December 31, 2026 for the first 5-year term of the lease.
- Final contract end date of December 31, 2036 includes both renewal terms that Tenant Co. is reasonably certain to elect.

The lease term for the above set of facts is 15 years, or 180 months.

Lease Term (in Years)		
Initial term	January 1, 2022 - December 31, 2026	5 years
Renewal 1	January 1, 2027 - December 31, 2031	5 years
Renewal 2	January 1, 2032 - December 31, 2036	5 years
Total Term		15 years
		x 12 months
	Total Months/Periods	180

Lease Liability

A lease liability is the financial obligation for the payments required by a lease, discounted to present value. Under ASC 842, the lease liability is calculated as the present value of the remaining lease payments.

Payments

The basic formula for calculating the lease liability is to take the present value of any remaining future lease payments. This calculation is straightforward; there is very little room for varying interpretations, judgments, or estimates. Where the lease liability calculation can be a bit trickier is in the determination of the remaining payments to capture and the discount rate to use.

Numerous payments varying in amount, timing, or triggering events can be specified within a lease agreement, and it can be hard to determine which of these to include in the lease liability calculation. ASC 842 defines the future lease payments to include in the lease liability calculation as:

- Fixed payments required by the lease agreement, such as base rent
- In-substance fixed payments required by the lease agreement
- Variable lease payments that depend on an index or rate
- Purchase options that are reasonably certain to be exercised
- Penalties for terminating the lease if the lease term reflects the lessee incurring any penalties for termination
- Fees paid by the lessee to the owners of a special purpose entity for structuring the transaction
- Payments probable of being owed by the lessee as the result of a residual value guarantee

Fixed vs. Variable

Lease payments can be separated into two categories: fixed and variable consideration.

- Fixed consideration is a payment made directly for the right to use the underlying asset and is explicitly stated in the lease contract. These payments will be included in the measurement of the lease liability and ROU asset.

- Variable consideration is a payment incurred for the right to use an asset that varies relative to changes occurring throughout the lease term. These payments are typically not included in the measurement of the lease liability or ROU asset and are simply expensed when incurred. However, variable payments may also include payments related to a stated index or rate, such as CPI. These payments are included in the lease liability calculation, and we discuss specific accounting treatment below.

An example of a fixed payment typically found in a lease agreement is base rent. Base rent is essentially the minimum required payment for a lease. It is the portion of the rent payment explicitly stated in the contract and will be included in the calculation of the asset and liability. A lease contract may include a payment schedule of the expected annual or monthly payments. Even if the contract includes escalations to the beginning or base payment amount, this type of rent is fixed.

When the periodic payments are structured so they cannot be calculated without the occurrence of an event, such as an amount of sales or units produced, the payments are not considered fixed. Examples of variable payments are monthly rent as a percentage of sales or a per mile rate once a mileage threshold is achieved. Variable lease costs will not be included in the lease liability calculation, but are still required to be disclosed.

Variable lease payments can be presented as what looks like a fixed payment at the beginning of a lease term, e.g. a specified amount for taxes is added to the base rent payment. However, if the payment will be reconciled to actual costs at a future date, and the lessee is required to pay the difference, the cost is considered variable because the final amount is dependent upon actual expenses. To avoid misclassifying variable payments as fixed payments, ask yourself if a reconciliation is required. If the payments are compared to actual expenses or some unknown future amount, they are likely variable.

In-substance Fixed

In-substance fixed payments are the opposite of variable payments presented as fixed payments. These payments can be tricky because they may appear as variable payments, but are in fact, fixed. An example of in-substance fixed payments would be a lease agreement with payments based on an amount of future sales and a required minimum amount.

While the amount based on sales is variable and cannot be calculated until sales are known, the minimum required payment is an in-substance fixed payment. The lessee knows at a minimum they will pay this amount according to the terms of the agreement and can therefore include this amount in their lease liability calculation.

Likewise for the example above of a rate for miles over a certain threshold. The lessee can calculate the lease liability with the base rent amount and any mileage overages are excluded from the initial lease measurement, to be expensed when or if incurred.

Variable Depending on a Rate/Index

As mentioned above, variable payments that depend on sales or an event are not included in the lease liability calculation. However, payments that are variable because of dependence on an index or rate are included in the initial lease liability calculation. The consumer price index (CPI) is an example of an index or rate to which a lease payment schedule may be linked.

A common use of this type of payment in a lease agreement is to specify a base rent amount with annual escalations equal to CPI. Similar to the mileage payment scenario above, the lessee knows the CPI in effect when the lease commences and can, therefore, calculate the initial lease liability with the index or rate at the lease commencement date. However, escalations based on increases to CPI are variable payments excluded from the lease liability measurement because the increase is an event that can not be predicted.

The initial lease liability is calculated with the index or rate in effect at the lease commencement date applied for the lease term. Over the term of the lease, as payments are made with the actual index or rate applied, any variance is recognized as expense. Additionally, a change in the index or rate the payments depend on does not trigger a remeasurement of the lease liability on its own. Rather, if another event occurs to cause a remeasurement, the index or rate is updated to the index or rate in effect at the remeasurement date.

Additional Payments

Some payment types, such as base rent, will be the main drivers in the calculation of the lease liability, but other items could also have an impact on the liability balance. These items include:

- The price of a purchase option, if the lessee is reasonably certain to exercise that option,
- Penalties for terminating the lease, if the lease term used for the lease liability calculation reflects the lessee exercising an option which invokes penalties,
- Fees paid by the lessee to the owners of a special purpose entity for structuring the transaction, and
- Payments for a residual value guarantee, if the payments are probable of being owed by the lessee.

Although this is not an exhaustive list, these are the types of payments to look for within a lease agreement when calculating the lease liability. A common trait in several of this group of payments is the ability to select an option or not.

Lease vs. Nonlease Components

Lease components are sections of the contract which directly transfer the right to use the underlying asset to the lessee in exchange for consideration. A nonlease component is a section of the contract which transfers a good or service to the lessee that is separate from the use of the underlying asset in exchange for consideration. Lastly, non-components are payments that do not contribute directly to the right to use the underlying asset and do not transfer any value to the lessee, such as property taxes or insurance.

The nature of the payment, fixed or variable, does not dictate the determination of whether it is a lease component. Frequent examples of nonlease components include the cost of common area maintenance (CAM) provided by the landlord for a real estate lease, or charges for maintenance, landscaping, janitorial, or other services related to the lease.

Some types of payments may be either a lease or nonlease component, depending on circumstances, such as a security deposit. When determining if a security deposit should be included in your lease payments, confirm if the deposit is refundable or non-refundable. In short, refundable deposits are not included as lease payments but any non-refundable deposits are, and if paid before commencement, will increase the value of the ROU asset.

It is also normal to see lease agreements structured with one payment stream consisting of both lease and nonlease components. If this is the case, ASC 842 requires the lessee to allocate the total contract consideration, or that of the combined components, to each of the individual lease and nonlease components on a relative standalone price basis. To complete the allocation lessees must use observable standalone prices for each component or estimate the standalone prices using the available market information if they are not readily available. However, a practical expedient exists which allows lessees and lessors to elect by underlying asset class to account for each lease and nonlease component as a single lease component, saving the resources required to separate these costs.

Discount Rates

The final element that goes into the lease liability calculation will be the discount rate used to calculate the net present value (NPV). The guidance recommends using the rate implicit in the lease as the rate that best represents the intended economics of the lease. However, this rate is often not easily determined by the lessee. An entity's incremental borrowing rate (IBR) is offered as an alternative to the implicit rate under ASC 842.

If the rate implicit in the lease is not easily determined, a company can choose to apply their IBR, or the rate an entity would be charged to borrow a similar amount, over a similar term, on a collateralized basis. A private company has the option to use either the IBR or a risk-free rate (the theoretical rate of return for an investment with no risk) at an underlying asset class level.

When choosing a rate, consider that although the risk-free rate can be estimated more easily than the IBR or implicit rate, lower discount rates lead to higher opening liability amounts.

Implicit Rate

The implicit rate should be used before any other rate if it is readily available or can be accurately calculated. This is explicitly stated in ASC 842, specifically in 842-20-30-3: "a lessee should use the rate implicit in the lease whenever that rate is readily determinable."

ASC 842 defines the implicit rate as the rate of interest that at any given date causes the aggregate present value of:

- The lease payments and
- The amount the lessor expects to derive from the underlying asset at the end of the lease term
  to equal the sum of both

- The fair value of the underlying asset minus any related investment tax credits retained and expected to be realized by lessor and
- Any deferred initial direct costs of the lessor.

This definition is shown below as a formula:

Present value of lease payments + Present value of the expected future value of the residual asset = Fair value of asset minus any related investment tax credit + Deferred lessor initial direct costs

Quickly Calculate the Discount Rate Implicit in Your Leases

Implicit Interest Rate Calculator for Leases

Incremental Borrowing Rate (IBR)

IBR is the interest rate all lessees are able to use when the implicit rate is not readily available or able to be calculated, as made clear by the continuation of paragraph ASC 842-20-30-3. This section of the guidance explicitly states "if the rate implicit in the lease is not readily determinable, a lessee uses its incremental borrowing rate."

The glossary of ASC 842 goes on to define the incremental borrowing rate as the rate of interest a lessee would have to pay to borrow an amount equal to the total lease payments on a *collateralized* basis over a similar term in a similar economic environment. Think about this as the rate charged by your bank or financial lender to borrow an amount of money equal to the total lease payments over the lease term. It is worth noting that this definition differs from ASC 840, which defined this rate as the rate the lessee would have incurred to borrow over a similar term *the funds necessary to purchase the leased asset*.

The incremental borrowing rate is calculated based on factors specific to the company and the contract such as credit rating, the underlying asset, the lease term, and the economic environment. It can be difficult and expensive to obtain IBRs for the various leases in an entity's portfolio, especially for non-public entities that may not have information like comparable credit spreads readily available. In cases where a company's treasury department is not equipped to establish these rates, organizations may choose to engage with external firms that specialize in valuations, third party lenders, or other parties to get an accurate estimation of an IBR. This can significantly increase the cost associated with compliance with ASC 842. No matter the method an entity uses to determine their IBR for their leases, it is important to document the method, reasoning, and overall findings and discuss the conclusions with the external auditors.

Risk-free Rate

The rate implicit in the lease is not usually readily determinable. Further, it can often be complex and even costly (if engaging an outside party) to estimate the incremental borrowing rate. In order to alleviate the burden of adopting ASC 842 for non-public entities, private entities are permitted by ASC 842 to apply a risk-free rate as the discount rate by class of underlying asset.

The risk-free rate is the rate investors expect to earn from an investment that carries zero risk over a period of time, such as a government treasury bill. The final portion of ASC 842-20-30-3 also states that the risk-free rate should be determined using a period comparable with the lease term. This election is not required to be applied, but it is one of the many optional expedients available to simplify the lease accounting transition to ASC 842.

Though the option to apply the risk-free rate was originally an accounting policy election to be applied across the entity, amendments issued as a result of the FASB's post-implementation review process allow private entities to elect to use the risk-free rate by class of underlying asset.

Present Value

Present value, commonly referred to as PV, is the calculation of what a future sum of money or stream of cash flows is worth today given a specified rate of return over a specified period of time.

Under the new lease accounting standards, lessees are required to calculate the present value of any future lease payments to determine the obligations to be recorded on the balance sheet for both operating and finance leases. The calculation is performed using the term and payments specified in the lease and a rate of return that is specific to either the lease or the organization. The present value of the lease payments is used to establish both the lease liability and the related ROU asset.

Determine the Present Value of Your Lease Payments

Present Value Calculator

Example 4: How to calculate the lease liability

To calculate the lease liability from the facts presented above in Example 3, first determine which required lease payments will be included.

- Base Rent of $2,000/month to be included in the lease liability calculation. The escalations will be expensed as incurred because the increase to CPI for the preceding 12 months is not yet known.
- The quarterly CAM payments depend on actual activity and are not included in the lease liability, but will be expensed as incurred.
- The payments based on sales specify a minimum required amount and are an in-substance fixed payment to be included in the lease liability calculation.
- The lease agreement includes a $100,000 purchase option Tenant Co. is not reasonably certain to exercise, and therefore it will not be included in the lease liability calculation.
- The contract stipulates a rent holiday for the first month of the lease term, making the total periodic payments Tenant Co. is obligated to pay 179.

Payment Schedule	
Total payments	
Base rent payments (179 months x $2,000, includes rent holiday)	358,000
In-substance fixed payments (179 months @ $200, includes rent holiday)	35,800
Total fixed payments	**$393,800**

Next, determine the discount rate to use for the present value calculation. In this example Tenant Co. decided to use a risk-free rate of 3%.

Finally, apply the discount rate to the payment stream to determine the present value of the required lease payment and the lease liability.

Lease Liability Calculation

Dates	Cash Flows	Total Payments
January 1, 2022	0	0
2/1/2022-12/1/2036	2,200	393,800
	Total fixed payments	**$393,800**
	Present value	**$317,168**

Below is a screenshot of the calculation of a present value of $317,168 for the total fixed payments of $393,800 using the risk-free rate of 3% over 180 months using the LeaseQuery present value calculator.

Periods in: Months

Payments Made at: Beginning of Period

Period	Cash	Present Value
0	$0.00	$0.00
1	$2,200.00	$2,194.51
2	$2,200.00	$2,189.04
3	$2,200.00	$2,183.58
4	$2,200.00	$2,178.14
5	$2,200.00	$2,172.71
6	$2,200.00	$2,167.29
7	$2,200.00	$2,161.88
8	$2,200.00	$2,156.49
9	$2,200.00	$2,151.11
10	$2,200.00	$2,145.75
11	$2,200.00	$2,140.40
12	$2,200.00	$2,135.06
168	$2,200.00	$1,446.26
169	$2,200.00	$1,442.65
170	$2,200.00	$1,439.06
171	$2,200.00	$1,435.47
172	$2,200.00	$1,431.89
173	$2,200.00	$1,428.32
174	$2,200.00	$1,424.76
175	$2,200.00	$1,421.20
176	$2,200.00	$1,417.66
177	$2,200.00	$1,414.12
178	$2,200.00	$1,410.60
179	$2,200.00	$1,407.08
TOTAL	$393,800.00	$317,168.47

Present Value is $317,168

ROU Asset

A right-of-use asset, or ROU asset, represents a lessee's authority to utilize a leased item, typically property or equipment, over the duration of an agreed-upon lease term. In other words, the lessee is granted the right to obtain the economic benefit from the usage of an asset owned by another entity.

Formula

Under ASC 842, initial operating and finance lease ROU assets are calculated using the exact same method. The steps are as follows:

Start with the initial amount of the lease liability, computed by discounting the remaining lease payments

+ Outstanding balance of prepaid rent or

– Cumulative remaining deferred rent

+ Initial direct costs

– Lease incentives paid at or before commencement of the lease

It is important to note that for basic leases, the ROU asset and lease liability will be equal upon lease commencement. For example, if a company has a lease without initial direct costs, prepaid/deferred rent, or a tenant improvement allowance (or some other lease incentive), then the ROU asset and the lease liability will be equal on the lease commencement date.

Lease Prepaids/Accruals

Under ASC 842, prepaid rent is included in the measurement of the ROU asset. Any prepaid rent outstanding as of the transition date is included in the measurement of the ROU asset, by crediting the prepaid account and debiting the ROU asset for the same amount. Subsequent lease accounting under ASC 842 also requires any prepaid amounts to be recorded to the ROU asset.

Deferred Rent

Deferred rent is a liability account representing the difference between the cash paid for rent expense in a given period and the straight-line rent expense recognized for operating leases under ASC 840. The transition to ASC 842 will result in the elimination of the deferred rent account from the balance sheet.

Any balance in the deferred rent account at transition will be included as an adjustment to the ROU asset. If the deferred rent balance at transition is a credit balance, the account will be cleared with a debit equal to the balance and a corresponding credit, or reduction, of the initial ROU asset. Subsequently, the accumulation and reduction of the deferred rent balance is recognized in the financial statements as part of the lease liability and ROU asset rather than in a separate deferred rent account.

Incentives

A lease incentive is a payment made from a lessor directly to a lessee, or on behalf of a lessee. As such, a lease incentive can come in many different forms and look like a lot of different things. Lease incentives do not include payments from the lessor to the lessee for any good or service that the lessee is providing to the lessor.

Common examples of lease incentives are:

- A lump sum cash payment from the lessor to the lessee at the date of lease execution
- A payment from the lessor to the lessee during the lease term to reimburse for leasehold improvements
- The lessor taking over a lessee's pre-existing lease to entice the lessee to enter into a new lease with the lessor

Regardless of what it may look like in practice, when dealing with a payment from the lessor to, or on behalf of, the lessee, that is most likely a lease incentive.

Similar to the treatment of new incentives, any unamortized incentive balances at transition are subtracted from the ROU asset, by clearing the unamortized incentive balance with a debit and crediting the ROU asset for the same amount. The remaining incentive is then amortized as part of the ROU asset amortization going forward.

Initial Direct Costs

Initial direct costs (IDC) are expenses directly related to the negotiation and execution of a lease agreement, such as legal fees. ASC 842 narrowed the scope of costs considered IDC by defining IDC as incremental costs that would not have been incurred if the lease had not been executed. Although a lessee doesn't have a separate account for IDC, they are included in the calculation of the ROU asset so they continue to be recorded on the balance sheet and amortized over the lease term.

Any unamortized IDC balances at transition must be reassessed according to the criteria under ASC 842 unless the lessee elects the package of practical expedients which allows the lessee to not reassess. The remaining balance of unamortized IDC costs are included in the ROU asset calculation, by crediting the IDC account and debiting the ROU asset for the same amount.

Amortization

Under ASC 842, the ROU asset is amortized from the lease commencement date (the date the lessee obtains possession of the underlying asset) to the end of the lease's term. In some cases, such as when the lessee is reasonably certain it will exercise an option to purchase the underlying asset, it may be from the commencement date to the end of the useful life of the asset.

Example 5: How to calculate the ROU asset

To calculate an ROU asset, start with the facts from Example 3 above and include this additional information:

Tenant Co. received a tenant improvement allowance of $50,000 as an incentive to sign the lease from the lessor. The lessor paid the contractor directly for the construction of the improvements, prior to the lease commencement date. The lessor also paid Tenant Co. a reimbursement of $10,000 in moving expenses at lease commencement.

Finally, Tenant Co. incurred initial direct costs of $5,000 to enter into the lease agreement.

To calculate the ROU asset, take the calculated lease liability of $317,168 (from Example 3) and make the following adjustments:

– Lease incentives paid before commencement of the lease of $50,000

– Lease incentives paid at commencement of the lease of $10,000

+ Initial direct costs of $5,000

The ROU asset aggregates to $262,168 ($317,168 - $50,000 - $10,000 + $5,000).

3. Lease Classification

ASC 842 uses a two-model approach for lessees; each lease is classified as either a finance lease or an operating lease. This applies to all leased asset categories covered under the standard, including leases of equipment and real estate. “Finance lease” is a new term and replaces the term, “capital lease,” used under Topic 840. Additionally, ASC 842 changes the criteria that define a finance/capital lease.

Classification Test

Lease classification is determined based on five tests, which are performed at lease commencement. If a lease meets any of the following criteria, it is classified as a finance lease:

1. The lease transfers ownership of the underlying asset to the lessee by the end of the lease term.

2. The lease grants the lessee an option to purchase the underlying asset that the lessee is reasonably certain to exercise.

3. The lease term is for the majority of the remaining economic life of the underlying asset. However, if the commencement date falls at or near the end of the economic life of the underlying asset, this criterion shall not be used for purposes of classifying the lease.

4. The present value of the sum of the lease payments and any residual value guaranteed by the lessee that is not already reflected in the lease payments in accordance with paragraph 842-10-30-5(f) equals or exceeds substantially all of the fair value of the underlying asset.

5. 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.

Any lease that doesn’t meet any of the above criteria is classified as an operating lease.

One change from ASC 840 is that the classification criteria no longer specify the exact thresholds of above 90% of present value and more than 75% of remaining life. However, implementation guidance allows for these bright lines being applied to support judgements related to these criteria.

Determine Your Lease Classification

Capital vs. Finance Lease Test

“Strong-Form” vs. “Weak-Form” Finance Leases

Here at LeaseQuery, we like to call finance leases that meet either the 1st or 2nd criterion “strong-form” finance leases and those that meet only the 3rd or 4th criterion “weak-form” finance leases.

This is an important distinction because there is one major difference between those types of leases. For finance leases that transfer ownership at the end of the lease term or those that have a purchase option the lessee is reasonably certain to exercise (strong-form finance leases), the underlying assets are depreciated over the useful life that would be assigned if the asset were owned.

For weak-form finance leases (those that meet only the 3rd or 4th criterion), the assets would be depreciated over the shorter of the useful life or the lease term. This is a subtle difference, but it obviously has profound accounting implications.

Example 6: How to determine lease classification

Assume Tenant Co. signs a lease for a point of sale system with the following assumptions:

- Fair value of the point of sale equipment is $23,000
- Lease term is 3 years
- Monthly payments of $700/month paid in advance; $75 of the monthly payment is related to maintenance
- Interest rate a bank would charge Tenant Co. for a $23,000 loan over 3 years is 4%
- Useful life of the point of sale system is 5 years
- At the end of the lease term, Tenant Co. can purchase the point of sale equipment for $2,500, which is the estimated fair value at the end of the lease.

To determine if they have a finance or operating lease, Tenant Co. must perform the finance versus operating lease test, which is composed of five parts under topic 842. If the lease meets any of the following five criteria, then it is a finance lease.

Criteria 1: There is a title transfer at the end of the lease term.

There is no title transfer at lease end, so the first test for finance lease accounting is not met.

Criteria 2: The lease agreement includes a purchase option that the lessee is reasonably certain to exercise.

Tenant Co. does not plan to exercise the purchase option, so the second test for finance lease accounting is not met.

Criteria 3: The lease term is greater than or equal to the major part of the useful life of the asset. (Note: Tenant Co. has maintained the greater than or equal to 75% threshold for this test).

The lease term is 3 years while the useful life is 5 years. 3 years is less than 75% of 5 years (3 versus 3.75), so the third test for finance lease accounting is not met.

Criteria 4: The present value of the sum of the lease payments is substantially all of the fair value of the leased asset. (Note: Tenant Co. has maintained the greater than or equal to 90% threshold for this test).

Note: Tenant Co. is using $625 instead of the full monthly payment of $700 because the $75 related to maintenance is deemed a nonlease component under ASC 842 and Tenant Co. is not electing the practical expedient to account for lease and nonlease components as a single lease component. The lessee should only be accounting for the portion of the payments that relate to the lease component when accounting for the lease arrangement. See further discussion of the test for criteria 4 below.

Criteria 5: 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.

The underlying asset is not specialized for Tenant Co. It will have value to the lessor when returned at the end of the lease term.

In order to perform the fourth test, Tenant Co. must calculate the present value of the minimum lease payments. This is calculated as the present value of monthly payments of $625 over 3 years at 4%.

Using our free present value calculator, we calculate a present value of $21,240 which is greater than 90% of the fair value of the asset (90% of $23,000 is $20,700). Tenant Co. has chosen to utilize the 90% threshold to represent “substantially all” of the fair value of the asset. As a result, this lease is classified as a finance lease per the fourth test, and as such finance lease accounting needs to be applied.

Number of Periods	36
	Refresh
Annual Rate	4.00%
Periods in	Months
Payments Made at	Beginning of Period

Period	Cash	Present Value
0	$625.00	$625.00
1	$625.00	$622.92
2	$625.00	$620.85
3	$625.00	$618.79
4	$625.00	$616.74
5	$625.00	$614.69
6	$625.00	$612.64
7	$625.00	$610.61
8	$625.00	$608.58
9	$625.00	$606.56
10	$625.00	$604.54
11	$625.00	$602.54
12	$625.00	$600.53
13	$625.00	$598.54
14	$625.00	$596.55
15	$625.00	$594.57
16	$625.00	$592.59
17	$625.00	$590.62
18	$625.00	$588.66
19	$625.00	$586.71
20	$625.00	$584.76
21	$625.00	$582.81
22	$625.00	$580.88
23	$625.00	$578.95
24	$625.00	$577.02
25	$625.00	$575.11
26	$625.00	$573.20
27	$625.00	$571.29
28	$625.00	$569.39
29	$625.00	$567.50
30	$625.00	$565.62
31	$625.00	$563.74
32	$625.00	$561.87
33	$625.00	$560.00
34	$625.00	$558.14
35	$625.00	$556.28

4. Finance/Capital Lease Accounting

Accounting for finance leases doesn't vary much from the previous guidance. When accounting for finance leases, lessees must:

- Recognize interest on the lease liability and amortization of the right-of-use asset in separate line items of the income statement
- Classify payments of the principal portion of the lease liability within financing activities and payments of interest on the lease liability within operating activities on the statement of cash flows

Example 7: How to account for a finance lease

The following schedule is the lease amortization schedule for the finance lease from Example 6. The amortization schedule is used to record the journal entries required for finance lease accounting:

Topic 842 Finance Lease Amortization Schedule

	LEASE LIABILITY				ROU ASSET		
Period	CASH	INTEREST EXPENSE	LIABILITY REDUCTION	TOTAL LIABILITY	BEGINNING BALANCE	ASSET AMORTIZATION	TOTAL ASSET
Beginning Balance				21,240			21,240
Jan 2022	625	67	558	20,682	21,240	590	20,650
Feb 2022	625	65	560	20,122	20,650	590	20,060
Mar 2022	625	63	562	19,560	20,060	590	19,470
Apr 2022	625	62	563	18,997	19,470	590	18,880
May 2022	625	60	565	18,432	18,880	590	18,290
Jun 2022	625	58	567	17,865	18,290	590	17,700
Jul 2022	625	56	569	17,296	17,700	590	17,110
Aug 2022	625	54	571	16,726	17,110	590	16,520
Sep 2022	625	53	572	16,153	16,520	590	15,930
Oct 2022	625	51	574	15,579	15,930	590	15,340
Nov 2022	625	49	576	15,003	15,340	590	14,750
Dec 2022	625	47	578	14,425	14,750	590	14,160
Jan 2023	625	45	580	13,846	14,160	590	13,570
Feb 2023	625	44	581	13,264	13,570	590	12,980
Mar 2023	625	42	583	12,681	12,980	590	12,390
Apr 2023	625	40	585	12,096	12,390	590	11,800
May 2023	625	38	587	11,509	11,800	590	11,210
Jun 2023	625	36	589	10,920	11,210	590	10,620
Jul 2023	625	34	591	10,330	10,620	590	10,030
Aug 2023	625	33	592	9,737	10,030	590	9,440
Sep 2023	625	31	594	9,143	9,440	590	8,850
Oct 2023	625	29	596	8,547	8,850	590	8,260
Nov 2023	625	27	598	7,949	8,260	590	7,670
Dec 2023	625	25	600	7,349	7,670	590	7,080
Jan 2024	625	23	602	6,747	7,080	590	6,490
Feb 2024	625	21	604	6,143	6,490	590	5,900
Mar 2024	625	19	606	5,537	5,900	590	5,310
Apr 2024	625	17	608	4,930	5,310	590	4,720
May 2024	625	16	609	4,320	4,720	590	4,130
Jun 2024	625	14	611	3,709	4,130	590	3,540
Jul 2024	625	12	613	3,096	3,540	590	2,950
Aug 2024	625	10	615	2,480	2,950	590	2,360
Sep 2024	625	8	617	1,863	2,360	590	1,770
Oct 2024	625	6	619	1,244	1,770	590	1,180
Nov 2024	625	4	621	623	1,180	590	590
Dec 2024	625	2	623	0	590	590	0

As documented above, the present value of the minimum lease payments is $21,240; so the initial journal entry to record the finance lease at least commencement is:

ACCOUNT	DEBIT	CREDIT
Finance Lease Asset	21,240	
Finance Lease Liability		21,240
To record a finance lease		

Each month, two entries need to be recorded; one to record the payment of the lease, and the second to record amortization expense. The following entries would be recorded during month-end close of the first month:

ACCOUNT	DEBIT	CREDIT
Finance Lease Liability	558	
Interest Expense	67	
Maintenance Expense	75	
Cash		700
To record the first month's payment		

A portion of the payment Tenant Co. makes goes against interest expense, a portion relates to the nonlease element of maintenance costs, and the remaining balance goes to reduce the finance lease liability. These numbers are obtained from the amortization schedule above.

Because this is a "weak-form" lease, it is amortized over the lease term of 3 years (36 months). The following journal entry represents the entry for amortization expense, which will not change throughout the lease:

ACCOUNT	DEBIT	CREDIT
Amortization Expense	590	
Accumulated Amortization		590
To record the first month's amortization		

Journal entries in subsequent months will be similar to the first month entries, in that the payment will be allocated between lease liability, interest expense, and maintenance expense and amortization expense will be recognized.

5. Operating Lease Accounting

Under ASC 840, operating leases were considered off-balance sheet transactions. The rent expense associated with the arrangements was recognized in the income statement, but there was not any balance sheet impact. Under ASC 842, the lessee must:

- Recognize a single lease cost allocated over the lease term, generally on a straight-line basis
- Classify all cash payments within operating activities on the statement of cash flows

Example 8: How to account for an operating lease

The following schedule is the lease amortization schedule for the operating lease from Examples 3-5 (The lease liability from Example 4 and the ROU asset from Example 5). The amortization schedule is used to record the journal entries required for operating lease accounting:

Topic 842 Operating Lease Amortization Schedule							
PERIOD	CASH	LIAB LEASE EXPENSE	LIABILITY REDUCTION	TOTAL LIABILITY	ASSET LEASE EXPENSE	NET ASSET BALANCE	TOTAL LEASE EXPENSE
Beginning Balance				317,168		262,168	
1/1/2022	0	793	-793	317,961	1,089	261,079	1,882
2/1/2022	2,200	789	1,411	316,550	1,093	259,986	1,882
3/1/2022	2,200	786	1,414	315,136	1,096	258,890	1,882
4/1/2022	2,200	782	1,418	313,719	1,100	257,790	1,882
5/1/2022	2,200	779	1,421	312,297	1,103	256,686	1,882
6/1/2022	2,200	775	1,425	310,873	1,107	255,579	1,882
7/1/2022	2,200	772	1,428	309,444	1,111	254,469	1,882
8/1/2022	2,200	768	1,432	308,012	1,114	253,355	1,882
9/1/2022	2,200	765	1,435	306,577	1,118	252,237	1,882
10/1/2022	2,200	761	1,439	305,138	1,121	251,116	1,882
11/1/2022	2,200	757	1,443	303,695	1,125	249,991	1,882
12/1/2022	2,200	754	1,446	302,249	1,128	248,862	1,882
1/1/2023	2,200	750	1,450	300,799	1,132	247,730	1,882
2/1/2023	2,200	746	1,454	299,346	1,136	246,594	1,882
3/1/2023	2,200	743	1,457	297,888	1,139	245,455	1,882
4/1/2023	2,200	739	1,461	296,428	1,143	244,312	1,882
5/1/2023	2,200	736	1,464	294,963	1,147	243,165	1,882
6/1/2023	2,200	732	1,468	293,495	1,150	242,015	1,882

Note: To conserve space we included the first and last portions of the amortization schedule here. Find the full amortization schedule at Appendix A.

11/1/2035	2,200	70	2,130	28,175	1,812	24,044	1,882
12/1/2035	2,200	65	2,135	26,040	1,817	22,227	1,882
1/1/2036	2,200	60	2,140	23,900	1,823	20,404	1,882
2/1/2036	2,200	54	2,146	21,754	1,828	18,576	1,882
3/1/2036	2,200	49	2,151	19,603	1,833	16,743	1,882
4/1/2036	2,200	44	2,156	17,446	1,839	14,904	1,882
5/1/2036	2,200	38	2,162	15,285	1,844	13,060	1,882
6/1/2036	2,200	33	2,167	13,117	1,850	11,211	1,882
7/1/2036	2,200	27	2,173	10,945	1,855	9,356	1,882
8/1/2036	2,200	22	2,178	8,766	1,860	7,495	1,882
9/1/2036	2,200	16	2,184	6,583	1,866	5,629	1,882
10/1/2036	2,200	11	2,189	4,393	1,871	3,758	1,882
11/1/2036	2,200	5	2,195	2,198	1,877	1,882	1,882
12/1/2036	2,200	2	2,198	0	1,882	0	1,882

The entry to record the operating lease would be as follows:

ACCOUNT	DEBIT	CREDIT
ROU Asset	262,168	
Leasehold Improvements (Incentives received)	50,000	
Cash (Incentives received)	10,000	
Operating Lease Liability		317,168
Cash (IDC paid)		5,000

To record an operating lease at lease commencement

Subsequent entries follow the amortization schedule. The entry made for the second month after recognition of the lease would be as follows:

ACCOUNT	DEBIT	CREDIT
Rent Expense	1,882	
Operating Lease Liability	1,411	
ROU Asset		1,093
Cash		2,200

To record rent payment and activity for 2/2022

Lease Impact to Financial Statements (Lessee)

Balance Sheet

With both finance and operating leases now requiring a liability and asset to be recorded, the total assets and liabilities recognized on the balance sheet are increased. No impact to debt occurs when transitioning to ASC 842. However, companies should consider how the new operating liability could potentially impact certain financial ratios.

Income Statement

The classification of a lease helps determine how and when the lessee recognizes expenses. No change to expense is recognized when transitioning from ASC 840 to ASC 842; therefore, the income statement remains consistent. Operating leases will continue to recognize rent expense on a straight-line basis and finance leases will recognize both interest expense and amortization expense.

Lease Disclosures

The disclosure requirements for ASC 842 are both qualitative and quantitative:

Qualitative

A general description of the leases into which the lessee has entered including, but not limited to

- The basis on which contingent rental payments are determined
- The existence and terms of renewal or purchase options and escalation clauses
- The nature of the residual value guarantee, including the events or circumstances that would require the lessee to perform under the guarantee, the current status, the maximum potential amount of future payments, and the current carrying amount of any liability
- Restrictions imposed by lease agreements
- Any significant assumptions or judgements made in the application of the guidance

Quantitative

- Finance lease cost, separated between amortization of the ROU asset and interest expense on the lease liability
- Operating lease cost
- Short-term lease cost, excluding the cost of leases with a term of one month or less
- Variable lease cost
- Gross sublease income
- Net gain or loss recognized on sale-leaseback transactions
- Cash paid for amounts included in the measurement of lease liabilities, separately for finance and operating leases
- Supplemental non-cash information on lease liabilities arising from obtaining right-of-use assets, separately for finance and operating leases
- Weighted-average remaining lease term, separately for finance and operating leases
- Weighted-average discount rate, separately for finance and operating leases
- The amount of short-term lease commitments, if short-term lease expense for the period is not reflective of those commitments
- Maturity analysis of undiscounted cash flows for a minimum of each of the first five years and a total amount for the remaining years, reconciled to the balance sheet, separately for finance and operating leases

6. Transition

ASC 842 contains guidance on how to transition properly, including several practical expedients. For more in-depth information on how to implement ASC 842, additional resources, such as our Lease Accounting Transition Guide and ASC 842 Transition Checklist can be found at **leasequery.com/resources**.

Practical Expedients

Due to the strenuous efforts often increasing the costs of implementation, the accounting boards provide support for accomplishing compliance with options to ease adoption called practical expedients. Entities may chose to apply these options lease by lease, by class of asset, or as an accounting policy election depending on the type of practical expedient. Identifying the appropriate practical expedients will save resources, but if not interpreted properly, entities run the risk of errors in lease accounting.

The Package of Practical Expedients

The following three practical expedients must be elected all at once for transition and cannot be elected individually. Under ASC 842 this group of expedients is referred to as “the package of practical expedients”.

No Reassessment of Lease Classification

Entities can opt not to reassess the lease classification of existing or expired leases under ASC 842, and simply maintain its original classification. Under the new guidance, the “bright-line” criteria (75% of the lease term and 90% or greater of PV of lease payments) in the lease classification test are removed. Additionally, there is a fifth test for specialized use at the end of the lease term.

However, if a lease was classified as a capital lease under ASC 840, it remains a capital lease, albeit with a name change to finance lease. If a lease was classified as an operating lease under the old standards, it is still an operating lease. The caveat being errors under ASC 840 are not exempt. In other words, if an error in classification occurred under ASC 840 it would also be treated as an error under ASC 842.

No Reevaluation of Existing or Expired Leases

Entities can elect not to reevaluate whether expired or existing leases contain a lease per the definition of ASC 842. Ultimately, if the accounting for leases embedded in service and outsourcing contracts were appropriately considered under the old standard, then you don’t need to reevaluate those contracts. Similar to the practical expedient above, this assumes no errors were made in previous evaluations.

No Reassessment of Initial Direct Costs

Entities can opt not to reassess previously capitalized initial direct costs as there are slight differences in how initial direct costs are defined under ASC 840 and ASC 842. Under ASC 840, a portion of your internal expenses could be allocated to initial direct costs. For instance, a percentage of the salaries could be allocated for internal real estate or legal staff. Under ASC 842, initial direct costs are defined as costs that would not have been incurred if the lease had not been signed – typically external costs, such as broker fees or external legal fees. This expedient allows the organization to not reassess those costs.

Discount Rates

Because evaluating the appropriate discount rate is challenging for all entities, several practical expedients related to determining the appropriate rate to use are available. The economics of any lease agreement is best represented by the rate implicit in the lease. This is the rate the lessor charges the lessee and the rate that results in the most accurate valuation of expected lease payments. Therefore, when assessing the rate lessees and lessors should first apply the stated or implicit rate in the lease.

Unfortunately, this can be difficult to determine for most lessees as lessors may not be willing to provide the implicit rate itself or all the required information to determine the implicit rate. If the implicit rate is not readily available, then lessees can apply the rate which it would pay to borrow funds under a collateralized loan for similar payments across a similar term as the lease, otherwise known as the incremental borrowing rate.

As it pertains to the application of the borrowing rate, companies can choose to apply rates on a lease-by-lease or portfolio basis. Applying rates on a portfolio level provides additional ease as it involves grouping leases with similar characteristics (i.e. lease term, location, etc.) and therefore reduces the effort of determining discount rates for each individual lease.

In addition to the ability to apply the incremental borrowing rate, private companies specifically can elect a practical expedient to use the risk-free interest rate. The risk-free rate is the rate investors expect to earn from risk-free investments over a period of time, such as a government treasury bill. If elected, this alternative can be applied by the class of underlying asset.

For example, a non-public entity could choose to apply the risk-free rate to vehicle leases but apply the IBR to their office building leases. Because the lower risk-free rate causes a higher lease liability, using different interest rates for the various asset classes can mitigate the potential impact of using the lower rate across the entire lease portfolio. If this election is chosen, the company must disclose how they applied the risk-free rate to their lease portfolio (i.e. the asset class to which it was applied).

Combining Lease and Nonlease Components

The practical expedient to combine lease and nonlease components is commonly misconstrued. Per the standard, components are activities that transfer goods and services, and the total contract consideration should be allocated to each separate lease and nonlease component. This expedient allows lessees and lessors to account for each lease and nonlease component as a single lease component, meaning lessees and lessors do not have to separate and allocate the consideration between lease and nonlease components.

7. Lease Changes

Modification vs. Remeasurement

Modification

A lease modification is a change to the terms and conditions of a contract resulting in a change to either the scope or consideration for a lease. This could be a change that either adds or terminates the right to use a portion or all of the underlying asset(s) or changes the lease term.

The proper accounting treatment for a lease modification depends on the nature of the modification. ASC 842 specifically distinguishes between two types of lease modifications:

1. Lease modifications that give the lessee additional rights not included in the original lease (and are not accounted for as a new lease), extend or reduce the term of an existing lease, or change only the consideration in the contract
2. Lease modifications that partially or fully terminate a lease by reducing the lessee's right to use one or more of the underlying assets

Modification of Existing Lease vs. New Lease

When first evaluating a lease modification, a lessee must ask themselves

- Does the modified contract contain a lease?
- If so, should the modified contract be accounted for as a new lease or a change to the original lease?

Sometimes a lease modification changes the scope or consideration of a lease so significantly it ultimately creates a new lease. Two conditions must be met for a lease modification to result in accounting for a new lease. If both of the conditions are met, the lease modification results in two separate contracts. If the conditions are not met, the modified lease is not a separate lease. The two criteria are:

1. The modification grants the lessee an additional right-of-use not specified in the original lease (for example, the right to use additional assets or additional floors/space in a building)

2. The lease payments required for the additional right-of-use are consistent with the standalone price for the additional right-of-use, including adjustments for conditions that may be unique to the contract

It is worth noting here, if the modification solely grants the lessee the right to use the asset for an additional period of time, that modification would not create a separate lease contract, even if the extended term is at market value. This is because while the extension may allow the lessee to use the asset for longer, it doesn't grant any ***additional*** rights. The extension is viewed as a change to an attribute of the existing right to use the asset already under the lessee's control.

If the modification results in a new lease, the lessee continues accounting for the original lease as before and calculates a new lease liability and ROU asset from the modified, or new lease terms. If the lease modification does not create a separate contract, the lessee remeasures the lease liability and ROU asset at the modification date, and reassesses the following:

- Lease term and purchase options
- Discount rate
- Allocation of consideration in the contract
- Lease classification

See **Example 11:** Accounting for amendments resulting in obtaining additional rights for more information on accounting for a contract modification as a new lease.

Modification to Terminate All or Part of the Lease

If the modified terms of the lease agreement reduce the lessee's rights to the underlying asset(s), then it is accounted for as a partial or full termination. If the lease modification fully relinquishes the lessee's rights to the underlying asset(s), the lessee accounts for the modification as a full termination.

If the lease modification only partially reduces the lessee's rights to the underlying asset(s), this is accounted for as a partial termination. For example, if a lessee is leasing four floors of a building and then negotiates with the landlord in the middle of the lease term to reduce the leased space to three floors, the modified contract results in a partial termination of the original lease arrangement.

In this scenario, the lease liability is remeasured based on the new payment terms, and the ROU asset is reduced based on either the proportionate change in the lease liability or the proportionate change in the asset.

Remeasurement

Lease modifications are often easily identifiable, as they require an agreed upon change in the contract between the lessee and the lessor. However, other potential events can occur throughout the lease term which require the lessee to remeasure the lease liability and ROU asset. Reassessments are required when an event does not involve renegotiation of the lease terms and conditions with the lessor, but when a change in the lessee's facts, assumptions, or other circumstances related to the lease occurs. For example, a lessee may change its conclusion on the certainty of the exercise of a purchase or renewal option.

Reassessments can be caused by any of the events below:

- A significant event or change in circumstances occurs that is within the control of the lessee that changes the lessee's certainty regarding exercising options to extend, renew or terminate the lease or purchase the underlying asset
- The contract is amended to require the lessee to change their conclusion(s) regarding the extension or termination of the lease
- The lessee reverses a previous decision regarding the exercise of the options in the lease

Modifications and reassessments both result in the remeasurement of the lease liability, however, the type of event dictates items such as whether the discount rate should be updated at the time of change, the lease classification should be reassessed, and consideration in the contract should be reallocated. See the chart below for a summary of the proper accounting treatments.

	Lease Modification	Reassessment - Related Events			
		Change in Lease Term	Change in Purchase Option Assessment	Change in Residual Value Guarantee	Resolution of a Contingency
Reallocate Consideration	✓	✓	✓	✓	✓
Reassess Classification	✓	✓	✓	✗	✗
Update Discount Rate	✓	✓	✓	✗	✗

Modifications Related to COVID-19 Pandemic

In April 2020, the Financial Accounting Standards Board (FASB) issued a staff Q&A discussing the impacts of COVID-19. Due to the expected number of lease modifications related to the pandemic, the FASB provided an electable alternative to requiring entities to treat lease concessions as a modification. The parameters of the available election options are outlined in this article regarding COVID-19 lease concessions.

Example 9: How to account for a lease modification under ASC 842

Assume a 10-year lease with annual payments in arrears of $100,000 increasing by 3% each year. Assume the lessee elects to use their incremental borrowing rate of 6%, and for purposes of this example, assume this is an operating lease. The total cash payments aggregate to $1,146,388, which calculates to an annual lease expense of $114,639 ($1,146,388/10 years) and a present value of $831,880.

The initial amortization schedule for this lease is as follows:

Topic 842 Operating Lease Amortization Schedule

PERIOD	CASH	LIAB LEASE EXPENSE	LIABILITY REDUCTION	TOTAL LIABILITY	ASSET LEASE EXPENSE	NET ASSET BALANCE	TOTAL LEASE EXPENSE
Beginning Balance				831,880		831,880	
1	100,000	49,913	50,087	781,793	64,726	767,154	114,639
2	103,000	46,908	56,092	725,701	67,731	699,423	114,639
3	106,090	43,542	62,548	663,153	71,097	628,326	114,639
4	109,273	39,789	69,484	593,669	74,850	553,477	114,639
5	112,551	35,620	76,931	516,739	79,019	474,458	114,639
6	115,927	31,004	84,923	431,815	83,634	390,824	114,639
7	119,405	25,909	93,496	338,319	88,730	302,094	114,639
8	122,987	20,299	102,688	235,631	94,340	207,754	114,639
9	126,677	14,138	112,539	123,092	100,501	107,253	114,639
10	130,477	7,386	123,092	0	107,253	0	114,639

Based on the amortization schedule above, the initial journal entry to record the lease is as follows:

ACCOUNT	DEBIT	CREDIT
ROU Asset	831,880	
Operating Lease Liability		831,880

To record an operating lease at lease commencement

The journal entry above is made at the beginning of year one. At the end of year one the following journal entry is made to reflect the rent payment of $100,000 (recall that payments are made in arrears in this example), the straight-line rent expense and amortization of the ROU asset:

ACCOUNT	DEBIT	CREDIT
Rent Expense	114,639	
Operating Lease Liability	50,087	
ROU Asset		64,726
Cash		100,000

To record year 1 rent payment and activity

Now, let us assume that at the end of year five, the lessee and lessor agree to modify the terms of the lease.

- The lease term is extended by five years.
- The rent payment for year six payment is now going to be $150,000 rather than $115,927 per the previous lease agreement and the annual payments still increase by 3% each year.

At the time of the amendment the lessee has an incremental borrowing rate of 7% rather than 6%. Based on these assumptions, the present value of the remaining payment stream as of the modification date is $1,188,079:

Number of Periods	10
Annual Rate	7.00%
Periods in	Years
Payments Made at	End of Period

Period	Cash	Present Value
6	$150,000.00	$140,186.92
7	$154,500.00	$134,946.28
8	$159,135.00	$129,901.56
9	$163,909.00	$125,045.39
10	$168,826.00	$120,370.60
11	$173,891.00	$115,870.92
12	$179,108.00	$111,539.46
13	$184,481.00	$107,369.62
14	$190,016.00	$103,356.11
15	$195,716.00	$99,492.09
TOTAL	$1,719,582.00	$1,188,078.96

Present Value is $1,188,079

At the end of year five under the old lease, the lease liability is $516,739. After the modification, however, the new lease liability is $1,188,079. The lease liability is increased by $671,340 ($1,188,079 - $516,739) and the ROU asset is increased by the same amount.

The new total lease expense is recalculated as the updated total of payments, from the beginning of the lease less the total lease expense previously recognized divided by the number of years remaining, or $167,730 (($2,250,495 - $573,194)/10 years). The amortization schedule for the modified lease is as follows:

Topic 842 Operating Lease Amortization Schedule

PERIOD	CASH	LIAB LEASE EXPENSE	LIABILITY REDUCTION	TOTAL LIABILITY	ASSET LEASE EXPENSE	NET ASSET BALANCE	TOTAL LEASE EXPENSE
Beginning Balance				831,880		831,880	
1	100,000	49,913	50,087	781,793	64,726	767,154	114,639
2	103,000	46,908	56,092	725,701	67,731	699,423	114,639
3	106,090	43,542	62,548	663,153	71,097	628,326	114,639
4	109,273	39,789	69,484	593,669	74,850	553,477	114,639
5	112,551	35,620	76,931	516,739	79,019	474,458	114,639
Amendment				671,340		671,340	
				1,188,079		1,145,799	
6	150,000	83,166	66,835	1,121,244	84,565	1,061,234	167,730
7	154,500	78,487	76,013	1,045,232	89,243	971,991	167,730
8	159,135	73,166	85,969	959,263	94,564	877,427	167,730
9	163,909	67,148	96,761	862,502	100,582	776,845	167,730
10	168,826	60,375	108,451	754,051	107,355	669,490	167,730
11	173,891	52,784	121,108	632,943	114,947	554,544	167,730
12	179,108	44,306	134,802	498,142	123,424	431,120	167,730
13	184,481	34,870	149,611	348,530	132,860	298,259	167,730
14	190,016	24,397	165,618	182,912	143,333	154,926	167,730
15	195,716	12,804	182,912	(0)	154,926	(0)	167,730

The entry to adjust the lease liability and ROU asset as a result of the modification is reflected below:

ACCOUNT	DEBIT	CREDIT
ROU Asset	671,340	
Operating Lease Liability		671,340

To record an increase in the lease liability and ROU asset due to a lease modification

The entry above is the entry recorded at the time of the modification. At the end of year six, (once again, payments are made in arrears) the journal entry made to reflect the new payment amount of $150,000 and the amortization of the ROU asset is as follows:

ACCOUNT	DEBIT	CREDIT
Rent Expense	167,730	
Operating Lease Liability	66,835	
ROU Asset		84,565
Cash		150,000

To record year 6 rent payment and activity

Terminations

If the new terms of the agreement reduce the rights to the underlying asset(s), then it is referred to as a partial or full termination. For example, if a lessee is leasing 9,000 square feet of an office building and then four years into the lease term signs an agreement with the landlord to only lease 6,000 square feet, the amended agreement would result in a partial termination of the existing lease arrangement. Now consider the same office building, but instead, the lessee decides to downsize and no longer needs any of the building space. This would result in a full termination.

Accounting for a Full Termination

Accounting for a full termination is relatively easy. At the time of termination, the lessee removes the total outstanding lease liability and ROU asset from their books. Whenever the carrying value of the ROU asset does not equal the lease liability balance at the termination date, the lessee recognizes a gain or loss through the income statement in the period of termination for the amount of the difference. This is often the case in finance leases or in operating leases with built-in payment escalations or free rent periods.

Accounting for a Partial Termination

When accounting for a partial termination, both the lease liability and ROU asset must be remeasured as of the modification date. Remeasuring the lease liability is straightforward as it is calculated the same way regardless of the type of modification, but remeasuring the leased asset of a partially terminated lease can be challenging. The lessee decreases the carrying amount of the lease asset in proportion to the partial termination of the lease.

Upon determining there is a partial termination, the lease classification needs to be reassessed. This means that the same lease classification test that was performed at lease commencement is performed again, but with the updated lease terms and using the discount rate as of the effective date of the partial termination. The effective date of the partial termination modification is the date in which both lessor and lessee agree to the modified terms.

Remeasuring the Lease Liability

Next, the lessee should remeasure the lease liability based on the revised lease payments in the modified contract using the discount rate as of the effective date of the partial termination.

Remeasuring the Right-of-use Asset

Determining the value of the ROU asset after a lease is partially terminated is a bit trickier, since the lease asset is reduced on a basis proportionate to the partial termination of the lease. Under ASC 842, the reduction to the ROU asset can either be interpreted as the proportionate change in the lease liability OR the proportionate change in the remaining ROU asset. Under either approach, the difference between the reduction in the liability and proportionate change in the ROU asset will be recognized as a gain or loss (ASC 842-10-25-13). ASC 842 offers Example 18 – Modification That Decreases the Scope of a Lease to demonstrate these two approaches to lease modification for partial terminations. Additionally, we walk through both sets of calculations in example 10 below.

Example 10: How to account for partial lease terminations

Assume Tenant Co. enters into an operating lease agreement commencing on January 1, 2022. The agreement states that Tenant Co. will lease five floors of a building for office space at $3,000,000 per year increasing by 2% over a period of 10 years. Payments are due at the beginning of each year. Tenant Co. has determined it will use its IBR on January 1, 2022, to measure the lease liability and related ROU asset.

The IBR is 5%, which results in the calculation of the beginning lease liability and ROU asset upon commencement (January 1, 2022) of $26,422,533.

Number of Periods	10
	Refresh
Annual Rate	5.00%
Periods in	Years
Payments Made at	Beginning of Period

Period	Cash	Present Value
0	$3,000,000.00	$3,000,000.00
1	$3,060,000.00	$2,914,285.71
2	$3,121,200.00	$2,831,020.41
3	$3,183,624.00	$2,750,134.11
4	$3,247,296.48	$2,671,558.85
5	$3,312,242.41	$2,595,228.60
6	$3,378,487.26	$2,521,079.21
7	$3,446,057.00	$2,449,048.37
8	$3,514,978.14	$2,379,075.56
9	$3,585,277.71	$2,311,101.98
TOTAL	$32,849,163.00	$26,422,532.81

Present Value is $26,422,533

The following amortization schedule presents the lease liability and lease asset throughout the full lease term:

Topic 842 Operating Lease Amortization Schedule

YEAR	CASH	LIAB LEASE EXPENSE	LIABILITY REDUCTION	TOTAL LIABILITY	ASSET LEASE EXPENSE	NET ASSET BALANCE	TOTAL LEASE EXPENSE
Beginning Balance				26,422,533		26,422,533	
2022	3,000,000	1,171,127	1,828,873	24,593,660	2,113,790	24,308,743	3,284,916
2023	3,060,000	1,076,683	1,983,317	22,610,343	2,208,233	22,100,510	3,284,916
2024	3,121,200	974,457	2,146,743	20,463,600	2,310,459	19,790,051	3,284,916
2025	3,183,624	863,999	2,319,625	18,143,975	2,420,918	17,369,133	3,284,916
2026	3,247,296	744,834	2,502,463	15,641,512	2,540,082	14,829,051	3,284,916
2027	3,312,242	616,463	2,695,779	12,945,733	2,668,453	12,160,598	3,284,916
2028	3,378,487	478,362	2,900,125	10,045,608	2,806,554	9,354,044	3,284,916
2029	3,446,057	329,978	3,116,079	6,929,529	2,954,939	6,399,105	3,284,916
2030	3,514,978	170,728	3,344,251	3,585,278	3,114,189	3,284,917	3,284,916
2031	3,585,278	0	3,585,278	0	3,284,916	0	3,284,916
Total	32,849,163						

Now assume in January of 2028, Tenant Co. and the lessor amend the original terms of the lease to only include 3 floors of the office space. According to the original terms of the lease, the balance of the lease liability and ROU asset at the end of 2027 are $12,945,733 and $12,160,598, respectively.

As a result of the renegotiated terms, Tenant Co. will now pay $2,000,000 annually starting January 1, 2028, and increase each year thereafter by 3%. Assume that the lessor did not charge a termination fee associated with this change. First, Tenant Co. re-evaluated their lease classification based on the updated lease terms, with the result that the lease will maintain its classification as an operating lease.

Due to the partial termination, Tenant Co. will now use its incremental borrowing rate on January 1, 2026, 4.5%, so the present value of the remaining lease payments is $7,829,394.

Number of Periods	4
	Refresh
Annual Rate	4.50%
Periods in	Years
Payments Made at	Beginning of Period

Period	Cash	Present Value
6	$2,000,000.00	$2,000,000.00
7	$2,060,000.00	$1,971,291.87
8	$2,121,800.00	$1,942,995.81
9	$2,185,454.00	$1,915,105.92
TOTAL	$8,367,254.00	$7,829,393.60

Present Value is $7,829,394

This will result in a $5,116,339 ($12,945,733 – $7,829,394) decrease in the lease liability. The modified lease liability calculation will remain consistent in both of the approaches below. However, the value of the ROU asset will change based on the approach selected.

The value of the ROU asset at the date of modification is determined based on either of the following:

1. The proportionate change in the lease liability
2. The proportionate change in the remaining ROU asset

Below is an example of how to calculate each method.

Example 10A: Proportionate change in the lease liability

To value the lease asset using the proportionate change in the lease liability, start by dividing the difference between the previous balance of the lease liability and the new lease liability (i.e. the $5,116,339 reduction calculated above) by the balance of the lease liability prior to modification. This yields the proportionate percentage change in the lease liability balance as a result of the partial termination. In this example, Tenant Co. calculates:

($12,945,733 – $7,829,394) / $12,945,733 = 39.52%

The carrying amount of the ROU asset prior to the modification ($12,160,598 as presented in the amortization table above) is then reduced by the percentage change in the lease liability. To calculate the change in this example:

$12,160,598 * 39.52% = $4,806,043

Then the new ROU asset is calculated by subtracting the necessary adjustment to the ROU asset calculated above from the ROU asset balance before the modification:

$12,160,598 – $4,806,043 = $7,354,555

The difference between the reduction of the lease liability ($5,116,339) and the reduction of the ROU asset ($4,806,043) is a gain:

$5,116,339 – $4,806,043 = $310,296

Tenant Co. would make the following journal entry for the modification if applying the proportionate change to the lease liability:

ACCOUNT	DEBIT	CREDIT
Lease Liability	5,116,339	
ROU Asset		4,806,043
Gain on Termination		310,296
To record reduction of lease liability and ROU asset due to partial termination		

Below is the updated amortization schedule reflecting the remeasurements resulting from applying the proportionate change in the lease liability:

Topic 842 Operating Lease Amortization Schedule							
YEAR	CASH	LIAB LEASE EXPENSE	LIABILITY REDUCTION	TOTAL LIABILITY	ASSET LEASE EXPENSE	NET ASSET BALANCE	TOTAL LEASE EXPENSE
Beginning Balance				7,829,394		7,354,555	
2028	2,000,000	262,323	1,737,677	6,091,717	1,710,781	5,643,774	1,973,104
2029	2,060,000	181,427	1,878,573	4,213,144	1,791,677	3,852,098	1,973,104
2030	2,121,800	94,110	2,027,690	2,185,454	1,878,993	1,973,104	1,973,104
2031	2,185,454	0	2,185,454	0	1,973,104	0	1,973,104

Example 10B: Proportionate change in the remaining ROU asset

To remeasure the lease asset using the proportionate change in the remaining ROU asset, Tenant Co. must assess the remaining ROU asset in comparison to the original terms of the lease agreement.

In this example, the original terms of the agreement state that Tenant Co. will lease five floors. These terms are amended to stipulate only three leased floors. This can be taken at face value whereby Tenant Co. can simply calculate the change in the number of floors they have access to or they can determine the square footage of each floor and then calculate the change.

For the sake of keeping it simple, let's assume that each floor has equivalent square footage, so Tenant Co. will take the difference in the number of leased floors as a result of the modification (5-3) over the original leased floors (5) and calculate the proportionate change.

(5-3) / 5 = 40%

Although the actual new lease liability value as a result of the partial termination was calculated above in Example 10A, in order to determine the gain/loss recognized under this approach, the percentage change in the physical asset must be applied to the pre-modification lease liability. This will provide a hypothetical change in the lease liability proportionate to the change in the ROU asset based solely on the change in the underlying asset.

$12,945,733 * 40% = $5,178,293

The difference between the proportionate reduction of the lease liability ($5,178,293) and the proportionate reduction of the ROU asset ($4,864,239) is recognized as a gain on termination:

$5,178,293 – $4,864,239 = $314,054

Finally, regardless of the approach used to remeasure the ROU asset due to a partial termination, the remeasured lease liability will always be calculated as the present value of the remaining payment stream. Therefore, Tenant Co. calculates the adjustment to the ROU asset as net of the adjustment to the lease liability calculated in Example 10A ($5,116,339) and the gain on the partial termination ($314,054):

$5,116,339 – $314,054 = $4,802,285

The entry Tenant Co. would make to record a partial termination based on the proportionate change in the remaining lease asset:

ACCOUNT	DEBIT	CREDIT
Lease Liability	5,116,339	
ROU Asset		4,802,285
Gain on Termination		314,054
To record net adjustments of lease liability and ROU asset due to partial termination from a porportionate change in the ROU asset		

An updated amortization schedule reflecting the modification of the agreement and partial termination by using the proportionate change in the ROU asset approach is presented below:

Topic 842 Operating Lease Amortization Schedule

YEAR	CASH	LIAB LEASE EXPENSE	LIABILITY REDUCTION	TOTAL LIABILITY	ASSET LEASE EXPENSE	NET ASSET BALANCE	TOTAL LEASE EXPENSE
Beginning Balance				7,829,394		7,358,313	
2028	2,000,000	262,323	1,737,677	6,091,717	1,711,721	5,646,593	1,974,043
2029	2,060,000	181,427	1,878,573	4,213,144	1,792,616	3,853,977	1,974,043
2030	2,121,800	94,110	2,027,690	2,185,454	1,879,933	1,974,043	1,974,043
2031	2,185,454	0	2,185,454	0	1,974,043	0	1,974,043

New/Increased Rights

When an amendment adds new or increased rights of use to a lease arrangement, this may be accounted for as a new lease and the lessee would record a separate lease liability and ROU asset.

Under ASC 842, when a tenant expands an existing lease, certain criteria have to be met to treat the amendment as a new lease versus a modification of the existing lease. A lease amendment must do both of the following:

- Grant the lessee an additional right of use, not specified in the original contract
- Require lease payments for the additional right of use equivalent to the standalone price for the additional right of use, including adjustments for conditions unique to the contract

To explain further, the amendment must include an additional right of use asset with payment similar to what would be required for the same asset under a standalone contract. However, some amount of variance to the standalone pricing may be appropriate if supported by the circumstances of the contract.

If both requirements are not met, then as of the effective date of the modification, the lessee must reassess the classification of the lease (using an updated discount rate) and modify the existing lease agreement. This modification is done by assessing how the lease liability and ROU asset will be remeasured based on the type of change.

Example 11: Accounting for amendments resulting in obtaining additional rights

Assume Tenant Co. enters into a 10-year lease with a landlord for one floor of a building with the following terms:

- Payments: $15,000/month
- Escalation: 1.5%, annually
- Lease commencement: January 1, 2023
- Lease end date: December 31, 2032
- Tenant improvement allowance (TIA): $80,000

The lease is classified as an operating lease and the incremental borrowing rate in effect at commencement is 3%. Tenant Co. calculates the lease liability as the present value of the remaining lease payments, which equals $1,686,505.

Number of Periods	10
	Refresh
Annual Rate	3.00%
Periods in	Years
Payments Made at	Beginning of Period

Period	Cash	Present Value
0	$180,000.00	$180,000.00
1	$182,700.00	$177,378.64
2	$185,440.50	$174,795.46
3	$188,222.11	$172,249.89
4	$191,045.44	$169,741.40
5	$193,911.12	$167,269.44
6	$196,819.79	$164,833.47
7	$199,772.08	$162,432.99
8	$202,768.67	$160,067.46
9	$205,810.20	$157,736.38
TOTAL	$1,926,489.90	$1,686,505.12

Present Value is $1,686,505

The right of use (ROU) asset is the lease liability minus the incentive balance of $80,000. The full amortization schedule for the lease liability and ROU asset is below:

Topic 842 Operating Lease Amortization Schedule							
YEAR	CASH	LIAB LEASE EXPENSE	LIABILITY REDUCTION	TOTAL LIABILITY	ASSET LEASE EXPENSE	NET ASSET BALANCE	TOTAL LEASE EXPENSE
Beginning Balance				1,686,505		1,606,505	
2023	180,000	45,195	134,805	1,551,700	139,454	1,467,051	184,649
2024	182,700	41,070	141,630	1,410,070	143,579	1,323,472	184,649
2025	185,441	36,739	148,702	1,261,369	147,910	1,175,562	184,649
2026	188,222	32,194	156,028	1,105,341	152,455	1,023,107	184,649
2027	191,045	27,429	163,617	941,724	157,220	865,887	184,649
2028	193,911	22,434	171,477	770,248	162,215	703,673	184,649
2029	196,820	17,203	179,617	590,631	167,446	536,227	184,649
2030	199,772	11,726	188,046	402,584	172,923	363,303	184,649
2031	202,769	5,994	196,774	205,810	178,655	184,649	184,649
2032	205,810	0	205,810	0	184,649	0	184,649

Next, on January 1, 2025, due to a growing internet sales business, Tenant Co. signs an amendment to the original lease to rent an additional floor in their current building, with the following terms:

- Payments: $14,000/month
- Escalation: 3%, annually
- Lease amendment effective date: January 1, 2025
- Additional TIA: $200,000
- Discount rate: 2% incremental borrowing rate

The payment terms for the lease of space under the original lease remain unchanged. Tenant Co. obtains access to the second floor and receives the TIA as a lump sum payment on January 1, 2025. The end date of the contract for the total leased premises remains unchanged at December 31, 2032.

To apply the correct accounting treatment under ASC 842, Tenant Co. must determine if the amendment meets the criteria for a new lease. In order for the amendment to be considered a new lease for accounting purposes, the amendment must grant Tenant Co. an additional right of use which was not part of the original contract and the payment terms must be equivalent to a standalone lease agreement.

The amendment in this example is for the use of an additional floor of space. The option to lease the additional floor was not mentioned in the original contract. Thus, the amendment is providing Tenant Co. with an additional right of use and the first criteria for a new lease is met.

The second criteria is for the payment terms to be commensurate with a standalone lease agreement for a similar asset. In this scenario, the original lease for office space was for $15,000/month. The original lease was for a single floor and represents a standalone lease. The amendment offers the additional floor at a rate of $14,000/month. The reduction is not a significant departure from the payment terms of the original lease and may represent a portion of the benefit gained by the landlord for not having to locate a new tenant.

As a result of the amendment meeting both criteria for a new lease agreement, the original amortization table and accounting for the lease of the first floor will not change. Instead, Tenant Co. will treat the amendment as a new, standalone lease agreement. Assuming in this scenario the lease amendment also qualifies as an operating lease, Tenant Co. must now calculate the lease liability and ROU asset for the new lease.

The lease liability for the amendment is the present value of the payments for the new floor over the remaining seven years of the lease term at the discount rate of 2%, calculated to be $1,391,033.

Number of Periods	8
	Refresh
Annual Rate	2.00%
Periods in	Years
Payments Made at	Beginning of Period

Period	Cash	Present Value
0	$168,000.00	$168,000.00
1	$173,040.00	$169,647.06
2	$178,231.20	$171,310.27
3	$183,578.14	$172,989.78
4	$189,085.48	$174,685.76
5	$194,758.04	$176,398.36
6	$200,600.79	$178,127.76
7	$206,618.81	$179,874.11
TOTAL	$1,493,912.46	$1,391,033.08

Present Value is $1,391,033

The ROU asset is equal to the lease liability less the TIA received at lease commencement, or $1,191,033 ($1,391,033 – $200,000). The entry to record the lease amendment as a separate lease is:

ACCOUNT	DEBIT	CREDIT
ROU Asset	1,191,033	
Cash	200,000	
Lease Liability		1,391,033
To record lease amendment as separate lease liability		

The amortization schedule for the amendment as a separate lease under ASC 842 is below:

Topic 842 Operating Lease Amortization Schedule							
YEAR	CASH	LIAB LEASE EXPENSE	LIABILITY REDUCTION	TOTAL LIABILITY	ASSET LEASE EXPENSE	NET ASSET BALANCE	TOTAL LEASE EXPENSE
Beginning Balance				1,391,033		1,191,033	
2025	168,000	24,461	143,539	1,247,494	137,278	1,053,755	161,739
2026	173,040	21,489	151,551	1,095,943	140,250	913,505	161,739
2027	178,231	18,354	159,877	936,066	143,385	770,120	161,739
2028	183,578	15,050	168,528	767,537	146,689	623,430	161,739
2029	189,085	11,569	177,516	590,021	150,170	473,260	161,739
2030	194,758	7,905	186,853	403,168	153,834	319,427	161,739
2031	200,601	4,051	196,549	206,619	157,688	161,739	161,739
2032	206,619	0	206,619	0	161,739	0	161,739

Purchase of Leased Asset

Under ASC 842 a lease that ends due to the lessee purchasing the underlying asset from the lessor does not constitute a lease termination. Instead, the lease is accounted for as a purchase. The total outstanding lease liability is derecognized and the ROU asset is reclassifed as a fixed asset. The lessee records the new fixed asset value as the carrying value of the leased asset plus or minus an adjustment equal to the difference between the purchase price and the lease liability balance at the time of purchase.

Impairment

ASC 360, *Property, Plant, and Equipment* (ASC 360) is the standard covering impairments. An impairment loss occurs when the cash flows expected to be generated from an asset over its useful life can no longer support the carrying value of that asset. When this occurs, the carrying value of the asset is reduced to its fair value. Impairments are applicable to both tangible and intangible assets including property, plant, equipment, goodwill, software, or ROU assets.

Under US GAAP, a company should evaluate long-lived assets for indicators of impairment if a significant change to its operations or the asset has occurred. In other words, if an organization is experiencing a change in its financial circumstances—such that its long-lived assets may be overvalued—an impairment analysis is in order.

Impairment Indicators

ASC 360-10-35-21 provides some examples of internal and external changes in events or circumstances that might drive an evaluation of impairment.

Impairment indicators include:

- Significant changes specific to the company such as a decrease in the market price of the asset, the way the asset is being used or its physical condition
- Significant changes in the operations or cash flows of the asset
- Legal proceedings that impact the future use or value of the asset
- Other general impacts such as adverse changes to the economy or business climate

As part of their quarterly and annual financial reporting processes, organizations with long-lived assets must have internal controls in place to monitor impairment indicators.

Once an indication of impairment has been determined, ASC 360 specifies these steps to be completed in the calculation of an impairment:

1. If impairment indicators are identified, test the recoverability of the asset by comparing the undiscounted cash flows expected to be generated over the asset's life against its current carrying value.
2. If warranted by the recoverability test, calculate the impairment loss as the difference between the carrying value recorded and the fair value of the asset.

Record the calculated impairment loss as a credit to the ROU asset and a debit to loss on impairment. The carrying value of the ROU asset immediately after the impairment is measured as the initial carrying value less the impairment loss and less any accumulated amortization.

When the impaired lease is classified as a finance lease, the ROU asset amortization expense is updated to be the straight-line amortization of the new ROU asset carrying value from the date of impairment to the earlier of it's useful life or the end of the lease term.

If the impaired lease is an operating lease, the single lease cost is updated and will no longer be a straight-lined amount. The new single lease cost will be made up of:

- The accretion of the lease liability calculated each period as the product of the remaining lease liability and the periodic discount rate used to measure the present value of the lease payments, and
- The straight-line amortization of the new ROU asset value to the earlier of the end of it's useful life or the end of the lease term

Resolution of a Contingency

When a contingency is resolved which results in variable lease payments becoming lease payments to be paid over the remaining lease term, this triggers a remeasurement of the lease with the new payment information. The lessee remeasures the lease liability using the remaining lease payments but does not update the discount rate used in the present value calculation. Additionally, the lessee is not required to reassess the classification of the lease and will also not reassess the lease term or a lessee purchase option. The lease liability is adjusted to reflect any change in the carrying value based on the remeasurement, and the lessee makes a corresponding adjustment to the ROU asset.

Updating the rate or index upon which variable lease payments are based does not equate to the resolution of a contingency or trigger a remeasurement of the lease.

Index or Rate Changes

If a lease agreement requires variable lease payments based on an index or rate, the initial lease liability is calculated with the index or rate effective at the lease commencement date applied for the entire lease term. Over the term of the lease, as payments are made with the actual index or rate applied, any variance is recognized as expense. Additionally, a change in the index or rate the payments depend on does not trigger a remeasurement of the lease liability on its own. Rather, if another event occurs to cause a remeasurement, the index or rate is updated to the index or rate in effect at the remeasurement date.

8. Additional Lessee Accounting

Subleasing

A sublease is defined as a transaction in which an underlying asset is re-leased by the original lessee to a third party, and the lease agreement between the two original parties remains in effect. The original lease is referred to as the head lease and the new lease with the third party is the sublease. The original lessee becomes the sublessor and records lease income from the sublessee, in addition to the lease expense recorded for the head lease.

If the original lease obligation is assumed by the new lessee, meaning the original lessee is relieved of any obligation associated with the lease, the transaction does not meet the criteria of a sublease. The original lessee records a lease termination for the lease assumed by the new lessee and the new lessee records a lease liability and ROU asset related to the assumed lease.

The accounting treatment of a head lease and sublease are similar to that of a normal lease, but there are complexities related to the classification of the sublease. Furthermore, a sublease transaction may trigger a reassessment of the head lease.

The first step in accounting for a sublease under ASC 842 is to determine whether the transaction qualifies as a sublease. Similar to ASC 840, if the original lessee is relieved of its primary obligations, termination of the original lease occurs and the original lessee accounts for the new lease as a new lessor lease.

In contrast, when the lessee transfers or sells the original lease to a third party but retains its obligations, this is a sublease. With a sublease, the lessor of the head lease will continue to account for their lease the same as before. Additionally, the accounting treatment of the sublease by the sublessee will be no different than other leases. The sublessee may or may not be aware that they are the lessee of a sublease, and therefore the sublease status will have no effect on their accounting treatment of the lease.

The accounting treatment for the head lease by the original lessee, now the sublessor, is what may change in a sublease. To account for a sublease, the sublessor must follow these three simple steps:

1. Establish the discount rate for the sublease.
2. Establish whether the sublease is an operating or finance lease.
3. Account for the sublease using the established discount rate and according to its lease type.

Under ASC 842-20-35-15, the sublessor will use the rate implicit in the lease to determine the classification of the sublease. However, in cases where the implicit rate is not readily determinable, possibly stemming from difficulties in establishing a fair value for the ROU asset, the sublessor should revert to the discount rate used in accounting for the head lease.

To determine the lease classification of a sublease, the sublessor will perform the standard finance vs. operating lease assessment by referencing the underlying asset of the lease in its analysis, rather than the ROU asset of the head lease. When the lease term of the sublease is longer than the term of the head lease, the classification of the head lease must be reassessed by the sublessor or original lessee.

The term to consider for each is the noncancelable term with any renewals the lessee (or sublessee) is reasonably certain to elect. This can occur when the sublessee is offered and elects renewal options that are the same as those of the head lease, but that the sublessor originally elected to not exercise. The longer term of the sublease would indicate the sublessor is now reasonably certain to exercise the same renewal options in the head lease, and the change in term would trigger a reassessment of lease classification and a remeasurement of the head lease.

Finally, once the discount rate and the classification of the sublease have been determined, the sublessor accounts for the sublease in accordance with the applicable lease classification. In some cases, this will be the same lease classification as the head lease, but it can also be a different classification. ASC 842 contains specific guidelines for accounting for the head lease and sublease in the various scenarios:

- If the head lease is an operating lease or a finance lease and the sublease is an operating lease, the sublessor continues to account for the original lease as it did prior to the commencement of the sublease and recognizes sublease income. One caveat exists – if the total expected sublease income is less than the head lease's cost for the term of the sublease, the sublessor has an indication that the ROU asset recorded for the original lease may not be recoverable. Therefore the sublessor must perform the recoverability test specified by ASC 360-10-35-17 to determine whether further asset impairment analysis is required for the head lease.
- If the head lease is a finance lease and the sublease is a sales-type or direct financing lease, the sublessor derecognizes the ROU asset from the head lease and records a net investment in the sublease. The sublessor continues to account for the lease liability of the original lease as it did prior to the commencement of the sublease.
- If the head lease is an operating lease and the sublease is a sales-type or direct financing lease, the sublessor derecognizes the ROU asset from the head lease and records a net investment in the sublease. The sublessor then accounts for the lease liability of the original lease in accordance with the accounting guidance for finance leases.

Generally, in any of these scenarios, separate presentation of the head lease expense and the sublease income on the income statement is required under ASC 842. Net presentation of expense and income may be allowed if the criteria for contract combinations are met or subleasing is not a major part of an organization's business.

Example 12: How to account for a sublease

To illustrate sublease accounting, let's assume that Tenant Co. has decided to sublease the additional floor they started leasing in Example 11. Below are the details of the sublease arrangement between Tenant Co., the original lessee and the sublessor, and a third party, the sublessee.

At the beginning of 2026 Tenant Co. experiences a decline in their internet sales business and enters into a contract with a third party to sublease the additional floor they began leasing in 2025. Rather than terminate the lease Tenant Co. finds a sublessee for the remaining lease term. Tenant Co. is not released from its obligations under the head lease through the sublease arrangement. Tenant Co., now the sublessor, negotiates the following terms for the sublease.

- Lease term: 7 years
- Lease payments: $200,000 annually, paid in advance
- No transfer of ownership
- No purchase option
- Lease classification: Operating

Straight-line amortization schedule for the head lease

Topic 842 Operating Lease Amortization Schedule							
YEAR	CASH	LIAB LEASE EXPENSE	LIABILITY REDUCTION	TOTAL LIABILITY	ASSET LEASE EXPENSE	NET ASSET BALANCE	TOTAL LEASE EXPENSE
Beginning Balance				1,391,033		1,191,033	
2025	168,000	24,461	143,539	1,247,494	137,278	1,053,755	161,739
2026	173,040	21,489	151,551	1,095,943	140,250	913,505	161,739
2027	178,231	18,354	159,877	936,066	143,385	770,120	161,739
2028	183,578	15,050	168,528	767,537	146,689	623,430	161,739
2029	189,085	11,569	177,516	590,021	150,170	473,260	161,739
2030	194,758	7,905	186,853	403,168	153,834	319,427	161,739
2031	200,601	4,051	196,549	206,619	157,688	161,739	161,739
2032	206,619	0	206,619	0	161,739	0	161,739

At the end of 2025, the present value of the remaining payments Tenant Co. owes under the head lease is $1,247,494 and the book value of the ROU asset is $1,053,755. Following the steps to account for a sublease under ASC 842, first Tenant Co. must determine the discount rate of the sublease.

The implicit rate of the sublease is not readily determinable from the facts available, so the sublessor will revert to the discount rate used to measure the head lease, which is 2%. Using the LeaseQuery Present Value Calculator Tenant Co. calculates the lease liability and the ROU asset of the sublease to be $1,320,286.

Number of Periods	7
	Refresh
Annual Rate	2.00%
Periods in	Years
Payments Made at	Beginning of Period

Period	Cash	Present Value
0	$200,000.00	$200,000.00
1	$200,000.00	$196,078.43
2	$200,000.00	$192,233.76
3	$200,000.00	$188,464.47
4	$200,000.00	$184,769.09
5	$200,000.00	$181,146.16
6	$200,000.00	$177,594.28
TOTAL	$1,400,000.00	$1,320,286.18

Present Value is $1,320,286

Next, Tenant Co. determines whether the sublease is a finance or operating lease. Based on the analysis below, the sublessor classifies the sublease as an operating lease:

- The sublease does not transfer ownership or provide for an option to purchase the underlying asset.
- The floor of the building which is the underlying asset of the head lease has a remaining economic life of 20 years at the commencement of the sublease. The sublease term of 7 years is for a less than a significant portion of the remaining economic life of the building. *Note: this analysis is performed with the remaining economic life of the underlying asset of the lease and not the ROU asset of the head lease.
- The present value of the sublease payments, $1,320,286 does not equate to substantially all of the fair value of the leased floor of the building at the commencement of the sublease.
- The leased floor of the building is not customized to the original lessee or the sublessee, such that at the end of the lease it has no value to the lessor.

Once the discount rate and lease classification of the sublease have been determined, the sublessor is able to proceed with accounting for the sublease. In this example since Tenant Co., the sublessor has concluded the sublease is classified as an operating lease, it accounts for the sublease exactly as it would account for any operating type lease as a lessor, which is to say Tenant Co. does not record any journal entries at the commencement of the sublease as the sublessor.

Following the commencement of the sublease, Tenant Co. makes the following entry at the beginning of 2026 to reflect the payment of cash to their lessor and the receipt of cash from the sublessee for the sublease. The head lease is amortized according to the original amortization table above but since the sublease is also an operating lease, only the income from the sublease is recorded by the sublessor:

ACCOUNT	DEBIT	CREDIT
Cash (receipt)	200,000	
Lease Expense	161,739	
Lease Liability	151,551	
ROU Asset		140,250
Sublease Income		200,000
Cash (payment)		173,040

To record cash payment for the head lease and cash receipt for the sublease for 2026

For the remaining term of the head lease, Tenant Co. will continue to record annual lease expense of $161,739 on the income statement. Tenant Co. will also record annual lease revenue of $200,000 for the 5 years of the sublease.

Sale-Leaseback Transactions

A sale-leaseback transaction occurs when an entity sells an asset it owns and immediately leases the asset back from the buyer. The seller then becomes the lessee and the buyer becomes the lessor. These types of transactions impact the accounting for both the seller-lessee and buyer-lessor.

With the adoption of ASC 606, *Revenue from Contracts with Customers* (ASC 606) and ASC 842, both seller-lessees and buyer-lessors are facing more stringent accounting requirements. ASC 840 has prescriptive requirements as outlined in ASC 840-40-25, which apply only to the seller-lessee, whereas under ASC 842 both parties must assess whether the buyer-lessor has obtained control of the asset and a sale has occurred.

Entities who haven't yet adopted the new lease accounting standard can take the package of practical expedients available during the transition and not reassess expired or existing lease contracts. This allows these companies to grandfather previous transactions that were accounted for as sale-leasebacks under ASC 840 but may not be under ASC 842.

Identifying a Sale-leaseback Transaction

The identification of a sale-leaseback transaction requires an immense amount of judgment, and it is good practice to review contracts of this nature with your auditors before entering into such arrangements. Although identifying sale leasebacks can be complicated, the following criteria should be assessed to determine how to account for the transaction: *Under ASC 842 entities must apply ASC 606 to evaluate the contract and determine whether or not the sale of an asset has occurred.*

Determining if a Sale Exists

The relevant sections of ASC 606 to apply in identifying and accounting for a sale-leaseback transaction are specified in ASC 842 and referenced below. The first step to identifying a sale-leaseback transaction is to assess whether there is a contract. ASC 606-10-25-1 through 8 explains the criteria for identifying whether an agreement is considered a contract.

Once it has been determined there is a contract, the entity must assess whether the performance obligation has been satisfied by transferring control of the asset to the buyer-lessor at a point in time (i.e. a sale has occurred). Similar to evaluating the transfer of control of an asset for a lease, entities should determine whether the ability to direct the use of and the right to substantially all of the remaining benefits from the asset have transferred to the buyer-lessor. ASC 842 refers to ASC 606-10-25-30 a through e for a list of indicators that are often present when control has been transferred to the buyer-lessor.

Those indicators include but are not limited to:

1. The buyer-lessor has legal title
2. The buyer-lessor has physical possession
3. The buyer-lessor has significant risks and rewards of ownership
4. The buyer-lessor has accepted the asset
5. The buyer-lessor has an obligation to pay for the asset

It's important to remember that under ASC 842, both the seller-lessee and buyer-lessor must individually assess whether control of the underlying asset is transferred to the buyer-lessor. Although the steps to assess control are identical for both parties, it is possible for each party to reach a different conclusion about the transfer of control and thus the occurrence of a sale. An example of when this may occur is when parties arrive at different lease classifications due to varying assumptions such as the economic life and fair value of the asset or the discount rate.

Exceptions to Accounting for a Transfer as a Sale

The existence of a leaseback alone does not guarantee the presence of a sale. The classification of a lease by both the seller-lessee and buyer-lessor is important in determining whether control has been transferred, and thus whether the transaction is accounted for as a sale-leaseback transaction. Per 842-40-25-2, if the seller-lessee classifies the leaseback as a finance lease or the buyer-lessor classifies the leaseback as a sales-type lease, then control has not been transferred to the buyer-lessor and the transaction should be accounted for as a financing transaction.

Another thing to consider is the presence of a purchase option within the leaseback. If the seller-lessee has an option to repurchase the asset, that option would preclude the transfer from being accounted for as a sale unless, as noted in ASC 842-40-25-3, the following two criteria are both met:

1. The exercise price of the purchase option and the fair value of the asset are equivalent at the time the option is exercised. (i.e. the purchase option only permits the seller-lessee to repurchase the asset at its current FV)

2. Other assets that are substantially the same as the transferred asset are readily accessible.

If the leaseback transaction fails to qualify as a sale because control is not transferred to the buyer-lessor, then the seller-lessee will classify the lease portion of the transaction as a finance lease and the buyer-lessor will classify the lease as a sales-type lease.

Accounting for a Sale-leaseback

Seller-Lessee

After concluding that the transaction is eligible for sale-leaseback accounting, the seller-lessee will recognize the sale and any profit or loss on the sale when the buyer-lessor obtains control of the asset. Simultaneously the seller-lessee will also derecognize the asset and account for the leaseback portion of the transaction in accordance with ASC 842 by recognizing a lease liability and corresponding ROU asset.

To recognize the appropriate impact of the transaction, the seller-lessee must also adjust for off-market terms by adjusting the sale price. Per ASC 842-40-30-1, the first step is to determine whether the transaction price is at fair value (FV). Entities can utilize one of two methods below as an acceptable approach:

1. Comparison of the sale price of the asset vs. FV of the asset

2. Comparison of the present value of the lease payments vs. the present value of market rental payments

Each method to determine the variance to FV will yield different results, so entities can select the appropriate method based on the information they have more readily available. Note: This does not need to be selected as an accounting policy election. It is also important for the seller-lessee to consider any variable consideration it reasonably expects to be entitled to.

If the transaction is between related parties, then the seller-lessee and buyer-lessor do not have to determine the off-market terms but will be responsible for disclosing the nature of the transaction.

Upon determining that a sale-leaseback transaction has off-market terms, the seller-lessee may be required to make adjustments to the sale price so that it can be recognized at fair value.

As mentioned above, in conjunction with the recognition of sale and any necessary off-market adjustments, the seller-lessee will additionally derecognize the carrying amount of the sold asset and account for the leaseback portion of the transaction in accordance with lease guidance in ASC 842.

Buyer-Lessor

The buyer-lessor will account for the purchase of the leaseback asset like the purchase of any other nonfinancial asset as described in ASC 360, *Property, Plant, and Equipment*. And similar to that of the seller-lessee, the buyer-lessor must also assess any off-market terms included in the total transaction agreement. Accounting for the leaseback portion will be in accordance with the lessor accounting model found in ASC 842-30.

Appendix A

The complete amortization table from Example 8: How to account for an operating lease

Topic 842 Operating Lease Amortization Schedule							
PERIOD	CASH	LIAB LEASE EXPENSE	LIABILITY REDUCTION	TOTAL LIABILITY	ASSET LEASE EXPENSE	NET ASSET BALANCE	TOTAL LEASE EXPENSE
Beginning Balance				317,168		262,168	
1/1/2022	0	793	-793	317,961	1,089	261,079	1,882
2/1/2022	2,200	789	1,411	316,550	1,093	259,986	1,882
3/1/2022	2,200	786	1,414	315,136	1,096	258,890	1,882
4/1/2022	2,200	782	1,418	313,719	1,100	257,790	1,882
5/1/2022	2,200	779	1,421	312,297	1,103	256,686	1,882
6/1/2022	2,200	775	1,425	310,873	1,107	255,579	1,882
7/1/2022	2,200	772	1,428	309,444	1,111	254,469	1,882
8/1/2022	2,200	768	1,432	308,012	1,114	253,355	1,882
9/1/2022	2,200	765	1,435	306,577	1,118	252,237	1,882
10/1/2022	2,200	761	1,439	305,138	1,121	251,116	1,882
11/1/2022	2,200	757	1,443	303,695	1,125	249,991	1,882
12/1/2022	2,200	754	1,446	302,249	1,128	248,862	1,882
1/1/2023	2,200	750	1,450	300,799	1,132	247,730	1,882
2/1/2023	2,200	746	1,454	299,346	1,136	246,594	1,882
3/1/2023	2,200	743	1,457	297,888	1,139	245,455	1,882
4/1/2023	2,200	739	1,461	296,428	1,143	244,312	1,882
5/1/2023	2,200	736	1,464	294,963	1,147	243,165	1,882
6/1/2023	2,200	732	1,468	293,495	1,150	242,015	1,882
7/1/2023	2,200	728	1,472	292,023	1,154	240,861	1,882
8/1/2023	2,200	725	1,475	290,548	1,158	239,703	1,882
9/1/2023	2,200	721	1,479	289,069	1,161	238,542	1,882
10/1/2023	2,200	717	1,483	287,586	1,165	237,377	1,882
11/1/2023	2,200	713	1,487	286,099	1,169	236,208	1,882
12/1/2023	2,200	710	1,490	284,609	1,172	235,036	1,882
1/1/2024	2,200	706	1,494	283,115	1,176	233,860	1,882
2/1/2024	2,200	702	1,498	281,617	1,180	232,680	1,882
3/1/2024	2,200	699	1,501	280,116	1,184	231,496	1,882
4/1/2024	2,200	695	1,505	278,611	1,187	230,309	1,882
5/1/2024	2,200	691	1,509	277,102	1,191	229,117	1,882
6/1/2024	2,200	687	1,513	275,589	1,195	227,922	1,882
7/1/2024	2,200	683	1,517	274,073	1,199	226,724	1,882
8/1/2024	2,200	680	1,520	272,552	1,203	225,521	1,882
9/1/2024	2,200	676	1,524	271,028	1,206	224,315	1,882
10/1/2024	2,200	672	1,528	269,500	1,210	223,105	1,882
11/1/2024	2,200	668	1,532	267,968	1,214	221,891	1,882
12/1/2024	2,200	664	1,536	266,433	1,218	220,673	1,882
1/1/2025	2,200	661	1,539	264,893	1,222	219,451	1,882
2/1/2025	2,200	657	1,543	263,350	1,225	218,226	1,882

2/1/2025	2,200	657	1,543	263,350	1,225	218,226	1,882
3/1/2025	2,200	653	1,547	261,803	1,229	216,996	1,882
4/1/2025	2,200	649	1,551	260,252	1,233	215,763	1,882
5/1/2025	2,200	645	1,555	258,697	1,237	214,526	1,882
6/1/2025	2,200	641	1,559	257,138	1,241	213,285	1,882
7/1/2025	2,200	637	1,563	255,576	1,245	212,040	1,882
8/1/2025	2,200	633	1,567	254,009	1,249	210,791	1,882
9/1/2025	2,200	630	1,570	252,439	1,253	209,539	1,882
10/1/2025	2,200	626	1,574	250,864	1,257	208,282	1,882
11/1/2025	2,200	622	1,578	249,286	1,261	207,022	1,882
12/1/2025	2,200	618	1,582	247,704	1,265	205,757	1,882
1/1/2026	2,200	614	1,586	246,117	1,268	204,489	1,882
2/1/2026	2,200	610	1,590	244,527	1,272	203,216	1,882
3/1/2026	2,200	606	1,594	242,933	1,276	201,940	1,882
4/1/2026	2,200	602	1,598	241,335	1,280	200,659	1,882
5/1/2026	2,200	598	1,602	239,733	1,284	199,375	1,882
6/1/2026	2,200	594	1,606	238,127	1,288	198,087	1,882
7/1/2026	2,200	590	1,610	236,516	1,292	196,794	1,882
8/1/2026	2,200	586	1,614	234,902	1,296	195,498	1,882
9/1/2026	2,200	582	1,618	233,284	1,300	194,197	1,882
10/1/2026	2,200	578	1,622	231,662	1,305	192,893	1,882
11/1/2026	2,200	574	1,626	230,035	1,309	191,584	1,882
12/1/2026	2,200	570	1,630	228,405	1,313	190,272	1,882
1/1/2027	2,200	566	1,634	226,770	1,317	188,955	1,882
2/1/2027	2,200	561	1,639	225,132	1,321	187,634	1,882
3/1/2027	2,200	557	1,643	223,489	1,325	186,309	1,882
4/1/2027	2,200	553	1,647	221,842	1,329	184,980	1,882
5/1/2027	2,200	549	1,651	220,192	1,333	183,647	1,882
6/1/2027	2,200	545	1,655	218,536	1,337	182,310	1,882
7/1/2027	2,200	541	1,659	216,877	1,341	180,968	1,882
8/1/2027	2,200	537	1,663	215,214	1,346	179,623	1,882
9/1/2027	2,200	533	1,667	213,547	1,350	178,273	1,882
10/1/2027	2,200	528	1,672	211,875	1,354	176,919	1,882
11/1/2027	2,200	524	1,676	210,199	1,358	175,561	1,882
12/1/2027	2,200	520	1,680	208,519	1,362	174,199	1,882
1/1/2028	2,200	516	1,684	206,835	1,366	172,833	1,882
2/1/2028	2,200	512	1,688	205,146	1,371	171,462	1,882
3/1/2028	2,200	507	1,693	203,454	1,375	170,087	1,882
4/1/2028	2,200	503	1,697	201,757	1,379	168,708	1,882
5/1/2028	2,200	499	1,701	200,056	1,383	167,325	1,882
6/1/2028	2,200	495	1,705	198,351	1,388	165,937	1,882
7/1/2028	2,200	490	1,710	196,641	1,392	164,545	1,882
8/1/2028	2,200	486	1,714	194,927	1,396	163,149	1,882
9/1/2028	2,200	482	1,718	193,209	1,400	161,749	1,882

9/1/2028	2,200	482	1,718	193,209	1,400	161,749	1,882
10/1/2028	2,200	478	1,722	191,486	1,405	160,344	1,882
11/1/2028	2,200	473	1,727	189,760	1,409	158,935	1,882
12/1/2028	2,200	469	1,731	188,028	1,413	157,522	1,882
1/1/2029	2,200	465	1,735	186,293	1,418	156,104	1,882
2/1/2029	2,200	460	1,740	184,553	1,422	154,682	1,882
3/1/2029	2,200	456	1,744	182,809	1,426	153,256	1,882
4/1/2029	2,200	452	1,748	181,061	1,431	151,825	1,882
5/1/2029	2,200	447	1,753	179,308	1,435	150,390	1,882
6/1/2029	2,200	443	1,757	177,551	1,439	148,951	1,882
7/1/2029	2,200	438	1,762	175,789	1,444	147,507	1,882
8/1/2029	2,200	434	1,766	174,023	1,448	146,058	1,882
9/1/2029	2,200	430	1,770	172,252	1,453	144,606	1,882
10/1/2029	2,200	425	1,775	170,478	1,457	143,149	1,882
11/1/2029	2,200	421	1,779	168,698	1,462	141,687	1,882
12/1/2029	2,200	416	1,784	166,915	1,466	140,221	1,882
1/1/2030	2,200	412	1,788	165,126	1,470	138,751	1,882
2/1/2030	2,200	407	1,793	163,334	1,475	137,276	1,882
3/1/2030	2,200	403	1,797	161,536	1,479	135,796	1,882
4/1/2030	2,200	398	1,802	159,735	1,484	134,313	1,882
5/1/2030	2,200	394	1,806	157,929	1,488	132,824	1,882
6/1/2030	2,200	389	1,811	156,118	1,493	131,331	1,882
7/1/2030	2,200	385	1,815	154,303	1,497	129,834	1,882
8/1/2030	2,200	380	1,820	152,483	1,502	128,332	1,882
9/1/2030	2,200	376	1,824	150,659	1,507	126,825	1,882
10/1/2030	2,200	371	1,829	148,830	1,511	125,314	1,882
11/1/2030	2,200	367	1,833	146,996	1,516	123,799	1,882
12/1/2030	2,200	362	1,838	145,158	1,520	122,278	1,882
1/1/2031	2,200	357	1,843	143,316	1,525	120,754	1,882
2/1/2031	2,200	353	1,847	141,469	1,529	119,224	1,882
3/1/2031	2,200	348	1,852	139,617	1,534	117,690	1,882
4/1/2031	2,200	344	1,856	137,760	1,539	116,151	1,882
5/1/2031	2,200	339	1,861	135,899	1,543	114,608	1,882
6/1/2031	2,200	334	1,866	134,034	1,548	113,060	1,882
7/1/2031	2,200	330	1,870	132,163	1,553	111,508	1,882
8/1/2031	2,200	325	1,875	130,288	1,557	109,950	1,882
9/1/2031	2,200	320	1,880	128,408	1,562	108,388	1,882
10/1/2031	2,200	316	1,884	126,524	1,567	106,822	1,882
11/1/2031	2,200	311	1,889	124,635	1,571	105,250	1,882
12/1/2031	2,200	306	1,894	122,741	1,576	103,674	1,882
1/1/2032	2,200	301	1,899	120,842	1,581	102,093	1,882
2/1/2032	2,200	297	1,903	118,939	1,586	100,507	1,882
3/1/2032	2,200	292	1,908	117,030	1,590	98,917	1,882

3/1/2032	2,200	292	1,908	117,030	1,590	98,917	1,882
4/1/2032	2,200	287	1,913	115,118	1,595	97,322	1,882
5/1/2032	2,200	282	1,918	113,200	1,600	95,722	1,882
6/1/2032	2,200	277	1,923	111,277	1,605	94,117	1,882
7/1/2032	2,200	273	1,927	109,350	1,610	92,508	1,882
8/1/2032	2,200	268	1,932	107,418	1,614	90,893	1,882
9/1/2032	2,200	263	1,937	105,481	1,619	89,274	1,882
10/1/2032	2,200	258	1,942	103,539	1,624	87,650	1,882
11/1/2032	2,200	253	1,947	101,592	1,629	86,021	1,882
12/1/2032	2,200	248	1,952	99,641	1,634	84,388	1,882
1/1/2033	2,200	244	1,956	97,685	1,639	82,749	1,882
2/1/2033	2,200	239	1,961	95,723	1,644	81,105	1,882
3/1/2033	2,200	234	1,966	93,757	1,648	79,457	1,882
4/1/2033	2,200	229	1,971	91,786	1,653	77,804	1,882
5/1/2033	2,200	224	1,976	89,810	1,658	76,145	1,882
6/1/2033	2,200	219	1,981	87,829	1,663	74,482	1,882
7/1/2033	2,200	214	1,986	85,843	1,668	72,814	1,882
8/1/2033	2,200	209	1,991	83,852	1,673	71,141	1,882
9/1/2033	2,200	204	1,996	81,856	1,678	69,463	1,882
10/1/2033	2,200	199	2,001	79,855	1,683	67,780	1,882
11/1/2033	2,200	194	2,006	77,850	1,688	66,092	1,882
12/1/2033	2,200	189	2,011	75,839	1,693	64,399	1,882
1/1/2034	2,200	184	2,016	73,823	1,698	62,701	1,882
2/1/2034	2,200	179	2,021	71,802	1,703	60,997	1,882
3/1/2034	2,200	174	2,026	69,776	1,708	59,289	1,882
4/1/2034	2,200	169	2,031	67,745	1,713	57,576	1,882
5/1/2034	2,200	164	2,036	65,709	1,718	55,858	1,882
6/1/2034	2,200	159	2,041	63,667	1,723	54,134	1,882
7/1/2034	2,200	154	2,046	61,621	1,729	52,406	1,882
8/1/2034	2,200	149	2,051	59,570	1,734	50,672	1,882
9/1/2034	2,200	143	2,057	57,513	1,739	48,933	1,882
10/1/2034	2,200	138	2,062	55,451	1,744	47,189	1,882
11/1/2034	2,200	133	2,067	53,384	1,749	45,440	1,882
12/1/2034	2,200	128	2,072	51,312	1,754	43,686	1,882
1/1/2035	2,200	123	2,077	49,235	1,759	41,926	1,882
2/1/2035	2,200	118	2,082	47,153	1,765	40,162	1,882
3/1/2035	2,200	112	2,088	45,065	1,770	38,392	1,882
4/1/2035	2,200	107	2,093	42,972	1,775	36,617	1,882
5/1/2035	2,200	102	2,098	40,874	1,780	34,836	1,882
6/1/2035	2,200	97	2,103	38,771	1,786	33,051	1,882
7/1/2035	2,200	91	2,109	36,662	1,791	31,260	1,882
8/1/2035	2,200	86	2,114	34,549	1,796	29,464	1,882
9/1/2035	2,200	81	2,119	32,429	1,801	27,663	1,882
10/1/2035	2,200	76	2,124	30,305	1,807	25,856	1,882

10/1/2035	2,200	76	2,124	30,305	1,807	25,856	1,882
11/1/2035	2,200	70	2,130	28,175	1,812	24,044	1,882
12/1/2035	2,200	65	2,135	26,040	1,817	22,227	1,882
1/1/2036	2,200	60	2,140	23,900	1,823	20,404	1,882
2/1/2036	2,200	54	2,146	21,754	1,828	18,576	1,882
3/1/2036	2,200	49	2,151	19,603	1,833	16,743	1,882
4/1/2036	2,200	44	2,156	17,446	1,839	14,904	1,882
5/1/2036	2,200	38	2,162	15,285	1,844	13,060	1,882
6/1/2036	2,200	33	2,167	13,117	1,850	11,211	1,882
7/1/2036	2,200	27	2,173	10,945	1,855	9,356	1,882
8/1/2036	2,200	22	2,178	8,766	1,860	7,495	1,882
9/1/2036	2,200	16	2,184	6,583	1,866	5,629	1,882
10/1/2036	2,200	11	2,189	4,393	1,871	3,758	1,882
11/1/2036	2,200	5	2,195	2,198	1,877	1,882	1,882
12/1/2036	2,200	2	2,198	0	1,882	0	1,882

9. Supplemental Resources

This guide covers much of the new guidance for lease accounting. However, there are some issues that aren't discussed here. Access the following resources for additional support:

- Blog: **ASC 805 Business Combinations & Lease Accounting Explained**
- Guide: **Be Ready for Your First Post-Transition Audit**
- Webinar: **ASC 842: Road to Compliance**

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