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Accounting for Leases Under ASC 842

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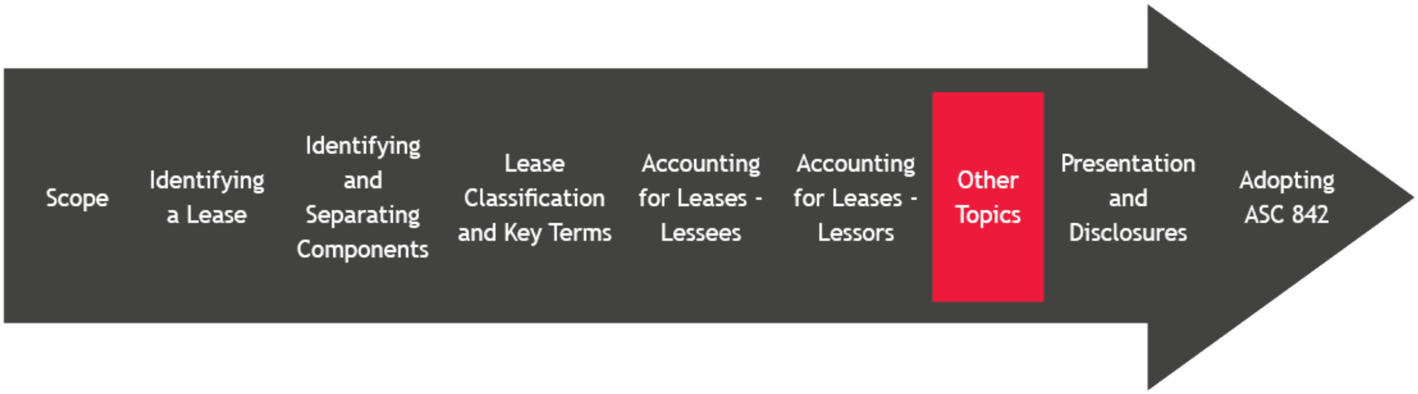
Other Topics



OVERVIEW

In articles 5 and 6 from this series, we discussed the accounting for leases by lessees and lessors, respectively.

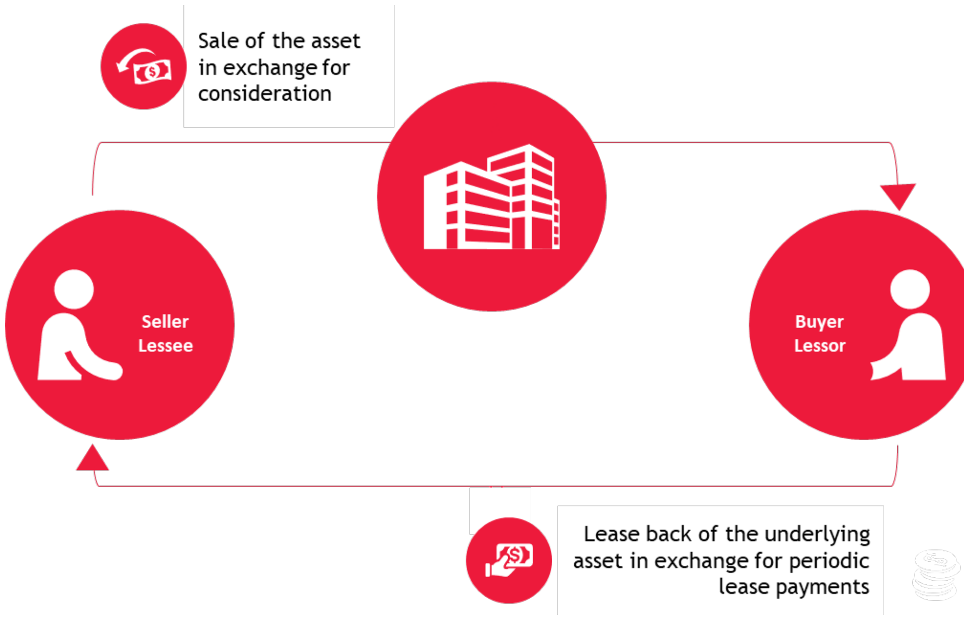
In this article, we discuss other transactions and topics that are affected by the requirements under ASC 842. Those include:

- Sale and leaseback transactions,
- Business combinations,
- Subleases, and
- Income taxes.

SALE AND LEASEBACK TRANSACTIONS

OVERVIEW

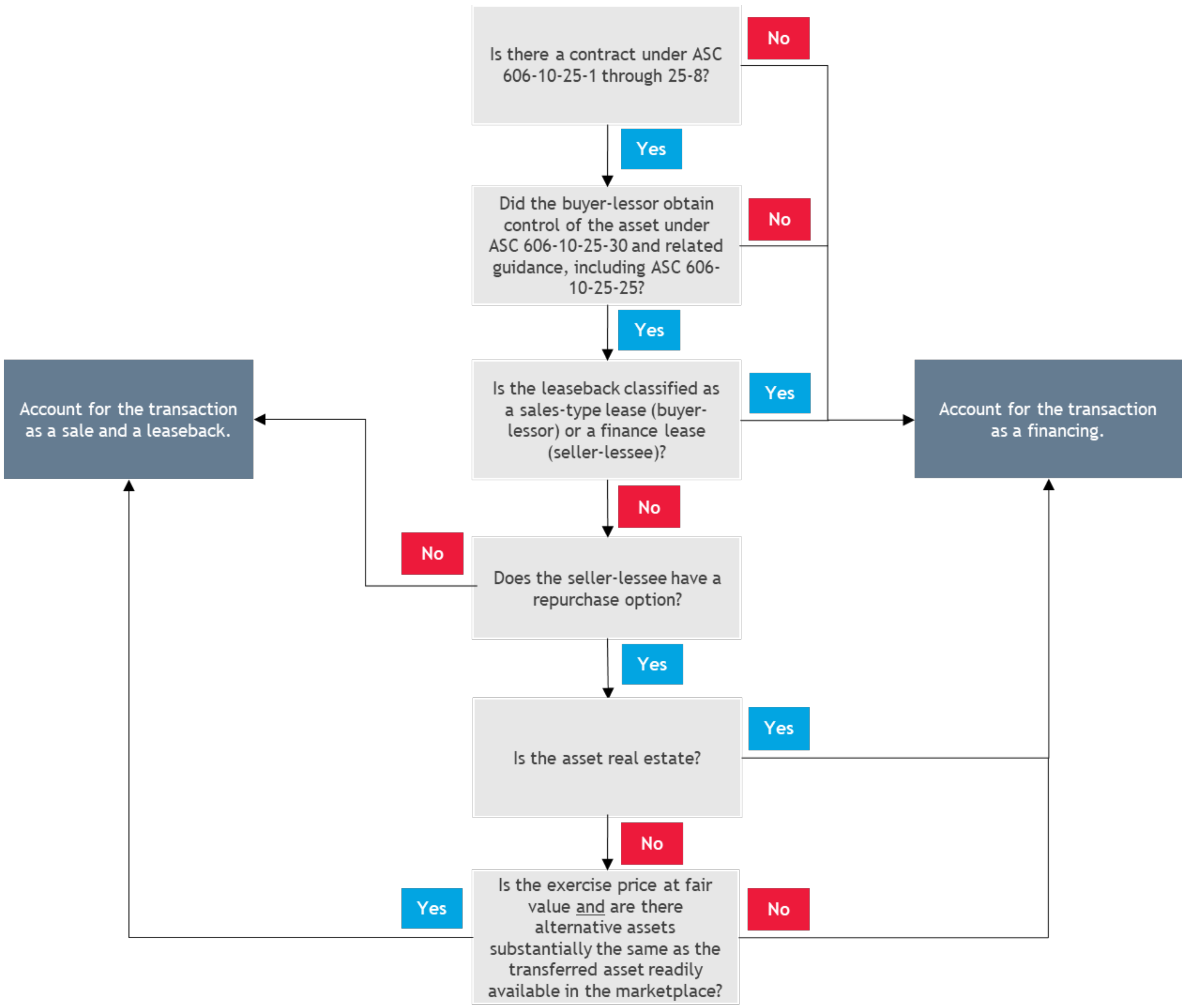
In a sale and leaseback transaction, one entity (seller-lessee) transfers an asset that it owns to another entity (buyer-lessor) and leases that asset back from the buyer-lessor for a period of time in exchange for consideration.



For transactions within the scope of the sale and leaseback guidance, the seller-lessee *and* the buyer-lessor apply the following requirements to determine whether to account for the transaction as a sale and a leaseback, or as a financing arrangement.

Evaluate under ASC 606 whether a contract exists and whether the buyer-lessor obtains control of the asset	ASC 842-40 relies on the guidance in ASC 606 in substantially the same way as does the guidance in ASC 610-20, which applies to sales of nonfinancial assets to parties other than customers. If under ASC 606 a contract does not exist or the buyer-lessor does not obtain control of the asset, no sale has occurred, and the transaction is accounted for as a financing. If a contract exists *and* the buyer-lessor obtains control of the asset, the entity applies the other requirements below.
Determine whether the leaseback is classified as a sales-type lease (buyer-lessor) or finance lease (seller-lessee)	The existence of a leaseback does not by itself prevent the buyer-lessor from obtaining control of the asset. However, if the leaseback is classified as a finance lease by the seller-lessee or a sales-type lease by the buyer-lessor, the buyer-lessor does not obtain control of the asset and the transaction is a financing. This is because the seller-lessee directs the use of, and obtains substantially all of the remaining benefits from, the underlying asset before and after the transaction.
Identify whether the seller-lessee has a repurchase option, and if so, evaluate whether such repurchase option precludes sale accounting	ASC 606 notes that a customer does not obtain control of an asset if the seller has the obligation or the right to repurchase the asset. However, for sale and leaseback transactions, a seller-lessee repurchase option does not preclude sale accounting if: ▶ The exercise price is the asset's fair value at the time of exercise, <u>and</u> ▶ There are alternative assets, substantially the same as the transferred asset, readily available in the marketplace (in other words, the buyer-lessor could use the proceeds from the repurchase to acquire an asset that is substantially the same in the marketplace). If either of those two conditions is not met or the transferred asset is real estate (because it is considered unique), the transaction is accounted for as a financing.

The following flowchart summarizes the decision steps to evaluate the accounting for sale and leaseback transactions:



We will analyze and explain the above steps in further details in the following sections.

SCOPE CONSIDERATIONS

Properly identifying transactions that must be evaluated under the sale and leaseback guidance is a critical step as it may result in accounting for the transaction very differently (for example, the buyer accounting for the transaction as a financing rather than a purchase of the asset). The following section discusses scope considerations.

APPLICATION BY SELLER-LESSEE *AND* BUYER-LESSOR

The guidance in ASC 842-40 applies to both the seller-lessee and the buyer-lessor (that is, it is intended to be symmetrical). This represents a significant change from ASC 840-40, which only applied to seller-lessees. This is also different from ASC 606 which applies to only the seller, not the customer. Buyer-lessors in sale-leaseback transactions must now determine whether they have a 'successful purchase' under ASC 842-40. This symmetrical treatment also applies in situations in which the lessee is considered the accounting owner of an asset before lease commencement, as further discussed below.

CONTROL OF UNDERLYING ASSET BEFORE COMMENCEMENT DATE

The sale and leaseback guidance applies when the lessee controls the underlying asset before lease commencement. As such, the guidance potentially applies to the following situations depending on the facts and circumstances:

Lessee obtains legal title to the underlying asset before that title is transferred to the lessor and the asset is leased to the lessee.

In those situations, the entity assesses whether the lessee *controls* the underlying asset before the asset transfers to the lessor (that is, whether the lessee directs the use of, and obtains substantially all of the remaining benefits from, the asset before it transfers to the lessor).

- If the lessee controls the asset before the commencement date, the transaction is in the scope of the sale and leaseback guidance.
- Otherwise, the transaction is accounted as a purchase of the asset by the lessor and a lease between the parties.

This could occur for example in transactions between a manufacturer, a lessor and a lessee for the purchase of an asset by the lessor from the manufacturer, in which the lessee obtains legal title momentarily for tax or other reasons. If the lessee obtains legal title to the asset but does not obtain control of the underlying asset before it is transferred to the lessor, the transaction is not a sale and leaseback transaction.

The evaluation of control should be based on the specific facts and circumstances of the transaction, including whether the lessee obtains physical possession of the asset, has the significant risks and rewards of ownership, and accepts the asset before the asset is transferred to the lessor.

Entity negotiates a lease before the underlying asset is available for use by the lessee, also referred to as build-to-suit transactions (e.g., the underlying asset must be constructed or redesigned).

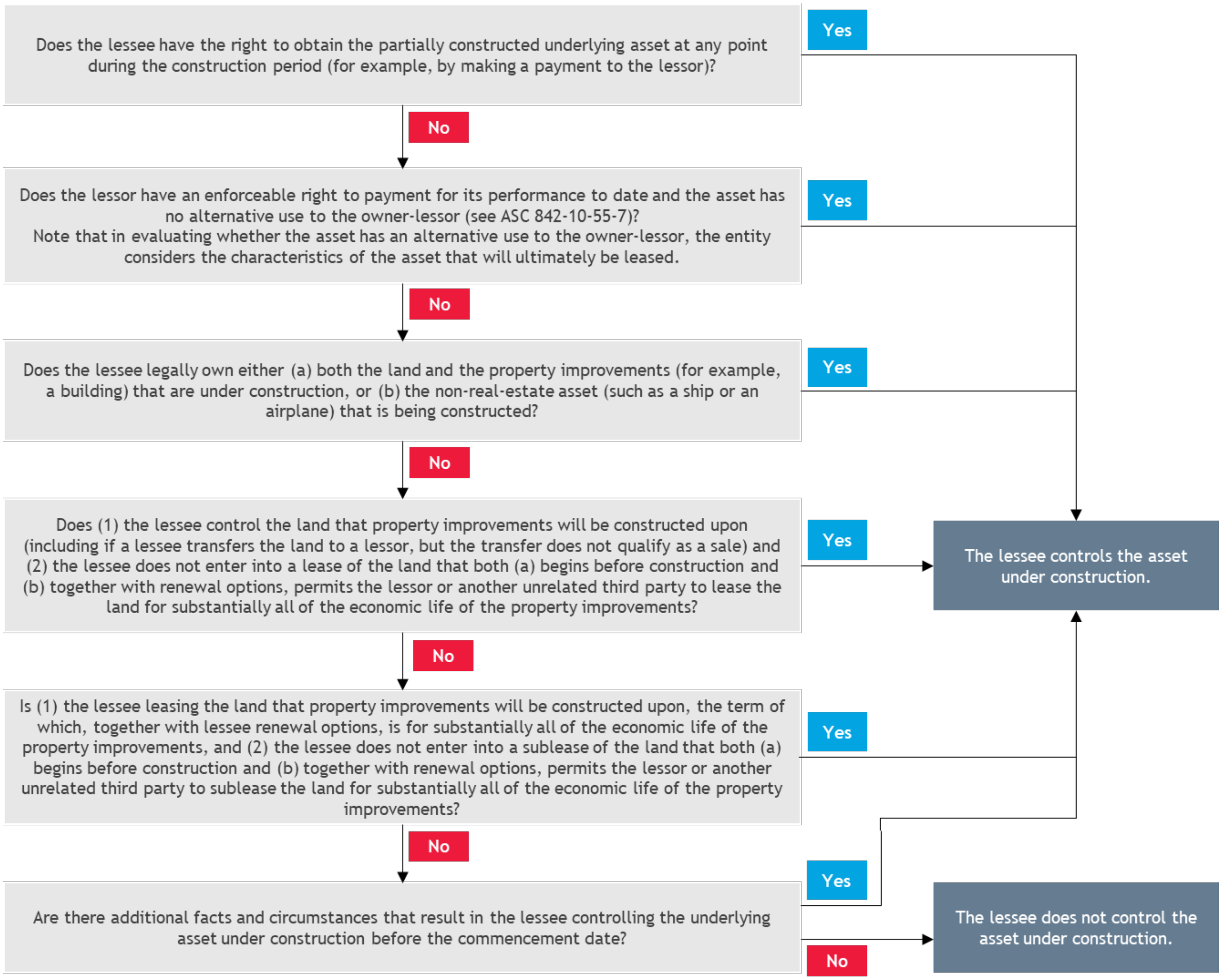
In those situations, the entity assesses whether the lessee controls the underlying asset being constructed before the commencement date by applying the guidance in ASC 842-40-55-5 (discussed on the next page).

If the lessee controls the asset being constructed before lease commencement, the transaction is in the scope of the sale and leaseback guidance.

If the lessee does not control the underlying asset under construction, the lessee may still incur costs relating to the construction or design of the underlying asset before the commencement date (for example, architectural services in developing the building specifications, specific leasehold improvements, etc.). In those situations, the lessee accounts for those costs as follows:

- Under other GAAP, such as ASC 360 or ASC 330, for lessee-owned assets (for example, leasehold improvements that the lessee pays for during the construction period and that will benefit the lessee in future periods) and for goods or services (other than the lease) provided to the lessee.
- As lease payments (i.e., prepaid rent), regardless of the timing or form of those payments such as contribution of construction materials, if the payments are made for the right to use the lessor-owned assets.

The following flowchart summarizes the decision steps to determine if the lessee controls the underlying asset under construction:



In the assessment of the first question above, we believe that a purchase option exercisable solely with the passage of time results in the lessee controlling the asset under construction from inception of the arrangement. However, if a purchase option becomes exercisable only after a contingent event, we believe the analysis will require judgment and the conclusion will depend on the specific facts and circumstances of the transaction, including whether the lessee or the lessor controls the occurrence of the contingent event. Also, if the lessor has a put option, we believe the analysis should be consistent with the guidance under ASC 606 (that is, whether the lessor has a significant economic incentive to put the asset back to the lessee).

Because the list of circumstances discussed in ASC 842-40-55-5 is not all inclusive, there could be other circumstances that result in the lessee controlling the underlying asset under construction before the commencement date. Therefore, in evaluating the last question of the flowchart above, judgment will be required to identify such circumstances, if any. In concept, the FASB noted that the evaluation above is similar to the evaluation under ASC 606-10-25-27 when determining if a performance obligation is satisfied over time.

See ASC 842-40-55 Example 3 for an illustration of the application of the above guidance by both the seller-lessee and the buyer-lessor.

If the lessee controls the asset under construction, it should recognize that asset just as it would recognize any other asset it controls, along with a liability for any amounts funded by the lessor. The lessor recognizes a receivable rather than construction in progress. Also, both entities should apply the guidance in Section “Determining whether the transfer of the asset is a sale” to determine if and when to recognize a sale. As discussed in that section, an entity typically cannot conclude that there is a sale until the commencement date of the leaseback.

Example 1A - Lessee Is the Accounting Owner During Asset Construction

FACTS

- Rx Hospital owns vacant land adjacent to its hospital. It plans to use the land to expand its operations to include additional medical facilities that will complement its current services provided to patients.
- Rx Hospital leases the vacant land to MJ Developer before construction begins and for a 40-year term with two 5-year extension options. The completed building is expected to have an economic life of 40 years.
- Rx Hospital will lease the completed building for an initial 20-year term with two 10-year extension options.
- Rx Hospital has a purchase option on the asset exercisable at any time throughout the construction period.

ANALYSIS

- RX Hospital entered into a lease of the land before construction begins and for a term including renewals that permit MJ Developer to lease the land for substantially all the property improvements’ economic life. However, Rx Hospital has a purchase option exercisable at any time during construction. It is therefore the accounting owner during construction, and the transaction is in the scope of sale and leaseback guidance.
- Rx Hospital recognizes the construction in progress in accordance with ASC 360. Any amounts funded by MJ Developer are recognized as a financial liability.
- Because the accounting is symmetrical under ASC 842-40, MJ Developer recognizes a receivable for construction costs incurred (rather than construction in progress) during the construction period.
- At the end of the construction period (commencement date of the lease), Rx Hospital and MJ Developer will assess whether the transaction qualifies as a sale and a leaseback.

Example 1B - Lessee Is Not the Accounting Owner During Asset Construction

FACTS

- Assume the same facts as in Example 1A, except that Rx Hospital does not have a purchase option. There are no other circumstances resulting in Rx Hospital being the accounting owner of the asset being constructed.
- Rx Hospital provides various materials during construction of the additional building.

ANALYSIS

- The transaction is not in the scope of the sale and leaseback guidance because Rx Hospital is not the accounting owner of the asset being constructed under ASC 842-40-55-5.
- Rx Hospital should account for the various materials provided during construction based on their nature. If the costs relate to leasehold improvements, Rx Hospital accounts for those under ASC 360. If the costs do not relate to leasehold improvements or other goods or services (other than the lease) provided to Rx Hospital, but rather are payments for the right to use the building once constructed, Rx Hospital accounts for those as lease payments (i.e., prepaid lease payments).

Example 2 - Lessor Partially Constructed the Asset Before Lease Inception

FACTS

- Lessee is in the luxury cruise line industry, and it enters into a lease with Developer for a new cruise ship that Developer partially constructed at lease inception. The fair value of the partially constructed ship at lease inception is $25 million, and total expected costs to complete it are approximately $600 million.
- Lessee has an option to purchase the partially constructed asset at any point during construction.

ANALYSIS

- Because of the purchase option, Lessee controls the luxury cruise ship under construction and the transaction is in the scope of the sale and leaseback guidance. Lessee therefore recognizes construction in progress at its fair value and a financing obligation at lease inception.
- Because the accounting is symmetrical under ASC 842-40, Developer derecognizes the construction in progress and recognizes a receivable. The amount of the receivable recognized, along with any selling profit, depends on the facts and circumstances. For example, if Developer has an obligation to complete the construction of the cruise ship, we believe Developer should recognize a receivable at cost plus an appropriate margin based on the percentage of completion method.

SALE OF A PARTIALLY CONSTRUCTED ASSET WITH A CONTEMPORANEOUS LEASE ONCE CONSTRUCTION IS COMPLETED

In some transactions, the owner of a partially constructed asset may sell the asset “as-is” to a developer (lessor) who commits to complete construction of the asset and to lease the completed asset back to the seller at the end of the construction period. The asset sold may be in different stages of construction (for example, only soft costs incurred, hard costs incurred in varying degrees, and so forth). These transactions are not specifically addressed in ASC 842, and therefore there may be multiple approaches to determine whether such transactions are in the scope of the sale and leaseback guidance. For example, the following approaches may be acceptable if applied consistently by an entity as an accounting policy:

- All sales of construction-in-progress assets, irrespective of the dollar amounts incurred or the stage of construction, with a commitment to lease the asset back once construction is completed are in the scope of the sale and leaseback guidance.
- Only transactions for which the construction-in-progress asset is substantially similar to the completed asset are in the scope of the sale and leaseback guidance.

However, because ASC 842 is not clear, other approaches between the two approaches described above may also be acceptable, such as establishing a threshold at which construction-in-progress assets with a commitment to lease the asset back once construction is completed are in the scope of the sale and leaseback guidance.

Example 3A - Sale of a Partially Constructed Asset

FACTS

- Lessee is in the logistics industry and has started construction of a new plane that it owns. So far it has incurred $75,000 in construction costs and total costs are expected to be approximately $350,000.
- Lessee sells the partially constructed plane to Aircraft Builder who agrees to complete construction of the plane and to lease the completed plane back to Lessee at the end of the construction period.
- Lessee is not the accounting owner of the asset during the remainder of the construction period (i.e., none of the conditions in ASC 842-40-55-5 are met after lease inception).

ANALYSIS

- Lessee has made an accounting policy to account for such transactions under the sale and leaseback guidance only if the partially constructed asset is substantially similar to the completed asset.
- Lessee considers the facts and circumstances of the transaction, including costs incurred to date compared to total expected costs, and concludes that the transaction is not in the scope of the sale and leaseback guidance because the partially constructed asset is not substantially similar to the completed asset.
- Lessee applies other GAAP (e.g., ASC 610-20) to determine whether and when to recognize the sale.

Example 3B - Sale of a Partially Constructed Asset With a Repurchase Option

FACTS

- Assume the same facts as above, except that the sale contract with Aircraft Builder provides Lessee with an option to purchase the partially constructed plane at any time during the construction period.

ANALYSIS

- The purchase option results in Lessee being the accounting owner of the asset under construction in accordance with ASC 842-40-55-5(a). Therefore, Lessee does not derecognize the partially constructed plane and accounts for the proceeds from the sale as a financial liability. Lessee will recognize any additional amounts funded by Aircraft Builder for the construction of the plane as increases to value of the construction in progress asset and the financial liability.
- Because sale-leaseback accounting is symmetrical, Aircraft Builder accounts for the cash paid and any additional amounts funded for the construction of the plane as a receivable rather than construction in progress.
- Lessee and Airplane Builder should wait until the commencement date of the leaseback to determine whether sale and leaseback is achieved. This is because ASC 842-40 precludes sale accounting when the leaseback is classified as a finance lease by the seller-lessee or sales-type lease by the buyer-lessor, and classification of the leaseback cannot be assessed prior to the commencement date.

SALE OR TRANSFER OF A PURCHASE OPTION TO A THIRD-PARTY WITH LEASEBACK OF THE ASSET

An entity may sell or transfer a purchase option on an asset to a third-party with a commitment from the third-party to exercise the option and lease the asset back to the entity. For example, a lessee may have a purchase option under an existing lease of a building (or equipment) which the lessee assigns to a third-party. In turn, the third-party commits to exercise the option to purchase the building (or equipment) and to lease the asset back to the lessee once the asset is purchased. Terms and conditions in such transactions may vary, such as the price at which the purchase option is exercisable (fair value vs. fixed price), whether the purchase option is currently exercisable, and so forth. Care should be given in these situations based on the specific facts and circumstances of the transaction to determine whether the sale and leaseback guidance applies. However, consistent with the concepts underlying the guidance in ASC 842-40-25-3 on repurchase options, we believe that if there are alternative assets substantially the same as the asset subject to the transaction and the strike price is fair value, the transaction may not be within the scope of the sale and leaseback guidance. This is because the lessee could have negotiated with a third-party (e.g., bank) for the direct purchase and lease of a different (but substantially similar) asset, which would not be subject to the sale and leaseback guidance. However, for assets like real estate, we believe such transactions will be in the scope of the sale and leaseback guidance because no two real estate assets are the same.

Example 4 - Assignment and Exercise of a Purchase Option in a Real Estate Lease

FACTS

- Distributor is the lessee of a warehouse that has a noncancelable term of ten years and for which the expiration is approaching. The lease includes two fixed price extension options for ten years each, and a fair market value purchase option exercisable at the end of the initial ten-year term.
- Distributor assigns the purchase option to Real Estate Co which commits to exercise the purchase option and to purchase the warehouse subject to due diligence procedures. Upon closing, Real Estate Co agrees to lease the warehouse to Distributor for a noncancelable period of ten years. The lease includes two fixed price extension options and a fair value purchase option.
- Following the due diligence procedures being satisfactory to Real Estate Co, the transaction closes and the lease between Distributor and Real Estate Co commences.

ANALYSIS

- In this example, Distributor and Real Estate Co evaluate the transaction and determine, based on the facts and circumstances of the transaction (including that the purchase option is on a real estate asset, which is considered unique) that Distributor is considered to control the warehouse before Real Estate Co’s purchase, even though Distributor does not legally own the warehouse. Therefore, the transaction is in the scope of the sale and leaseback guidance.
- Because the lease between Distributor and Real Estate Co also includes a purchase option, the transaction is accounted for as a financing by Distributor and Real Estate Co.

SALE-LEASEBACK TRANSACTIONS WITH VARIABLE INTEREST ENTITY BUYER-LESSORS

Certain sale-leaseback transactions may be structured with a legal entity that the buyer-lessor specifically created for tax, legal or other reasons to hold assets related to one or more sale and leaseback transactions. In those situations, an entity should carefully consider whether other GAAP guidance applies to the transaction, specifically the variable interest entity (VIE) subsections of ASC 810-10 on consolidation. If for example the lease includes a repurchase option or residual value guarantee that represents a variable interest in the buyer-lessor entity, the VIE subsections of ASC 810-10 would apply unless a scope exception is met. If the VIE subsections apply, the seller-lessee should determine whether it has a controlling financial interest in the buyer-lessor entity that holds the nonfinancial asset(s). If the seller-lessee is the primary beneficiary of the buyer-lessor entity, the seller-lessee would apply ASC 810-10 and consolidate the buyer-lessor entity rather than apply ASC 842-40 on sale and leaseback transactions. For further discussion on the application of the VIE guidance in ASC 810-10, see our publication **BDO Knows: Variable Interest Entities** available here. See also this link for a consultation the SEC staff discussed at the 2019 AICPA Conference on Current SEC and PCAOB Developments related to a sale-leaseback transaction involving a variable interest entity. Because transactions may be structured in a variety of ways, an entity with a complex structure may consider discussing the appropriate accounting with their accounting advisors.

LESSEE INDEMNITY FOR PREEXISTING ENVIRONMENTAL CONTAMINATION

A lessee may be required to indemnify the lessor for preexisting environmental contamination. However, this provision alone does not mean that the lessee controlled the underlying asset prior to the lease commencing. This is regardless of the likelihood of a loss resulting from the indemnity. Therefore, the presence of such a provision does not mean the transaction is in the scope of the sale and leaseback guidance.

SALE-LEASEBACK-SUBLEASE TRANSACTIONS

An entity may enter into a sale-leaseback transaction for which the asset is subject to an operating lease or is subleased (or intended to be subleased) by the seller-lessee to another party under an operating lease. A sale-leaseback-sublease transaction is within the scope of the sale and leaseback guidance. However, the existence of the operating sublease does not by itself prevent the buyer-lessor from obtaining control of the asset nor does it prevent the seller-lessee from controlling the asset before the transfer. All facts and circumstances should be considered in determining whether the buyer-lessor obtains control of the underlying asset in a sale-leaseback-sublease transaction.

SALE SUBJECT TO A PREEXISTING LEASE

An entity may obtain an ownership interest in an underlying asset and at or near the same time enter into an operating lease as a lessee for all or a portion of the underlying asset. For example, this could occur when an entity has an investment in a partnership or subsidiary that owns the underlying asset. The entity subsequently sells its interest in the partnership, or the partnership sells the underlying asset to an independent third party, and the entity continues to lease the underlying asset under the preexisting operating lease.

- If the scope or price of the preexisting lease is modified in connection with the sale, the transaction is in the scope of the sale and leaseback guidance. Otherwise, the sale should be accounted for under other Topics.
- However, a lease between parties under common control should not be considered a preexisting lease. Accordingly, the sale and leaseback guidance should be applied to transactions that include nonfinancial assets within the scope of ASC 842-40, except if ASC 980 on regulated operations applies. That is, if one of the parties under common control is a regulated entity with a lease that has been approved by the appropriate regulatory agency, that lease should be considered a preexisting lease.

TRANSFER OF TAX BENEFITS

Refer to ASC 842-40-55-11 through 55-17 for additional guidance.

DETERMINING WHETHER THE TRANSFER OF THE ASSET IS A SALE

If a transaction is in the scope of the sale and leaseback guidance, the entity (seller-lessee and buyer-lessor) must determine whether the transfer of the asset is a sale. To do so, the entity:

- Evaluates under ASC 606:
  - Whether a contract exists, and
  - Whether the buyer-lessor obtains control of the asset,
- Assesses classification of the leaseback to determine whether the leaseback is classified as a finance lease (seller-lessee) or sales-type lease (buyer-lessor), and
- Identifies repurchase options and determines if such repurchase options preclude sale accounting.

IS THERE A CONTRACT?

In accordance with ASC 606-10-25-1, all of the following conditions must be met for a contract to exist:

The parties to the contract have approved the contract and are committed to perform their respective obligations. The contract may be in writing, orally, or in accordance with other customer business practices.

The entity can identify each party's rights regarding the goods or services to be transferred. That is, the legal rights regarding the transfer of the goods/ property are identifiable for the seller-lessee and the buyer-lessor.

The entity can identify the payment terms for the goods or services to be transferred.

The contract has commercial substance. In other words, the risk, timing, or amount of the entity's future cash flows is expected to change as a result of the contract.

It is probable the entity (the seller-lessee) will collect substantially all the consideration to which it will be entitled in exchange for the goods or services that will be transferred to the customer (the buyer-lessor).

The application of this step generally does not create application issues. This is because sale and leaseback transactions typically include at least a purchase and sale agreement and a lease agreement, for which the rights and obligations of each party are clearly identified, including payment terms. Also, in many sale-leaseback transactions, the transaction has economic substance because the buyer-lessor pays the consideration upfront and takes on risks associated with the asset, including risks of changes in fair market rent, changes in the fair value of the asset, credit risk and so forth.

Once the entity concludes that a contract exists, the next step is to determine whether the buyer-lessor has obtained control of the asset.

DOES THE BUYER-LESSOR OBTAIN CONTROL OF THE ASSET?

The following control indicators in ASC 606-10-25-30 are used to evaluate whether the buyer-lessor has obtained control of the asset:

- The seller-lessee has a present right to payment for the asset.
- The buyer-lessor has legal title to the asset.
- The seller-lessee has transferred physical possession of the asset. However, in sale and leaseback transactions, the buyer-lessor generally does not receive physical possession of the asset until the end of the lease and therefore this indicator will typically not be present.
- The buyer-lessor has the significant risks and rewards of ownership; for example, when the buyer-lessor has the ability to sell the asset if the property value increases and also absorbs any losses if the property value declines.
- The buyer-lessor has accepted the asset. However, this indicator may not be applicable in sale and leaseback transactions that do not include agreed-upon specifications for the asset.

The assessment of most indicators above will be objective in nature (for example, the seller-lessee's present right to payment or the buyer-lessor having legal title). But the analysis of the risks and rewards indicator may be subjective and there may be limitations on risks that the buyer-lessor takes. For example, a seller-lessee may guarantee the residual value of the asset at the end of the lease term. Such guarantee does not in isolation preclude accounting for the transaction as a sale and leaseback. Instead, the guarantee is considered in the entity's overall consideration of the risks and rewards indicator. The analysis may therefore require the use of professional judgment and the entity should consider in its overall assessment the principle of transfer of control in ASC 606-10-25-25, which is that the customer (in this case, the buyer-lessor) has the right to direct the use of, and obtain substantially all of the remaining economic benefits from, the asset. The lessee residual value guarantee should also be included in the determination of lease classification discussed below.

CLASSIFICATION OF THE LEASE AS A FINANCE OR SALES-TYPE LEASE

The existence of the leaseback does not by itself prevent the buyer-lessor from obtaining control of the asset. Because the lease payments received by the buyer-lessor during the lease term, plus the benefits that the buyer-lessor can generate from the residual asset after the lease term, represent substantially all of the remaining benefits to be derived from the asset immediately before the asset is leased to the seller-lessee, the buyer-lessor obtains control of the asset.

However, when a lease is classified as a finance lease by the seller-lessee or a sales-type lease by the buyer-lessor, the seller-lessee controls the underlying asset as a result of the leaseback; that is, the seller-lessee directs the use of, and obtains substantially all the remaining benefits from, the underlying asset. The FASB determined that no sale should occur because a finance lease is economically similar to purchasing the asset, and it would be inappropriate for a seller-lessee to account for a concurrent sale and, in effect, repurchase of the same asset. In an operating lease, the seller-lessee does not obtain substantially all of the remaining benefits from the underlying asset, and thus an operating leaseback does not preclude accounting for the transaction as a sale.

In performing this step, an entity assesses classification at the leaseback commencement date and at the lease component level. Accordingly, if there are multiple assets, the lease components must be identified first. See the earlier article from this series for additional details on identifying the components of a contract.

Example Lease Components
Right to use real estate, such as a retail store in a mall, or a floor in an office building.
Right to use computer equipment.
Right to use a vehicle, such as a truck.

Accounting When Leaseback Has Not Yet Commenced

In some sale and leaseback transactions, the leaseback does not commence until a future period (for example, until a building or warehouse is constructed or renovated). In those situations, the entity cannot recognize a sale (or purchase) until the leaseback commences. This is because ASC 842-40-25-2 requires an assessment of the classification of the leaseback, which is done at lease commencement. Therefore, even if there is a high likelihood that the lease will be classified as an operating lease by the seller-lessee, or a direct financing or operating lease by the buyer-lessor, an entity cannot determine that a sale exists until the leaseback commences.

Example 5 - Sale of Land With Leaseback Following Construction of a Building

FACTS

- Rx Hospital owns vacant land adjacent to its hospital and it plans to expand its operations to include additional medical facilities that complement its current services provided to patients.
- To that effect, Rx Hospital sells the vacant land to MJ Developer who will construct the building.
- Once construction is completed, Rx Hospital agrees to lease the completed building for a noncancelable term of 20 years, with two 10-year extension options.

ANALYSIS

- The leaseback of the medical office building once construction is completed includes an implicit lease of land (see article on [definition of a lease]). Therefore, the sale of the land is in the scope of the sale and leaseback guidance.
- Rx Hospital and MJ Developer cannot conclude that a sale has occurred until leaseback commencement. Therefore, Rx Hospital (not MJ Developer) recognizes the land during the construction period.
- Both entities should also determine whether Rx Hospital is the accounting owner of the building under construction (See Scope section above for additional discussion).

Sale of an Asset With Leaseback For a Portion of the Asset Sold

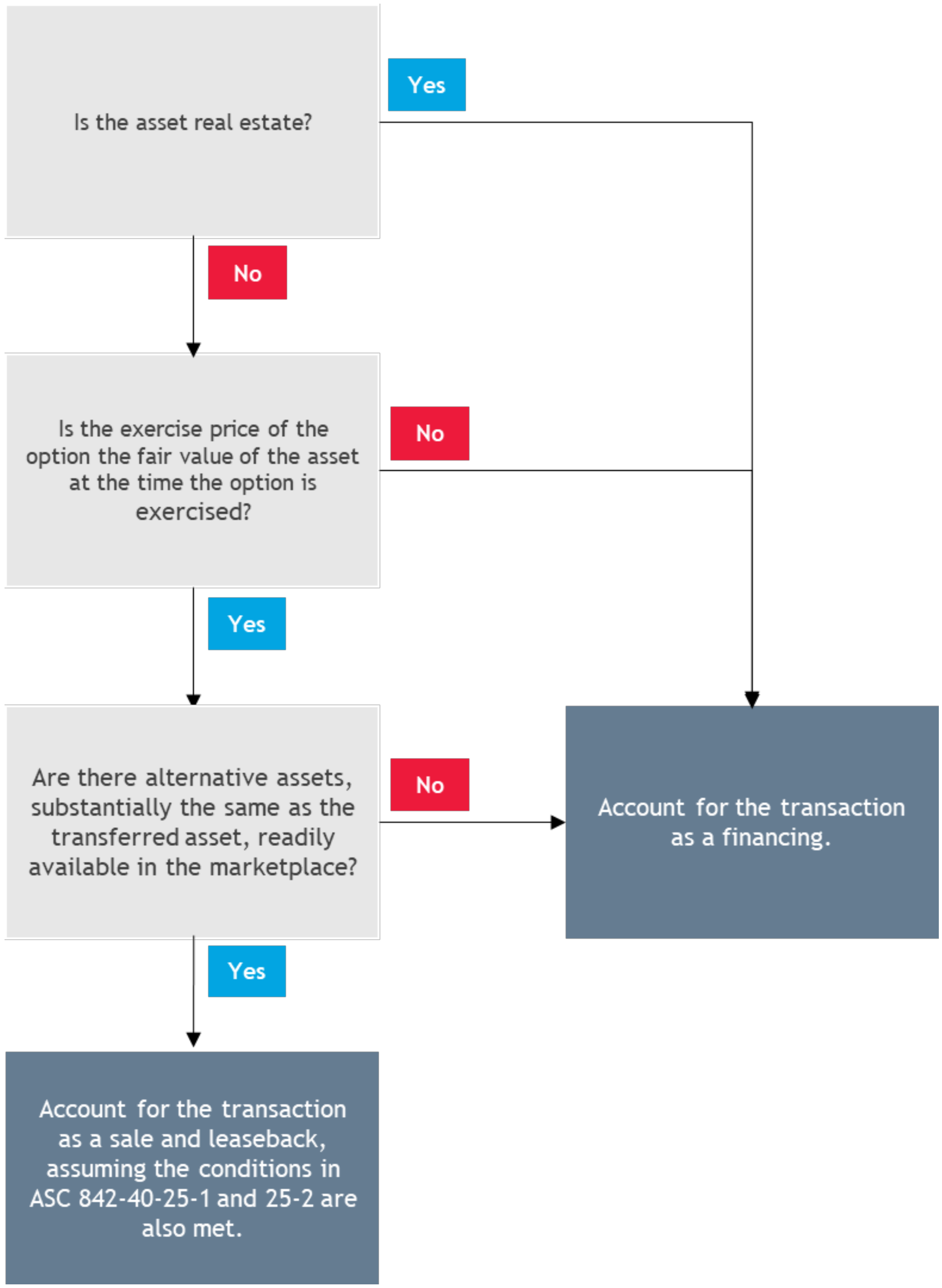
In some sale and leaseback transactions, a seller-lessee may not have business needs for a leaseback of the entire asset sold and therefore may lease back only a portion of it. For example, a seller-lessee may sell a multi-story office building in which it leases back one or more, but not all of the floors in the building. Depending on the terms and conditions of the leaseback and the facts and circumstances of the transaction, the portion that is leased back may be classified as a finance lease by the seller-lessee, or a sales-type lease by the buyer-lessor. In those situations, we generally believe that whether the transaction is accounted for as a financing transaction will depend on whether the portion leased back is legally distinct. If it is, the finance/sales-type leaseback will not preclude sale accounting for the other legally distinct portions of the asset (e.g., the other floors not leased back by the seller-lessee), assuming the other requirements for sale accounting are met. If the portion leased back is not legally distinct, consistent with the principle of transfer of control in ASC 606-10-25-25, including that the customer (in this case the buyer-lessor) obtains substantially all of the remaining economic benefits from the underlying asset, we believe that sale accounting would be precluded unless the leaseback is for a minor portion of the asset sold. If sale accounting is precluded based on the facts and circumstances of the transaction, additional complexity in the accounting may arise. For example, while the seller-lessee accounts for the transaction as a financing, it should consider accounting for imputed leases for the portions of the asset that are not leased back.

REPURCHASE OPTIONS

Under ASC 606, a customer does not obtain control of an asset if the seller has the obligation or the right to repurchase the asset. However, the FASB decided that certain repurchase options do not preclude sale accounting. The FASB noted in paragraph BC352 of ASU 2016-02 that “a buyer-lessor is not constrained in its ability to direct the use of and obtain substantially all the remaining benefits from the asset if the seller-lessee can only repurchase the asset at its then-prevailing fair market value and the buyer-lessor could use the proceeds from the repurchase to acquire an asset that is substantially the same in the marketplace.”

The FASB also noted in paragraph BC352(c) that “Board members generally observed that real estate assets would not meet criterion (2). This is because real estate is, by nature, ‘unique’ (that is, no two pieces of land occupy the same space on this planet) such that no other similar real estate asset is ‘substantially the same’.” Therefore, a repurchase option in a sale-leaseback transaction involving real estate (including integral equipment as defined in ASC 978) will always preclude sale accounting, even if the repurchase option is at fair value.

The following flowchart summarizes the decision steps under ASC 842 to determine whether an unconditional repurchase option precludes sale and leaseback accounting (see discussion below of contingent repurchase options, rights of first offer and rights of first refusal).



Also, sale and leaseback transactions may include terms, such as extension options for substantially all of the remaining economic life of the asset, or residual value guarantees, that have resulted in practice issues in the application of ASC 842-40-25-3.

Renewal Clauses

Some lease arrangements may provide for fixed price or fair value renewal options for all or substantially all of the remaining economic life of the underlying asset. In paragraph BC218 of ASU 2016-02, the Board concluded that “a purchase option is the ultimate option to extend the lease term. A lessee that has an option to extend a lease for all of the remaining economic life of the underlying asset is, economically, in a similar position to a lessee that has an option to purchase the underlying asset. Accordingly, the Board decided that those two options should be accounted for in the same way.”

Accordingly, we believe that care should be given in determining whether renewal options are economically the same as repurchase rights, and whether such renewals preclude sale accounting (e.g., whether the renewal options are at a fixed price versus at fair market rent, the nature of the underlying asset). Entities are encouraged to discuss such transactions with their accounting advisor or auditor.

Residual Value Guarantees in a Sale-Leaseback

In some equipment sale and leaseback transactions, a seller-lessee may guarantee the residual value of the asset and may also have a fair value repurchase option exercisable at the end of the lease term. Accordingly, the amount the buyer-lessor will receive upon exercise of the repurchase option depends on the fair value at the exercise date compared to the residual value guarantee (RVG) amount. If the fair value of the asset is equal to or greater than the RVG, no payment under the RVG is triggered and the buyer-lessor receives an amount equal to fair value. If the fair value of the asset is less than the RVG and the seller-lessee exercises its repurchase right, the buyer-lessor would receive the RVG amount (that is, an amount in excess of fair value). Therefore, the repurchase option is not solely at fair value. However, if all other conditions for sale accounting are met (that is, the conditions in ASC 842-40-25-1 and 25-2 are met), the transaction may still meet the conditions in ASC 842-40-25-3 on repurchase options if there are alternative assets, substantially the same as the equipment, that are readily available in the marketplace. This is because the buyer-lessor will always receive an amount that is at least equal to fair value, which it could use to acquire an equivalent asset at fair value in the marketplace.

Lastly, transactions involving the sale and leaseback of real estate often include various forms of repurchase rights. Those rights may include conditional (or contingent) repurchase rights, rights of first refusal, and rights of first offer. We discuss those below along with considerations as to whether such clauses preclude sale accounting.

Contingent Repurchase Options in Real Estate Sale and Leaseback Transactions

Lease agreements may include repurchase rights that can only be exercised if a specified event has occurred; for example, if there is a change of control of the buyer-lessor or seller-lessee. ASC 842-40 does not specifically address contingent repurchase options. However, paragraph BC 352(c) in the Basis of Conclusions of ASU 2016-02 makes clear that the guidance on repurchase options is based on the guidance on repurchase rights in ASC 606. Under ASC 606, contingent repurchase options do not automatically preclude sale accounting. Rather, such repurchase options are evaluated based on the specific facts and circumstances of the transaction. For example, if a repurchase option is exercisable based on a contingent event that is within the entity's (seller's) control, this generally implies that the customer has not obtained control of the asset and, therefore, sale accounting is precluded. In contrast, if the contingency is within the customer's control, this may imply that the customer has the ability to determine whether the repurchase option is exercisable and, therefore, the customer is not limited in its ability to direct the use of, and obtain substantially all of the remaining benefits from, the asset.

Therefore, similar to contracts with contingent repurchase options within the scope of ASC 606, we believe that for real estate:

- A sale-leaseback transaction that includes a contingent repurchase option for which the contingency is within the seller-lessee's control would preclude sale-leaseback accounting.
- A sale-leaseback transaction that includes a contingent repurchase option for which the contingency is within the buyer-lessor's control may not preclude sale-leaseback accounting, even if the underlying asset is real estate. The evaluation would be similar to the evaluation of buyer put rights under ASC 606 (that is, whether the buyer-lessor has a significant economic incentive to exercise the put).
- If the contingency is outside the control of both the seller-lessee and buyer-lessor, whether sale-leaseback accounting is achieved depends on the specific facts and circumstances of the transaction. For example, if the contingent event was put in place as a protective measure and the likelihood at the transaction date that the event will occur is remote, this may imply that the buyer-lessor has obtained control of the asset, even if the underlying asset is real estate. In contrast, if the contingent event was put in place in contemplation of a transaction or event potentially occurring in the near future and at the transaction date that contingent event is likely to occur, this may imply that the buyer-lessor has not obtained control of the asset because the buyer-lessor is limited in its ability to direct the use of, and obtain substantially all of the remaining benefits from, the asset (because there is a contingency that is outside of its control and the contingent event is likely to occur).

Right of First Refusal in Real Estate Sale and Leaseback Transactions

A right of first refusal (ROFR) is most commonly structured as an option that grants the seller-lessee the right to repurchase the property subject to the sale-leaseback transaction if the buyer-lessor obtains a bona fide offer from a third-party to purchase the property. A ROFR will generally only allow the seller-lessee the right to match that third-party offer. If the seller-lessee elects to exercise the ROFR, the buyer-lessor must sell the property to the seller-lessee, rather than to the third-party.

A provision that allows the seller-lessee the option to repurchase the property only if the buyer-lessor has decided to sell the property and has obtained an offer from a third-party ordinarily will not result in a failed sale/purchase (assuming the other conditions outlined in ASC 842-40-25-1 and 25-2 are also met). In that scenario, the buyer-lessor controls the property through retaining the right to decide whether and when to sell the property.

Right of First Offer in Real Estate Sale and Leaseback Transactions

A right of first offer (ROFO) is most commonly structured as an option that grants the seller-lessee the right to offer to repurchase the property from the buyer-lessor. ROFOs may have varying terms and may be exercisable only after a period of time or at a specified time, and only for a fixed or determinable amount, based on a formula, or at market rates.

Whether a ROFO in a sale-leaseback transaction results in a failed sale/purchase will depend on the specific terms and conditions. Generally, if the buyer-lessor has the ability to reject the seller-lessee's offer with no significant negative economic consequences, then the existence of the ROFO will not preclude sale accounting (assuming the other conditions outlined in ASC 842-40-25-1 and 25-2 are also met). However, if the buyer-lessor would be compelled economically or contractually to accept the offer, the ROFO is equivalent to a repurchase option and would thus result in a failed sale/purchase for real estate transactions. In addition, if the seller-lessee is economically or contractually compelled to make an offer, a ROFO may be the equivalent to an obligation to repurchase the property (i.e., a forward) if the buyer-lessor is compelled to accept the offer, which also will result in a failed sale/purchase. The buyer-lessor and seller-lessee should consider all relevant factors when determining whether the buyer-lessor or the seller-lessee would be compelled to accept the offer, or make an offer, respectively. The factors outlined in ASC 842-10-55-26 typically will be useful in evaluating the existence of economic compulsion.

ACCOUNTING WHEN TRANSFER OF THE ASSET IS A SALE

RECOGNITION

If after analyzing the terms as noted in the previous sections it is determined that the transfer of the asset is a sale, the sale of the asset and subsequent leaseback are accounted for independently, with the leaseback accounted for as any other lease under ASC 842 by each party.

When the transaction is at market terms, the following occurs at the date the buyer-lessor obtains control of the asset:

The seller-lessee	The buyer-lessor
▶ Derecognizes the carrying amount of the underlying asset, ▶ Recognizes the transaction price in accordance with ASC 606-10-32-2 through 32-27, ▶ Recognizes a gain or loss for the difference between the transaction price and carrying amount of the asset, ▶ Accounts for the leaseback in accordance with ASC 842-20 on lessee accounting (see Accounting for Leases - Lessees).	▶ Accounts for the purchase of the asset in accordance with other GAAP (typically ASC 360), ▶ Accounts for the leaseback in accordance with ASC 842-30 on lessor accounting (see Accounting for Leases - Lessors).

The following Examples illustrate the accounting for various sale and leaseback transactions under different scenarios. Please note that for the illustrations throughout this article, the tables presented in each Example are consistent with how they would be displayed in a spreadsheet, with amounts shown with no decimals, and no rounding function used.

Example 6A: Sale-Leaseback Transaction When Transfer of Asset Is a Sale

FACTS

- Seller-Lessee sells an airplane to an unrelated Buyer-Lessor for $3.0 million, which is its fair value.
- The carrying amount of the airplane is $2.7 million and it has a remaining useful life of 15 years.
- At the same time, Seller-Lessee enters into a contract with Buyer-Lessor for the right to use the airplane for 5 years, with annual payments of $300,000 payable in arrears and escalating 2% annually.
- The leaseback does not transfer ownership to Seller-Lessee at the end of the lease term and does not include a purchase option. There are no initial direct costs.
- Assume that the requirements in ASC 606 on contract existence and transfer of control are met and that the leaseback is classified as an operating lease by both Seller-Lessee and Buyer-Lessor.
- Seller-Lessee's incremental borrowing rate is 4%. The rate implicit in the lease is not readily determinable.

ANALYSIS

Assessing whether the transfer of the asset is a sale

- Seller-Lessee and Buyer-Lessor determine that the transfer of the asset is a sale. This is because:
  - The requirements in ASC 606 on contract existence and transfer of control are met,
  - The leaseback is classified as an operating lease,
  - There is no repurchase option.

Accounting by Seller-Lessee

- At the commencement date, Seller-Lessee records the following journal entry:

	$	$
Dr. Cash	3,000,000	
Cr. Property, plant or equipment		2,700,000
Cr. Gain on sale		300,000

- Seller-Lessee also recognizes a lease liability for the leaseback at the present value of the lease payments, discounted using its incremental borrowing rate of 4%, which results in an initial lease liability of $1,387,891 calculated as follows:

	PMT
Year 1	300,000
Year 2	306,000
Year 3	312,120
Year 4	318,362
Year 5	324,730
Undiscounted PMTs	**1,561,212**
PV(4%) =	**1,387,891**

- The initial measurement of the right-of-use asset is the same as the lease liability since there are no prepayments, lease incentives, or initial direct costs.

- Seller-Lessee calculates the total lease cost to be recognized over the lease term:

Total lease payments (paid and not yet paid)	$1,561,212
Plus, initial direct costs	0
Total lease cost [A]	$1,561,212
Periodic lease cost [B] = [A] / 5	**$312,242**

- The following table summarizes the accounting for the lease liability, assuming no modifications.

	Beg. Balance	Interest (4%)	PMT	Closing Balance
Year 1	1,387,891	55,516	(300,000)	1,143,407
Year 2	1,143,407	45,736	(306,000)	883,143
Year 3	883,143	35,326	(312,120)	606,349
Year 4	606,349	24,254	(318,362)	312,240
Year 5	312,240	12,490	(324,730)	-

- The following table summarizes the accounting for the right-of-use asset, assuming no modifications and impairments. See Accounting for Lease - Lessees for additional details and explanations.

	Opening Balance	Periodic Lease Cost	Interest (4%)	Amortization	Closing Balance
	[A]	[B]	[C] - see above	[D] = [B] + [C]	[A] + [D]
Year 1	1,387,891	(312,242)	55,516	(256,727)	1,131,164
Year 2	1,131,164	(312,242)	45,736	(266,506)	864,658
Year 3	864,658	(312,242)	35,326	(276,917)	587,741
Year 4	587,741	(312,242)	24,254	(287,988)	299,753
Year 5	299,753	(312,242)	12,490	(299,753)	-

- Seller-Lessee recognizes straight-line lease expense of $312,242 on an annual basis throughout the lease term.

Accounting by Buyer-Lessor

- Buyer-Lessor recognizes the airplane at cost for $3.0 million. Buyer-Lessor subsequently accounts for the asset under ASC 360.
- Because the lease is classified as an operating lease, Buyer-Lessor recognizes lease income of $312,242 annually, assuming collectibility of the lease payments is probable throughout the lease term. See **Accounting for Leases - Lessors** for additional details on collectibility considerations for operating leases.

OFF-MARKET TERMS

The sale price and lease payments in a sale and leaseback transaction are interdependent since they are negotiated as a package. For example, the sale price might be more than the fair value of the asset because the leaseback payments are above market; or vice versa. Because this could misstate the amounts recorded by the seller-lessee and buyer-lessor, both in the day-1 accounting (the sale) and day-2 accounting (the leaseback), the FASB decided that an entity should adjust the sale (purchase) price of the asset if the sale and leaseback occurs at other than a market rate.

Related party sale and leaseback transactions

The above guidance on adjustments for off-market terms does not apply if the transaction is between related parties. Instead, the related party lessee and lessor should make appropriate disclosures. This is consistent with the FASB's decision that an entity should account for a related party lease in accordance with the enforceable terms and conditions of that lease.

The entity determines whether the transaction is at market by comparing the difference between either of the following, whichever is more readily determinable, maximizing the use of observable prices and observable information:

- The sale price of the asset and the fair value of the asset,
- The present value of the lease payments and the present value of market rental payments.

Accordingly, an entity does not have to determine the fair value of *both* the underlying asset and the market rental payments. The FASB decided that such a requirement would likely be unnecessary given that any overpayment for the underlying asset by the buyer-lessor would often be accompanied by above market rental payments, and vice versa.

Variable payment off-market terms

The FASB noted in ASC 842-40-30-3 and in paragraph BC365 of ASU 2016-02 that variable payments are a part of the negotiated exchange between the parties and therefore should be considered in determining whether the transaction is at a market rate. In doing so, the entity should consider those variable payments it reasonably expects to be entitled to (or to make) based on all the information (historical, current, and forecast) that is reasonably available to the entity. For a seller-lessee, this includes estimating any variable consideration to which it expects to be entitled in accordance with ASC 606-10-32-5 through 32-9. However, variable payments considered in this evaluation should not be recognized as part of the transaction price for the seller-lessee, the cost of the asset to the buyer-lessor, or included in the seller-lessee's measurement of the lease liability, except in accordance with the guidance in ASC 842 or other Topics such as ASC 606 or ASC 360.

If there are off-market terms, the entity accounts for those as follows:

- If the sale price is below fair value, as prepaid rent because the underpayment is no different, in substance, from a prepayment of rent by the seller-lessee. The prepaid rent is recognized by the buyer-lessor as deferred rent (recognized over the lease term typically on a straight-line basis), and the lessee includes the amount as part of the initial measurement of the right-of-use asset (recognized over the lease term as part of the amortization of the right-of-use asset).
- If the sale price is above fair value, as additional financing provided by the buyer-lessor to the seller-lessee in accordance with other Topics because the overpayment is no different than the buyer-lessor granting the seller-lessee a loan in addition to purchasing the seller-lessee's asset. The buyer-lessor and seller-lessee recognize a financial receivable and financial liability, respectively, and allocate the payments under the contract between the lease and financing components.

See ASC 842-40-55 Example 1 for an illustration of the accounting by both the seller-lessee and buyer-lessor for off-market terms. See also Examples 6B and 6C below.

Example 6B - Sale-Leaseback Transaction With Off Market Terms – Sale Price Exceeds Fair Value

FACTS

- Assume the same facts as in Example 6A, except that Seller-Lessee sells the airplane to Buyer-Lessor for $3.5 million. The observable fair value of the airplane is $3.0 million. Because the fair value of the airplane is observable, Seller-Lessee and Buyer-Lessor use that benchmark to evaluate whether the sale is at market terms.
- The leaseback includes annual payments of $310,000 payable in arrears.

ANALYSIS

Assessing whether the transfer of the asset is a sale

- Consistent with Example 6A, the Seller-Lessee and Buyer-Lessor determine that the transfer of the asset is a sale. The changes in sale price and contractual lease payments did not change the conclusion.

Accounting by Seller-Lessee

- At the commencement date, Seller-Lessee records the following journal entry:

	$	$
Dr. Cash	3,500,000	
Cr. Property, plant or equipment		2,700,000
Cr. Gain on sale		300,000
Cr. Financial liability		500,000

- Seller-Lessee then determines the contractual payments attributable to repayment of the additional financing; that is, the amount of each annual payment that must be attributed to repayment of the financial liability for that liability to reduce to zero at the end of the lease term.
- Seller-Lessee could calculate that amount using either of the following approaches, which should result in the same amounts allocated:
  - Using the PMT function in Excel based on the payment terms and conditions of the lease, which in this example results in $112,314 annual payments attributed to the financial obligation, or
  - Allocating the payments based on the relative basis of the initial lease liability and financial liability recognized. In doing so, Seller-Lessee would calculate the lease liability as the present value of five payments of $310,000 discounted at 4% (which amounts to $1,380,065) less the initial amount of the financial liability of $500,000, resulting in a lease liability of $880,065. Seller-Lessee would allocate the contractual payments as follows:

	Measurement	Percentage	Allocation
Lease liability	880,065	63.77%	197,686
Financial liability	500,000	36.23%	112,314
Total	1,380,065		310,000

- The following table summarizes the accounting for the financial liability throughout the lease term.

	Beg. Balance	Interest (4%)	PMT	Closing Balance
Year 1	500,000	20,000	(112,314)	407,686
Year 2	407,686	16,307	(112,314)	311,680
Year 3	311,680	12,467	(112,314)	211,834
Year 4	211,834	8,473	(112,314)	107,994
Year 5	107,994	4,320	(112,314)	-

- Seller-Lessee also recognizes a lease liability for the leaseback at the present value of the contractual payments attributable to the lease of $197,686 ($310,000 annual payment less $112,314 attributed to the financial liability). The following table summarize the accounting for the lease liability, assuming no modifications.

	Beg. Balance	Interest (4%)	PMT	Closing Balance
Year 1	880,065	35,203	(197,686)	717,581
Year 2	717,581	28,703	(197,686)	548,598
Year 3	548,598	21,944	(197,686)	372,855
Year 4	372,855	14,914	(197,686)	190,083
Year 5	190,083	7,603	(197,686)	-

- The following table summarizes the accounting for the right-of-use asset, assuming no modifications and impairments. See Accounting for Leases - Lessees for additional details and explanations.

	Opening Balance	Periodic Lease Cost	Interest (4%)	Amortization	Closing Balance
	[A]	[B]	[C] - see above	[D] = [B] + [C]	[A] + [D]
Year 1	880,065	(197,686)	35,203	(162,484)	717,581
Year 2	717,581	(197,686)	28,703	(168,983)	548,598
Year 3	548,598	(197,686)	21,944	(175,743)	372,855
Year 4	372,855	(197,686)	14,914	(182,772)	190,083
Year 5	190,083	(197,686)	7,603	(190,083)	-

- Seller-Lessee recognizes straight-line lease expense of $197,686 along with interest expense on the financial liability (for example, $20,000 in Year 1) throughout the lease term.

Accounting by Buyer-Lessor

- Buyer-Lessor recognizes the airplane at a cost of $3.0 million. Buyer-Lessor subsequently accounts for the asset under ASC 360.
- Buyer-Lessor recognizes a financial asset for the additional financing provided to Seller-Lessee in the amount of $500,000.
- Buyer-Lessor determines an interest rate in accordance with ASC 835-30-25-12 and 25-13 and allocates the contractual payments between the leaseback and financial asset. The contractual payments attributable to repayment of the additional financing is the amount of each annual payment that must be attributed to the financial asset for that asset to reduce to zero at the end of the lease term (consistent with how it was calculated for Seller-Lessee above).
- Buyer-Lessor will also recognize lease income and interest income based on the amounts attributed to the leaseback and financial asset.

Example 6C - Sale-Leaseback Transaction With Off Market Terms - Sale Price Is Less Than Fair Value

FACTS

- Assume the same facts as in Example 6A, except that Seller-Lessee sells the airplane to Buyer-Lessor for $2.5 million. The observable fair value of the airplane is $3.0 million. Because the fair value of the airplane is observable, Seller-Lessee and Buyer-Lessor use that benchmark in evaluating whether the sale is at market terms.
- The leaseback includes annual payments of $290,000 payable in arrears.

ANALYSIS

Assessing whether the transfer of the asset is a sale

- Consistent with Example 6A, the Seller-Lessee and Buyer-Lessor determine that the transfer of the asset is a sale. The changes in sale price and contractual lease payments did not change the conclusion.

Accounting by the Seller-Lessee

- Because the sale price is less than the fair value of the plane, Seller-Lessee accounts for the difference of $500,000 as a prepayment of rent.
- Seller-Lessee recognizes a lease liability for the leaseback at the present value of the unpaid lease payments, discounted using its incremental borrowing rate of 4%, which results in an initial lease liability of $1,291,028 calculated as follows:

	PMT
Year 1	290,000
Year 2	290,000
Year 3	290,000
Year 4	290,000
Year 5	290,000
Undiscounted PMTs	**1,450,000**
PV(4%) =	**1,291,028**

- The initial measurement of the right-of-use asset is the same as the lease liability plus the prepayment of $500,000. There are no lease incentives, nor initial direct costs, and therefore the initial amount of the right-of-use asset is $1,791,028 (1,291,028 + 500,000).
- At the commencement date, Seller-Lessee records the following journal entry:

	$	$
Dr. Cash	2,500,000	
Dr. Right-of-use asset	1,791,028	
Cr. Property, plant or equipment		2,700,000
Cr. Lease liability		1,291,028
Cr. Gain on sale		300,000

- Seller-Lessee calculates the total lease cost to be recognized over the lease term:

Total lease payments (not yet paid)	$1,450,000
Prepayment of rent (i.e., off market terms)	500,000
Plus, initial direct costs	0
Total lease cost [A]	$1,950,000
Periodic lease cost [B] = [A] / 5	**$390,000**

- The following table summarizes the accounting for the lease liability, assuming no modifications.

	Beg. Balance	Interest (4%)	PMT	Closing Balance
Year 1	1,291,028	51,641	(290,000)	1,052,670
Year 2	1,052,670	42,107	(290,000)	804,776
Year 3	804,776	32,191	(290,000)	546,967
Year 4	546,967	21,879	(290,000)	278,846
Year 5	278,846	11,154	(290,000)	-

- The following table summarizes the accounting for the right-of-use asset, assuming no modifications and impairments.

	Opening Balance	Periodic Lease Cost	Interest (4%)	Amortization	Closing Balance
	[A]	[B]	[C] - see above	[D] = [B] + [C]	[A] + [D]
Year 1	1,791,028	(390,000)	51,641	(338,359)	1,452,670
Year 2	1,452,670	(390,000)	42,107	(347,893)	1,104,776
Year 3	1,104,776	(390,000)	32,191	(357,809)	746,967
Year 4	746,967	(390,000)	21,879	(368,121)	378,846
Year 5	378,846	(390,000)	11,154	(378,846)	-

- Seller-Lessee recognizes straight-line lease expense of $390,000 on an annual basis throughout the lease term.

Accounting by the Buyer-Lessor

- Buyer-Lessor recognizes the airplane at cost for $3.0 million. Buyer-Lessor subsequently accounts for the asset under ASC 360.
- Buyer-Lessor recognizes deferred rent in the amount of $500,000 at the commencement date.
- Because the lease is classified as an operating lease, Buyer-Lessor recognizes lease income of $390,000 annually (the sum of the unpaid lease payments and the prepayment, divided by five), assuming collectibility of the lease payments is probable throughout the lease term. See **Accounting for Leases - Lessors** for additional details on collectibility considerations for operating leases.

ACCOUNTING WHEN TRANSFER OF THE ASSET IS NOT A SALE

RECOGNITION

If the transfer is not a sale, the transaction is accounted for as a financing by *both* the seller-lessee and buyer-lessor.

The Seller-Lessee	The Buyer-Lessor
▶ Continues to recognize the transferred asset, and to apply ASC 360 (depreciation, impairment, etc.), ▶ Accounts for amounts received as a financial liability in accordance with other Topics, ▶ Allocates rent payments made between interest expense and principal amortization.	▶ Does not recognize the transferred asset under ASC 360, ▶ Accounts for amounts paid as a receivable in accordance with other Topics, ▶ Allocates rent payments received between interest income and principal amortization.

SELLER-LESSEE ADJUSTMENTS TO INTEREST RATE ON FINANCIAL LIABILITY

A seller-lessee (but not a buyer-lessor) should adjust the interest rate on the financial liability as necessary to avoid negative amortization of the financial liability and a built-in-loss when the asset is derecognized. This is achieved by determining that both:

- Interest on the financial liability is not greater than the payments over the shorter of the lease term and the term of the financing. The term of the financing could be shorter, for example, when a repurchase option that precluded sale accounting expires before the end of the lease term. In considering this requirement, we believe it applies over the *entire* lease term or term of the financing rather than to individual periods.
- The carrying amount of the asset does not exceed the carrying amount of the financial liability at the earlier of the end of the lease term and the date at which control of the asset transfers to the buyer-lessor. That is, there is no built-in loss at the earlier of the end of the lease term or the term of the financing.

We believe the above requirements apply only to situations in which control of the asset is expected to transfer to the buyer-lessor at some point. If for example the leaseback includes a lessee option to repurchase the asset at the end of the lease term that is reasonably certain of exercise, we believe the seller-lessee should impute interest at a rate that amortizes the financial liability at the end of the lease term to the price of the repurchase option. That is, there should be no gain or loss recognized at the end of the leaseback term because control of the asset is not expected to transfer to the buyer-lessor at any point. See Example 7D for illustration.

ACCOUNTING AT THE DATE THE BUYER-LESSOR OBTAINS CONTROL

At the end of the leaseback period (or at the date the buyer-lessor obtains control of the underlying asset), the seller-lessee recognizes any remaining balance of the financial liability as proceeds from the sale of the asset. The gain, if any, that is recognized reflects any difference between those proceeds and the carrying amount of the asset at that date. The buyer-lessor derecognizes the carrying amount of its financial asset and recognizes the transferred asset at that same amount. This accounting is consistent with Example 2 in ASC 842-40-55.

As discussed earlier, in a failed sale and leaseback transaction the buyer-lessor may obtain control of the underlying asset before the end of the leaseback (for example, when a repurchase option that precluded sale accounting expires before the end of the leaseback term). Example 2 in ASC 842-40-55 illustrates the accounting both initially and once the purchase option expires. However, this example has led to a number of questions, including whether lease classification should be reassessed once the repurchase option expires. Accordingly, care should be given in those situations, and entities are encouraged to discuss these situations with their accounting advisor or auditor.

Example 7A - Accounting for Failed Sale-Leaseback

FACTS

- Seller-Lessee sells an airplane to an unrelated Buyer-Lessor for $3 million, which is its fair value.
- The carrying amount of the airplane is $2.7 million and it has a remaining useful life of 15 years.
- At the same time, Seller-Lessee enters into a contract with Buyer-Lessor for the right to use the airplane for 5 years, with annual payments of $300,000 payable in arrears and escalating 2% annually.
- Seller-Lessee has a fixed price repurchase option at the end of year 5 for $1.8 million, which Seller-Lessee is not reasonably certain to exercise.
- Absent the repurchase option, there are no other terms or conditions that would preclude sale accounting.
- Seller-Lessee’s incremental borrowing rate is 4%.

ANALYSIS

- The exercise price of the repurchase option is fixed and therefore precludes accounting for the transaction as a sale.
- Seller-Lessee therefore accounts for the $3 million of proceeds received as a financial liability, and it utilizes its incremental borrowing rate of 4% to recognize interest expense.
- Seller-Lessee also continues to recognize the asset and continues to depreciate it over the remainder of its useful life (assume depreciation expense is $180,000 annually).
- Seller-Lessee’s accounting for the financial liability and asset are determined as follows:

	Beg. Liability Balance [A]	Interest [B] = [A] x 4.00%	PMT [C]	End. Liability Balance [D] = [A] + [B] + [C]	End. Asset Balance
Year 1	3,000,000	120,000	(300,000)	2,820,000	2,520,000
Year 2	2,820,000	112,800	(306,000)	2,626,800	2,340,000
Year 3	2,626,800	105,072	(312,120)	2,419,752	2,160,000
Year 4	2,419,752	96,790	(318,362)	2,198,180	1,980,000
Year 5	2,198,180	87,927	(324,730)	1,961,377	1,800,000

Seller-Lessee determines that there is no negative amortization of the financial liability and no built-in-loss at the end of the lease term (financing term). Therefore, no further adjustments to the interest rate are required.

- Buyer-Lessor also accounts for the transaction as a financing and determines an appropriate interest rate in accordance with ASC 835-30-25-12 and 25-13.
- If at the end of Year 5 the repurchase option is not exercised and expires, Seller-Lessee recognizes the sale of the asset by derecognizing the underlying asset for $1.8 million, derecognizing the carrying amount of the financial liability of $1.96 million, and recognizing a gain of $161,377. Buyer-Lessor recognizes the underlying asset at the amount of its financial receivable at that date.

Example 7B - Accounting for Failed Sale-Leaseback by Seller-Lessee - Negative Amortization

FACTS

- Assume the same facts as Example 7A above, except that the payments are $105,000 annually, payable in arrears.

ANALYSIS

- As stated in Example 7A, this transaction is considered a financing transaction.
- Seller-Lessee's accounting for the financial liability and asset are determined as follows:

	Beg. Liability Balance	Interest	PMT	End. Liability Balance	End. Asset Balance
	[A]	[B] = [A] x 4.00%	[C]	[D] = [A] + [B] + [C]	
Year 1	3,000,000	120,000	(105,000)	3,015,000	2,520,000
Year 2	3,015,000	120,600	(105,000)	3,030,600	2,340,000
Year 3	3,030,600	121,224	(105,000)	3,046,824	2,160,000
Year 4	3,046,824	121,873	(105,000)	3,063,697	1,980,000
Year 5	3,063,697	122,548	(105,000)	3,081,245	1,800,000

Seller-Lessee determines that there is no built-in-loss at the end of the lease term (financing term). However, there is negative amortization of the financial liability (the aggregate interest expense over the 5-year period exceeds the aggregate payments made). Therefore, Seller-Lessee is required to adjust the interest rate.

- Seller-Lessee therefore determines an adjusted interest rate that does not result in negative amortization of the financial liability. In this case, it is 3.50% (i.e., $105,000 annual payment divided by the initial financial liability of $3,000,000). The updated balances are as follows:

	Beg. Liability Balance	Interest	PMT	End. Liability Balance	End. Asset Balance
	[A]	[B] = [A] x 3.50%	[C]	[D] = [A] + [B] + [C]	
Year 1	3,000,000	105,000	(105,000)	3,000,000	2,520,000
Year 2	3,000,000	105,000	(105,000)	3,000,000	2,340,000
Year 3	3,000,000	105,000	(105,000)	3,000,000	2,160,000
Year 4	3,000,000	105,000	(105,000)	3,000,000	1,980,000
Year 5	3,000,000	105,000	(105,000)	3,000,000	1,800,000

- If at the end of Year 5 the repurchase option is not exercised and expires, Seller-Lessee recognizes the sale of the asset by derecognizing the underlying asset for $1.8 million, derecognizing the carrying amount of the financial liability of $3.0 million, and recognizing a gain of $1.2 million.

Example 7C - Accounting for Failed Sale-Leaseback by Seller-Lessee - Built-in-loss

FACTS

- Assume the same facts as Example 7A above, except that the payments are $375,000 annually, payable in arrears.

ANALYSIS

- As stated in Example 7A, this transaction is considered a financing transaction.
- Seller-Lessee's accounting for the financial liability and asset are determined as follows:

	Beg. Liability Balance	Interest	PMT	End. Liability Balance	End. Asset Balance
	[A]	[B] = [A] x 4.00%	[C]	[D] = [A] + [B] + [C]	
Year 1	3,000,000	120,000	(375,000)	2,745,000	2,520,000
Year 2	2,745,000	109,800	(375,000)	2,479,800	2,340,000
Year 3	2,479,800	99,192	(375,000)	2,203,992	2,160,000
Year 4	2,203,992	88,160	(375,000)	1,917,152	1,980,000
Year 5	1,917,152	76,686	(375,000)	1,618,838	1,800,000

Seller-Lessee determines that there is no negative amortization of the financial liability but there is a built-in-loss at the end of Year 5 (i.e., the carrying amount of the asset exceeds the carrying amount of the financial liability). Therefore, Seller-Lessee is required to adjust the interest rate.

- Seller-Lessee therefore determines an adjusted interest rate that does not result in a built-in-loss at the end of Year 5. In this case, it is approximately 5.305% (calculated so that the financial liability equals the carrying amount of the asset at the end of the lease term).
- The updated balances are as follows:

	Beg. Liability Balance	Interest	PMT	End. Liability Balance	End. Asset Balance
	[A]	[B] = [A] x 5.305%	[C]	[D] = [A] + [B] + [C]	
Year 1	3,000,000	159,149	(375,000)	2,784,149	2,520,000
Year 2	2,784,149	147,698	(375,000)	2,556,847	2,340,000
Year 3	2,556,847	135,640	(375,000)	2,317,487	2,160,000
Year 4	2,317,487	122,942	(375,000)	2,065,429	1,980,000
Year 5	2,065,429	109,570	(375,000)	1,800,000	1,800,000

- If at the end of Year 5 the repurchase option is not exercised and expires, Seller-Lessee recognizes the sale of the asset by derecognizing the underlying asset for $1.8 million, derecognizing the carrying amount of the financial liability of $1.8 million, and recognizing no gain or loss.

Example 7D - Accounting for Failed Sale-Leaseback by Seller-Lessee - Repurchase Option Reasonably Certain of Exercise

FACTS

- Assume the same facts as Example 7A above, except that the repurchase option at $1.8 million is reasonably certain of exercise.

ANALYSIS

- As stated in Example 7A, this transaction is considered a financing transaction.
- Because control of the asset is not expected to transfer to Buyer-Lessor at any point, there should be no gain or loss recognized by Seller-Lessee at the end of the leaseback term. Accordingly, Seller-Lessee should adjust the interest rate so that the financial liability at the end of Year 5 equals the exercise price of the purchase option. In this case, this results in an interest rate of approximately 2.838%.
- Seller-Lessee's accounting for the financial liability and asset are determined as follows:

	Beg. Liability Balance [A]	Interest [B] = [A] x 2.838%	PMT [C]	End. Liability Balance [D] = [A] + [B] + [C]	End. Asset Balance
Year 1	3,000,000	85,138	(300,000)	2,785,138	2,520,000
Year 2	2,785,138	79,040	(306,000)	2,558,178	2,340,000
Year 3	2,558,178	72,599	(312,120)	2,318,657	2,160,000
Year 4	2,318,657	65,802	(318,362)	2,066,096	1,980,000
Year 5	2,066,096	58,634	(324,730)	1,800,000	1,800,000

- At the end of Year 5 the repurchase option is exercised. Seller-Lessee derecognizes the carrying amount of the financial liability of $1.8 million, and credits cash for the payment made to Buyer-Lessor.

BUSINESS COMBINATIONS (OR ACQUISITIONS BY NOT-FOR-PROFIT ENTITIES)

There are several areas for which the accounting for leases acquired in a business combination or an acquisition by a not-for-profit entity (herein referred to as business combinations) differs from the accounting for a new lease. For some of these areas ASC 805 and ASC 842 provide clear accounting guidance. For other areas the guidance, including the interaction of ASC 805 and 842, is not clear. Additionally, the guidance sometimes differs depending on whether the acquiree is a lessee or a lessor.

LEASE CLASSIFICATION

ASC 842-10-55-11 notes that the acquirer of a lease in a business combination should retain the acquiree's previous lease classification, unless the lease is modified and that modification is not accounted for as a separate contract. This guidance applies whether the acquired entity is a lessee or a lessor. If there is a modification and the modification is not accounted for as a separate contract, the acquirer should reassess classification. See Lease Classifications and Key Terms for lease classification guidance. In some cases, an acquired lease may be amended to change only the name of the parties specified in the lease. We believe such changes are administrative in nature and are not a modification because they do not change the scope of or the consideration for the lease.

Classification of an Acquired Lease in an Asset Acquisition

ASC 842 does not specify whether classification of an acquired lease in an asset acquisition should be reassessed or retained like in business combinations. However, an acquired lease is typically measured as if it were a new lease of the acquirer; and for a new lease, one of the steps an entity performs is assessing classification. The only explicit exception that exists is for acquired leases in a business combination. Therefore, for asset acquisitions we believe the acquiring entity should generally reassess lease classification. However, there may be differing views on this question, and entities are encouraged to discuss classification of leases acquired in an asset acquisition with their accounting consultants and auditors.

LEASE IDENTIFICATION

While ASC 842 discusses lease classification in a business combination, it does not provide guidance on whether an acquirer should reassess an acquiree's conclusions about whether a contract is or contains a lease. However, consistent with the guidance in paragraph 842-10-15-6, which states that an entity reassesses whether a contract is or contains a lease only if the terms and conditions of the contract are changed, we believe that an acquirer should not reassess the acquiree's previous lease identification conclusion determined under ASC 842 unless the contract is modified in connection with the transaction and such modification is not accounted for as a separate contract. Reassessing lease identification may also result in a conclusion that the contract does not contain a lease at the acquisition date, thereby directly conflicting with the specific requirement to retain lease classification of the acquiree in a business combination. However, there could be additional complexity when the acquirer and acquiree have adopted ASC 842 at different dates and/or have used different transition practical expedients. Entities are encouraged to discuss those situations with their accounting consultants and auditors.

RECOGNITION AND MEASUREMENT (ACQUIREE IS THE LESSEE)

The acquirer recognizes assets and liabilities arising from leases in which the acquiree is a lessee in accordance with ASC 842. That is, the acquirer recognizes a lease liability and right-of-use asset on the balance sheet. However, ASC 805-20-25-28B provides an accounting policy election in which the acquirer may elect not to recognize assets or liabilities for leases that, at the acquisition date, have a remaining lease term of 12 months or less. This includes not recognizing an intangible asset or liability for favorable or unfavorable market terms. The election to not recognize leases on balance sheet at the acquisition date is made by asset class and applies to all of an entity's acquisitions.

If the acquirer does not make the election for leases with a remaining lease term of 12 months or less above, or if the lease is more than 12 months, the acquirer must measure the acquired lease as follows:

- Notwithstanding that the classification of a lease acquired in a business combination is not reassessed (absent a modification), the acquirer must measure the lease liability at the present value of the remaining lease payments, as if the acquired lease were a new lease of the acquirer at the acquisition date.[1] The FASB explained in paragraph BC415 of ASU 2016-02 that measuring the acquired lease as if it were a new lease encompasses reassessing the following assumptions: the lease term, any lessee purchase options, lease payments (such as amounts probable of being owed under a residual value guarantee), and the discount rate.
- The acquirer measures the right-of-use asset at the amount of the lease liability, adjusted for any favorable or unfavorable terms (i.e., off-market terms) present in the lease. In other words, the acquirer is required to value off-market terms as before adoption of ASC 842, except that those off-market terms are now recognized as part of the initial measurement of the right-of-use asset rather than as separate intangibles.

The acquirer must also separately recognize the following, if applicable:

- Identifiable intangible assets associated with the lease, usually called an in-place lease intangible, representing market participants' willingness to pay a price for the lease, even if the lease is at market, such as the lease of gates at an airport or of prime location retail space.
- Leasehold improvements owned by the acquiree (see discussion below on subsequent measurement).

The following table summarizes the potential assets and liabilities that may be recognized for leases acquired in a business combination when the acquiree is the lessee:

	Operating Lease / Finance Lease
Assets	▶ Right-of-use asset (equal to lease liability adjusted for above/below market terms) ▶ In-place lease intangible (fair value) ▶ Leasehold improvements owned by the acquiree (fair value)
Liabilities	▶ Lease liability (present value of the remaining lease payments, as if the lease were a new lease of the acquirer at the acquisition date)

Accounting for Acquired Operating Leases When Acquirer Is Reasonably Certain to Exercise a Purchase Option

As previously noted, ASC 842 is clear that in a business combination the acquirer measures an acquired lease as if it were a new lease of the acquirer at the acquisition date. The acquirer therefore reassesses the lease term, purchase options, lease payments and discount rate. In doing so, the acquirer may determine at the acquisition date that it is reasonably certain to exercise a purchase option included in the acquired lease, which would result in the lease being classified as a finance lease. The acquiree may have previously determined otherwise and classified the lease as an operating lease. Also, ASC 842 is clear that the acquirer should retain the acquiree's lease classification. Therefore, even if the acquirer's assumptions (as compared to the previous assumptions used by the acquiree) would result in a change in lease classification if assessed at the acquisition date, the acquiree's lease classification should be retained (unless the lease is modified and that modification is not accounted for as a separate contract). In those situations, the measurement of the lease liability should include the payment related to exercise of the purchase option. Additional complexities may arise in the day-2 accounting, including the period and method for amortizing

[1] The measurement of an acquired lease in a business combination represents an exception to the fair value measurement principle that is generally required for acquired assets and liabilities. The FASB determined that the benefit of measuring acquired leases at fair value would not justify the costs of collecting the data needed to apply a fair value measurement.

the right-of-use asset and, therefore, entities are encouraged to discuss those situations with their accounting consultants and auditors.

Recognition and Measurement of Acquired Leases When Acquiree's and Acquirer's Policy on Nonseparation Differ

As discussed in Identifying and Separating Components, a lessee may elect a practical expedient by asset class not to separate nonlease component(s) from the associated lease component. Electing the practical expedient may in some situations change classification from operating to finance when performing the present value test in ASC 842-10-25-2(d). Also, an acquiree and acquirer may have made different elections regarding nonseparation of lease and non-lease components. For example, the acquirer may have elected the nonseparation practical expedient while the acquiree did not, or vice versa, potentially resulting in different conclusions on classification of the acquiree's leases if the acquirer's policy had been applied. Therefore, questions have arisen as to how the acquirer should classify and measure acquired leases when conforming the acquiree's accounting policies to those of the acquirer.

As discussed previously, ASC 842-10-55-11 is clear that lease classification is retained in a business combination, with the only exception being for modifications not accounted for as a separate contract. Therefore, we believe the acquirer should retain the acquiree-lessee's previous classification, even if the accounting policy between the acquiree and acquirer on nonseparation is different. However, we believe that the acquirer should conform the acquiree's policies to its own and measure the acquired lease consistent with the acquirer's own policy. Specifically:

- If the acquirer elected the nonseparation practical expedient while the acquiree did not, the acquirer should combine the acquiree's nonlease components with the associated lease component when initially measuring the acquiree's leases in its business combination accounting.
- If the acquirer did not elect the nonseparation practical expedient while the acquiree did, the acquirer should separate the acquiree's nonlease components from the associated lease component when initially measuring the acquiree's leases in its business combination accounting. One acceptable approach to separate the components would be to use standalone prices at the business combination date.

Measurement of Related Party Leases With Off-Market Terms Acquired in a Business Combination

ASC 842-10-55-12 requires leases between related parties to be accounted for based on their legally enforceable terms and conditions. ASC 842-40-30-4 also notes that for sale and leaseback transactions between related parties, the entity does not adjust the sale price for off-market terms. As a result, entities typically do not adjust their lease accounting for off-market terms in related party leases. However, we believe an exception may apply for acquired related party leases in a business combination. Specifically, the acquirer in a business combination applies ASC 805-20-25-12 (applicable to acquired operating leases) and ASC 805-20-30-24 (applicable to all leases of an acquiree-lessee) to account for all leases. Those paragraphs indicate that the acquirer should measure the right-of-use asset at the same amount as the lease liability, adjusted to reflect favorable or unfavorable terms of the lease when compared with market terms.

RECOGNITION AND MEASUREMENT (ACQUIREE IS THE LESSOR)

The recognition and measurement of assets and liabilities related to an acquired lease in which the acquiree is the lessor depends on lease classification.

- For a sales-type or direct financing lease, the acquirer measures the net investment in the lease at the sum of the following:

  Lease receivable at the present value, discounted using the rate implicit in the lease, of the following as if the acquired lease were a new lease at the acquisition date:

  - The remaining lease payments,
  - The amount the lessor expects to derive from the underlying asset following the end of the lease term that is guaranteed by the lessee or any other third party unrelated to the lessor

  +

  Unguaranteed residual asset, as the difference between the fair value of the underlying asset at the acquisition date and the carrying amount of the lease receivable

  The net investment in the lease is therefore equal to the fair value of the underlying asset at the acquisition date. In calculating the acquisition-date fair value of an underlying asset that is subject to a sales-type lease or a direct financing lease by the acquiree-lessor, the acquirer should take into account the terms and conditions of the lease.

- For an operating lease, the underlying asset is recognized and measured at fair value. The fair value of the underlying asset is not affected by the lease (that is, the fair value would be the same whether or not there is an operating lease in place). Also, if the contract terms are favorable or unfavorable as compared to market terms, the acquirer should recognize an intangible asset or liability, respectively, for those off-market terms.
- Additionally, for all types of acquired leases for an acquiree-lessor, it may be appropriate to recognize identifiable intangible assets such as in-place leases or customer relationships. Any such intangible assets are recognized at fair value following the principles of ASC 805.

The following table summarizes the potential assets and liabilities that may be recognized for leases acquired in a business combination when the acquiree is the lessor:

	Sales-type or Direct Finance Lease	Operating Lease
Assets	▶ Net investment in the lease (lease receivable + unguaranteed residual asset) ▶ In-place lease intangible (fair value) ▶ Customer relationship intangible (fair value)	▶ Underlying asset (fair value) ▶ Favorable lease terms (fair value) ▶ In-place lease intangible (fair value) ▶ Customer relationship intangible (fair value)
Liabilities	▶ Not applicable	▶ Unfavorable lease terms (fair value)

LEASEHOLD IMPROVEMENTS ACQUIRED IN A BUSINESS COMBINATION

The acquirer should recognize the fair value of leasehold improvements acquired in the business combination. Additionally, ASC 842-20-35-13 requires leasehold improvements acquired in a business combination to be amortized over the shorter of the useful life of the assets and the remaining lease term at the date of acquisition. However, as discussed in ASC 805-20-35-6, if the lease transfers ownership of the underlying asset to the lessee, or the lessee is reasonably certain to exercise a purchase option, the lessee should amortize the leasehold improvements to the end of their useful life.

SUBLEASES

OVERVIEW

A sublease is a transaction in which an underlying asset is re-leased by the lessee (intermediate lessor or sublessor) to a third-party (sublessee) and the original (or head) lease between the lessor and the lessee remains in effect. In the FASB's view, leases of right-of-use assets (i.e., subleases) should be accounted for in the same way as other leases. Accordingly, subleases are within the scope of ASC 842.

The following summarizes the accounting by each party under the original lease and/or sublease.

Original lessor	The accounting by the original lessor is unchanged, unless the original lease agreement is replaced by a new agreement with a new lessee.
Original (or head) lease ↓	
Original lessee / sublessor	The entity applies lessee accounting to the original lease and lessor accounting to the sublease, unless the original lessee is relieved of its primary obligation under the original lease. The sublease may also impact accounting for the head lease (e.g., lease term reassessment, impairment considerations).
Sublease ↓	
Sublessee	The sublessee accounts for the sublease like any other leases in which it is a lessee.

Disclosures related to subleases are discussed in upcoming, Presentation and Disclosures.

ORIGINAL LESSOR ACCOUNTING

The accounting by the original lessor depends on the nature of the transaction.

Original lessee subleases the asset or sells/ transfers the original lease agreement to a third party →	▶ Original lessor continues to account for the lease as it did before.
Original lease agreement is replaced by a new agreement with a new lessee →	▶ Lessor accounts for the transaction as a termination of the original lease. ▶ Lessor classifies and accounts for the new lease as a separate transaction like any other leases (see Accounting for Leases - Lessors for additional guidance on lessor accounting).

SUBLESSEE ACCOUNTING

A sublessee classifies and accounts for the sublease like any other leases as a lessee (see Accounting for Leases - Lessees for detailed guidance). The sublessee assesses classification of the sublease by reference to the underlying asset rather than by reference to the right-of-use asset. For example, in classifying the sublease the sublessee evaluates whether the sublease term is for a major part of the remaining economic life of the underlying asset, rather than the remaining term of the head lease.

SUBLESSOR ACCOUNTING

A sublessor should account for a head lease and a sublease as two separate contracts (i.e., two separate units of account) unless those contracts meet the contract combination guidance in ASC 842-10-25-19 (which we believe will be infrequent because the counterparty to the sublease is typically a different entity from the counterparty to the head lease).

The accounting by the original lessee (sublessor) depends on whether it retains the primary obligation under the original lease.

ORIGINAL LESSEE IS RELIEVED OF ITS PRIMARY OBLIGATION UNDER ORIGINAL LEASE

The Original Lessee:
▶ Derecognizes the right-of-use asset and lease liability. ▶ Recognizes any difference in profit or loss. ▶ Includes any consideration paid or received upon termination that was not already included in the lease payments (for example, a termination payment) in the determination of profit or loss to be recognized. ▶ Recognizes a guarantee obligation in accordance with ASC 405-20-40-2 if the original lessee is secondarily liable. In this case, the guarantee obligation is initially measured at fair value and that amount reduces the determination of profit or loss to be recognized.

ORIGINAL LESSEE RETAINS PRIMARY OBLIGATION UNDER ORIGINAL LEASE

If the nature of a sublease is such that the original lessee is not relieved of the primary obligation under the original lease, the original lessee (as sublessor) accounts for the original lease in one of the following ways:

Original Lease Classification	Sublease Classification	The Original Lessee (Sublessor):
Operating or finance lease	Operating lease	▶ Continues to account for the original lease as before the sublease commencement. ▶ Recognizes sublease income over the lease term (See Accounting for Leases - Lessors). ▶ If the lease cost of the original lease for the term of the sublease exceeds the anticipated sublease income for the same period, that circumstance is an indicator that the carrying amount of the original lease right-of-use asset may not be recoverable in accordance with ASC 360-10-35-21. Refer to Accounting for Leases - Lessees for additional complexities on application of ASC 360 to right-of-use assets when a lessee plans or enters into a sublease.
Operating or finance lease	Sales-type or direct financing lease	▶ Derecognizes the original lease right of use asset. ▶ Continues to account for the original lease liability as before the sublease commencement. ▶ Recognizes a net investment in the sublease and any selling profit or loss consistent with the classification of the sublease (see Accounting for Leases - Lessors). ▶ Evaluates the net investment in the sublease for impairment like any other lessors (see Accounting for Leases - Lessors).

The sublessor assesses classification of the sublease by reference to the underlying asset rather than by reference to the right-of-use asset. For example, in classifying the sublease the sublessor evaluates whether the sublease term is for a major part of the remaining economic life of the underlying asset, rather than the remaining term of the head lease.

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

Impact of Entering into a Sublease on Head Lease Term

The sublessor should also consider the reassessment requirements applicable to the head lease upon entering into the sublease in accordance with ASC 842-10-35-1(a) and ASC 842-10-55-28(d). The original lessee may enter into a sublease that includes extension options that, if exercised by the sublessee, would force the original lessee to also exercise one or more extension options in the original lease. We observe that ASC 842-10-30-1 on lease term notes that periods covered by an option to extend (or not terminate) the lease in which exercise of the option is controlled by the lessor are included in the lease term. However, the FASB noted at a Board meeting that this requirement does not extend to options held by third parties (such as a sublessee). Accordingly, whether sublease options are included in the assessment of the head lease term depends on the facts and circumstances. Generally, the head lessee would be required to reassess and update the head lease term when the sublease term (determined in accordance with ASC 842-10-30-1) exceeds the remaining lease term of the head lease. See Accounting for Leases - Lessees for additional details about reassessment events and impact on accounting for lessees.

Example 8A - Sublease With a Term That Exceeds Remaining Lease Term of the Original Lease

FACTS

- Dessert Co. enters into a retail store lease in a shopping mall for an initial period of four years, with two 2-year extension periods.
- At lease commencement, Dessert Co. determined that it was not reasonably certain to exercise the extension options, and therefore the lease term was four years.
- The original lease was classified as an operating lease.
- After one year into the lease, Dessert Co. enters into an agreement with Mikey's Cookie Company to sublease the entire retail store for a noncancelable term of five years.
- Dessert Co. is not relieved of the primary obligation under the original lease.
- The sublease is determined to be an operating lease.

ANALYSIS

- Because Dessert Co. is still the primary obligor under the original lease, the sublease does not represent a termination of the original lease.
- Since the sublease term of 5 years exceeds the remaining lease term of the original lease of 3 years, Dessert Co. is required to reassess and update the lease term to be at least 5 years (i.e., 3 years remaining in the initial lease term plus at least one 2-year extension period). See Accounting for Leases - Lessees for additional guidance and impact on accounting for lessees.

Example 8B - Sublease With Extension Options That Are Not Reasonably Certain of Exercise

FACTS

- Assume the same facts as in Example 8A, except that the sublease with Mikey's Cookie Company has a three-year noncancelable term with two 2-year extension options.
- Dessert Co. as sublessor assessed the lease term of the sublease and determined that it is three years (i.e., Mikey's Cookie Company is not reasonably certain to exercise its extension options).

ANALYSIS

- The lease term for the sublease is three years, which is the remaining lease term of the original lease.
- Even though Dessert Co. would be forced to exercise its extension option(s) in the original lease if Mikey's Cookie Company were to exercise its extension option(s) in the sublease (that is, exercise of the extension options in the original lease is now outside Dessert Co.'s control), Dessert Co. determined that Mikey's Cookie Company is not reasonably certain to exercise its extension options and therefore Dessert Co. would not update the lease term of the original lease solely as a result of entering into the sublease.

Example 8C - Sublease With Extension Options That Are Reasonably Certain of Exercise

FACTS

- Assume the same facts as in Example 8B, except that Mikey's Cookie Company is reasonably certain to exercise its first extension option.

ANALYSIS

- In this case, like in Example 8A the sublease term exceeds the remaining lease term of the original lease. Therefore, Dessert Co. is required to reassess and update the lease term to be at least 5 years (i.e., 3 years remaining in the initial lease term plus at least one 2-year extension period). See **Accounting for Leases - Lessees** for additional guidance and impact on accounting for lessees.

In a sublease arrangement, the original lessee may require the sublessee to pay directly to the original lessor or a third-party either or both the rent payments and other costs such as property taxes and insurance otherwise due under the original lease.

ASC 842-10-15-40A requires a lessor to exclude from variable payments lessor costs paid by a lessee directly to a third party. However, costs excluded from the consideration in the contract that are paid by a lessor directly to a third party and are reimbursed by a lessee are considered lessor costs that should be accounted for by the lessor as variable payments.

This requirement also applies to a sublessor for lessor costs paid by the sublessee directly to a third-party, including the head lessor. Therefore, the accounting by the sublessor can be summarized as follows:

Sublessee pays lessor costs directly to a third-party, including the head lessor	Sublessor pays costs and is reimbursed by sublessee
▶ Exclude from variable payments. ▶ In other words, treat like a sublessee cost, which does not affect the accounting for the lease.	▶ Account for costs excluded from consideration in the contract as lessor costs (i.e., as variable payments). ▶ In other words, recognize on a gross basis.

Importantly however, the above requirements do not apply to payments (whether fixed or variable) for the right to use the underlying asset that are paid by the sublessee directly to the original lessor. Accordingly, if the sublease requires the sublessee to make such payments directly to the original lessor, the original lessee (sublessor) should still present those amounts gross in profit or loss.

ACCOUNTING FOR INCOME TAXES

OVERVIEW

A leasing arrangement generally provides a financing party (the lessor) with the right to claim tax benefits from the ownership of an asset intended to be used by another party (the lessee) so that the tax benefits can be "shared" with the lessee through lower rent or lease payments. The basic tax benefit is tax deferral – i.e., accelerated tax deductions in early years to reduce income from the leasing arrangement and from other sources in exchange for more taxable income in later years when tax depreciation deductions from the leased asset are less than in early years. Additional tax benefits might include investment tax credits.

ASC 740 provides for two basic principles related to the accounting for income taxes:

1	To recognize the estimated taxes payable or refundable on tax returns for the current year as a tax liability or asset.	For example, in a "true lease" for federal income tax purposes, a lessor would determine taxable income based on, among other things, rental income (as earned), depreciation on the asset under the Modified Accelerated Cost Recovery System, and deductible interest expense using the interest method.
2	To recognize deferred tax liabilities and assets for the future tax consequences of events that have been recognized in an entity's financial statements or tax returns (i.e., timing differences and carryforwards).	See below for further discussion.

Tax Classification of Leases

The U.S. federal income treatment or classification of leases range from a "true lease" which means the lessor is considered the tax owner of the leased property (the lessee does not own an asset for tax purposes), a conditional sale (the lessor is a conditional seller and the lessee is a conditional buyer), a lending transaction (the lessor is a creditor and the lessee is a debtor and the owner of a mortgaged asset), or other type of participation. Therefore, depending on the terms of the arrangement, the classification of a lease arrangement for federal income tax purposes could differ from the classification for financial reporting purposes.

For a true tax lease, the lessor is considered the tax owner of the leased property. As such, the lessor is entitled to tax deductions related to the ownership of the property, including depreciation and interest expense as note above, while recognizing rental income. The primary focus of the U.S. federal tax classification analysis is whether the lessor retains sufficient risks and rewards from ownership, including consideration of whether the lessor has made a substantial equity investment and retains a meaningful interest in the residual value of the asset (i.e., whether the lessor has upside and downside residual risk in the leased property).

While U.S. federal tax law does not contain a comprehensive articulation of "true leases," certain principles have been developed through IRS administrative guidance and case law that define a "true lease" including:

- Minimum unconditional "at risk" investment (i.e., equity investment and remaining useful life beyond lease terms),
- No bargain purchase options (i.e., less than fair market value when option is exercised) or put option to lessee,
- No economic compulsion to purchase the asset at the end of the term or at a fixed purchase option,
- No investment by lessee beyond certain improvements or additions,
- No lessee loans or guarantees,

- Profit (beyond tax benefits) and positive cash flow requirements,
- No limited use property,
- Commercially feasible that another party can use the asset after lease expiration, considering remaining useful life and residual value,
- Other considerations and facts and circumstances.

DEFERRED INCOME TAXES

The following terminologies are important for the understanding and accounting for deferred taxes:

Temporary Differences	Deferred Tax Assets	Deferred Tax Liabilities
Relate to the difference between the tax basis of an asset or liability and its reported amount in the financial statements that will result in taxable or deductible amounts in future years when the reported amount is recovered or settled.	Result from *deductible* temporary differences that exist at the end of a period and are measured using enacted tax rates and provisions of the enacted tax law.	Result from *taxable* temporary differences that exist at the end of a period and are measured using enacted tax rates and provisions of the enacted tax law.

The issuance of ASC 842 did not change the principles for income tax accounting for leases. As such, the requirement to recognize deferred taxes for timing differences remains the same.

- For some leases, there will be no significant changes to the accounting for income taxes. For example, ASC 842 does not have a significant impact on the accounting requirements for lessors or lessees for finance leases. As such, there is not a significant change in the accounting for income taxes related to these leases.
- For other leases, there will be a greater impact. Most notably, since ASC 842 now requires lessees to recognize lease liabilities and right-of-use assets on the balance sheet for operating leases, the adoption of ASC 842 will, in most cases, require lessees to record new deferred tax assets and liabilities. Notwithstanding, transitioning to ASC 842 will not impact how leases are classified for federal income tax purposes.

New Deferred Taxes for Lessee Operating Leases Under ASC 842

For book purposes under ASC 842, a lessee in an operating lease recognizes a lease liability and a right-of-use asset at the commencement date, except for short-term leases. However, for tax purposes, if the lease is considered a true lease, there will be zero tax basis for the lease liability and right-of use asset. This creates two separate temporary differences for which deferred taxes must be recognized. Specifically, a lessee in an operating lease recognizes:

- A deferred tax liability (measured at the applicable tax rate) for the right-of-use asset since future recovery of the book basis (i.e., generating cash inflows from the use of the leased asset) will not have a corresponding depreciable tax basis, thereby resulting in more taxable income to the lessee.
- A deferred tax asset (measured at the applicable tax rate) for the lease liability because the future settlement of the lease liability (i.e., paying down the carrying value or principal) will result in a tax deduction through deductible rents.

Also, the subsequent measurement of the lease liability and right-of-use asset will often diverge, and thus the respective deferred taxes will not entirely offset.

These temporary differences must be tracked separately for disclosure purposes (as gross deferred tax assets and liabilities must be separately disclosed) and, because the reversal pattern for the deferred tax liabilities will likely be different than the reversal pattern for the deferred tax assets, this could impact the measurement of valuation allowances.

A deferred tax asset is assessed, together with all other deferred tax assets within a jurisdiction or a taxpaying entity, for realizability. However, the deferred tax liability for the right-of-use asset would generally be considered a source of income to support realization of the deferred tax asset.

The magnitude of the deferred taxes recognized initially will depend on several factors, including the length of the lease term, significance of lease payments, and the lessee's accounting policy election related to not separating non-lease components (such as maintenance services) from the related lease component, as discussed in Identifying and Separating Components. For example, a lessee that elected for its equipment asset class to not separate the non-lease components (maintenance) from the related equipment lease component will include the maintenance payments in the measurement of the lease liability and right-of-use asset that would otherwise be allocated to the maintenance component. For tax purposes, the standalone value of the non-lease component (the maintenance service) would not be capitalized as part of the cost basis of leased property; rather, any prepayment of non-lease components could be capitalized as a separate asset and amortized over time. However, in some cases, non-lease components could also be deducted as incurred depending on the terms of the agreement and the taxpayer's method of accounting for such items. As such, the measurement of deferred taxes must consider all these factors.

INITIAL DIRECT COSTS

For book purposes, lease origination costs that qualify as initial direct costs under ASC 842 are capitalized and recognized as an expense over the lease term. For lessees, initial direct costs are part of the right-of-use asset, irrespective of lease classification, and thus affect the measurement of the deferred taxes associated with the right-of-use asset. For lessors with operating leases, initial direct costs are capitalized as a separate asset and amortized over the lease term. As such, they will give rise to a separate temporary difference. For lessors with sales-type or direct-financing leases, initial direct costs that are deferred are automatically included in the net investment in the lease based on how the rate implicit in the lease is calculated. As such, they do not give rise to a separate temporary difference; rather they affect any deferred taxes associated with the net investment in the lease.

The definition of initial direct costs under ASC 842 is narrower than under ASC 840. Under ASC 842, initial direct costs include incremental costs of a lease that would not have been incurred if the lease had not been obtained (See Lease Classifications and Key Terms for additional details). Consequently, certain origination costs that previously were capitalized under ASC 840 now will be expensed under ASC 842. Also, for sales-type leases, lessors are required to expense initial direct costs for leases in which the fair value of the underlying asset differs from its carrying amount at lease commencement. For income tax purposes lease origination costs are still required to be capitalized (and amortized), thereby creating additional temporary differences and associated deferred income taxes, although federal tax law allows for an immediate deduction of de minimis costs incurred to acquire an asset (up to $5,000 of the entire cost for taxpayers with applicable financial statements). This tax deduction allowance might be suitable for small value leases (e.g., certain office equipment and computers).

SALE-LEASEBACK TRANSACTIONS

The accounting for sale-leaseback transactions under ASC 842 may result in temporary differences. As discussed earlier in this article, ASC 842 requires the application of ASC 606 (existence of a contract and transfer of control), the lease classification guidance under ASC 842, and specific repurchase option guidance to determine whether the transaction qualifies for sale accounting. If a sale-leaseback transaction fails sale accounting, the consideration paid by the buyer-lessor for the asset is accounted for as a financing by both the seller-lessee and the buyer-lessor.

Some sale-leaseback transactions that meet the current tax law requirements for sales for seller-lessees and purchases for buyer-lessors may fail the accounting requirements above on sale accounting, creating temporary differences. For example, a seller-lessee would recognize current taxable income but would recognize a deferred tax asset for the future inclusion of book income. Conversely, certain sale-leaseback transactions involving real estate which did not qualify as sales under ASC 840 may result in sale accounting under ASC 842, also impacting deferred income taxes.

OTHER CONSIDERATIONS

There might be current tax implications as a result of the adoption of ASC 842, such as a redetermination of state and local income taxes due to changes in apportionment factors used to allocate income to states and local jurisdictions. Additionally, the adoption of ASC 842 could cause an entity to re-evaluate its tax accounting method for leases. Currently, Section 6.03 of Rev. Proc. 2019-43 provides an automatic change procedure for taxpayers to change the classification of sale, lease or financing transactions for tax purposes.

TRANSFER PRICING

Intercompany transactions between related parties should meet the so-called 'arms- length' standard, which generally requires that such transactions be priced similar to how such transactions would be priced with unrelated parties. Typically, certain financial indicators are used to determine whether such transactions are at arms- length. Such indicators include return on sales, return on assets and other measures. Most often, these ratios are computed on a US GAAP basis. Due to the adoption of ASC 842, the US GAAP ratios may change, which may impact the intercompany pricing between related parties. Companies with intercompany transactions should carefully analyze the impact the new leasing standard may have on its US GAAP measures used to set its intercompany pricing.

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