A PRACTICE AID FROM BDO'S PROFESSIONAL PRACTICE GROUP

# Accounting for Leases Under ASC 842

UPDATED SEPTEMBER 2021

# BDO Knows Accounting for Leases – Lessees


## OVERVIEW

We discussed in the previous article on Lease Classification and Key Terms important concepts such as the commencement date, lease term, lease payments, discount rate, and so forth, and how an entity classifies a lease. Once the entity has determined all those relevant inputs, it can recognize and measure the lease on balance sheet at the commencement date.

Users of financial statements indicated that previous lease accounting guidance did not provide sufficient useful information with regards to an entity's leasing activities because most leases (that is, operating leases) were not recognized on the balance sheet. As a result, users often adjusted lessees' financial statements to capitalize operating leases to better reflect lessees' leverage and exposure to credit risk, but different estimation approaches and limited information available created information asymmetry in the market, and adjustments varied significantly based on different assumptions.

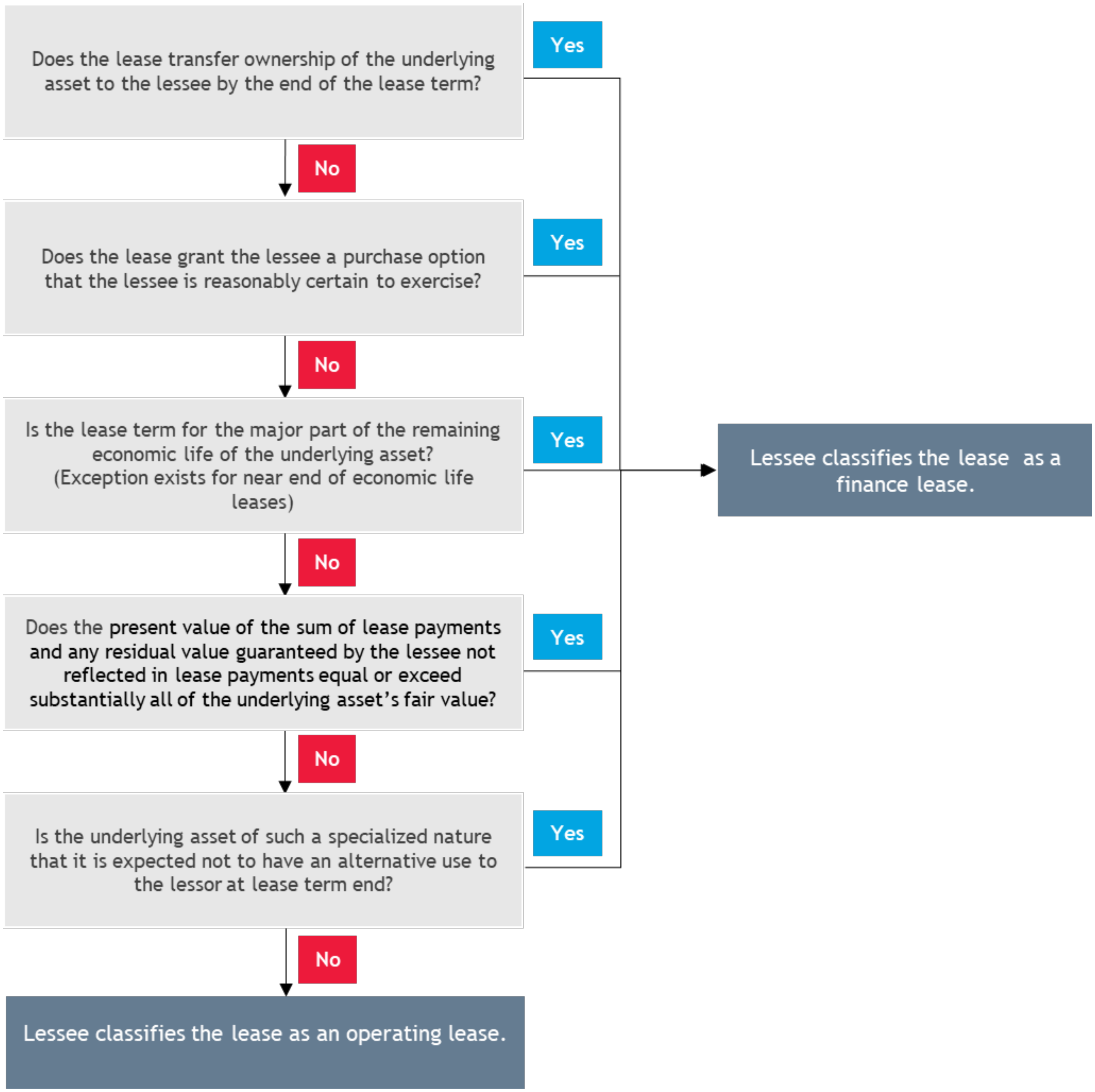
ASC 842 is intended to address those issues because most leases (whether operating or finance) are now recognized on balance sheet at the commencement date unless the practical expedient for short-term leases is elected (see below). The new model reflects that at the commencement date of a lease, a lessee has a financial obligation to make lease payments to the lessor in exchange for its right to use the underlying asset, and accordingly it should recognize a right-of-use (ROU) asset and a lease liability for these rights and obligations.

The lessee accounting model in ASC 842 still retains the distinction between operating and finance leases because the FASB viewed economic differences among those leases. Specifically, the FASB determined that finance leases are generally economically similar to purchased PP&E because the lessee essentially obtains control of the underlying asset rather than merely obtaining control over the use of the underlying asset for the lease term. In contrast, in an operating lease the lessee does not obtain substantially all of the remaining benefits from the underlying asset; frequently, the lessee obtains only a minor portion of the remaining benefits and will not be exposed to or benefit from any changes in the underlying asset's value during the lease term.

The FASB also provided lessees with a practical expedient not to recognize short-term leases on balance sheet. A short-term lease is a lease with a lease term of 12 months or less and that does not include a lessee purchase option that is reasonably certain of exercise. This election is by asset class and, if elected, a lessee recognizes lease payments on a straight-line basis over the lease term along with variable lease payments when incurred, consistent with ASC 840.

## LEASE CLASSIFICATION BY LESSEES

As a reminder, the following flowchart summarizes a lessee's classification of a lease under ASC 842, which we discussed in further details in the Lease Classification and Key Terms article from this series.



## SUMMARY ACCOUNTING REQUIREMENTS BASED ON LEASE CLASSIFICATION

| | Finance Leases | | Operating Leases | |
|---|---|---|---|---|
| | **ROU Asset** | **Lease Liability** | **ROU Asset** | **Lease Liability** |
| **Balance Sheet** | ROU asset is initially measured at the amount of the lease liability, plus initial direct costs and prepaid lease payments, less lease incentives received. | Lease liability is initially measured at the present value of the unpaid lease payments. | Initial measurement is the same as for finance leases. | |
| | Subsequently, ROU asset is typically amortized on a straight-line basis to the earlier of the end of its useful life or lease term.[1] | Subsequently, lease liability is increased to reflect interest using the interest method and decreased for lease payments made. | Amortize based on difference between periodic straight-line lease cost (incl. amortization of initial direct costs) and periodic interest accretion. | Subsequent measurement is the same as for finance leases. |
| **Income Statement** | ▶ Recognize amortization of ROU asset,<br>▶ Recognize interest on lease liability,<br>▶ Recognize variable lease payments not included in the lease liability when incurred, and<br>▶ Recognize an impairment loss if the ROU asset is impaired under ASC 360. | | ▶ Recognize a single lease cost generally on a straight-line basis,<br>▶ Recognize variable lease payments not included in the lease liability when incurred, and<br>▶ Recognize an impairment loss if the ROU asset is impaired under ASC 360. Also, after an impairment, recognition of lease cost is no longer on a straight-line basis (but still recognized as a single lease cost). | |

Also, note the following:

- ASC 842 considers the right to control the use of the underlying asset as the equivalent of physical use. That is, recognition of lease cost under the operating lease model, or amortization of the right-of-use asset for finance leases, should not be affected by the extent to which the lessee uses the underlying asset, and therefore typically is on a straight-line basis.
- The right-of-use asset is a nonmonetary asset while the lease liability is a monetary liability. Therefore, when accounting for a lease denominated in a foreign currency, if remeasurement into the lessee's functional currency is required, the lease liability is remeasured using the current exchange rate, while the right-of-use asset is remeasured using the exchange rate as of the commencement date.
- Once recognized on balance sheet, ASC 842 also includes requirements for lessees to update the measurement of leases for certain lease modifications and other reassessment events. Lessees will need robust processes and controls to timely and completely identify and account for such events.

[1] However, if the lease transfers ownership of the underlying asset to the lessee or the lessee is reasonably certain to exercise an option to purchase the underlying asset, the lessee amortizes the right-of-use asset to the end of the useful life of the underlying asset.

## SHORT-TERM LEASES

The Master Glossary defines a short-term lease as:

> "A lease that, at the commencement date, has a lease term of 12 months or less and does not include an option to purchase the underlying asset that the lessee is reasonably certain to exercise."

ASC 842 provides lessees with a practical expedient related to short-term leases under which the ASC 842 balance sheet recognition provisions are not applied to these leases. This election is made by class of underlying asset to which the right of use relates (e.g. office equipment, real estate, vehicles). If elected, leases that qualify for the exemption are not recognized on balance sheet and lease payments are recognized on a straight-line basis over the lease term, consistent with legacy guidance for operating leases. Variable lease payments are also recognized in the period in which the obligation for those payments is incurred.

If the lease term or the assessment of a lessee purchase option changes such that, after the change, the remaining lease term extends more than 12 months from the end of the previously determined lease term or the lessee is reasonably certain to exercise its purchase option, the lease no longer meets the definition of a short-term lease and the lessee should apply the general guidance, including balance sheet recognition, as if the date of the change in circumstances is the commencement date of the lease.

This practical expedient was provided to simplify the accounting for such short-term leases. However, a lessee still must apply the ASC 842 requirements related to initial assessment of the lease term and lessee purchase options, including whether the lessee is reasonably certain to exercise an extension or purchase option. This also means that short-term leases are subject to the lease term and purchase option reassessment requirements in ASC 842. Short-term leases also are subject to specific disclosure requirements. Accordingly, even with the practical expedient, short-term leases are not scoped out of ASC 842 entirely.

In deliberating whether to include the short-term lease exception, the FASB considered the risk that entities may wish to structure a lease in order to obtain short-term lease accounting; for example, by setting a noncancelable lease period which is shorter than 12 months while incorporating a series of one-year renewal options, or by entering into a longer-term lease that includes a series of termination options. However, the FASB noted in paragraph BC381 of ASU 2016-02 "that there are significant economic disincentives to both parties to entering into a series of short-term leases in place of longer-term leases such that there is not a significant structuring risk throughout the system. For example, lessees may have to pay a premium rental price to compensate the lessor for its increased residual asset risk, and some lessors will be unable to enter into short-term leases depending on the terms of the financing they obtained to acquire the underlying asset."

**Example 1 - Lease is a short-term lease**

**FACTS**

- Dom Co. is an auto leasing company.
- Lessee enters into a lease with Dom Co. for the use of 20 cars for use by its sales force.
- The stated term of the lease is 12 months, with the lessee having the right to renew the lease for an additional 12 months.
- The monthly lease payments during the renewal period are the same as the monthly payments in the initial period.
- There are no purchase options.
- The cars are not specialized, and alternative cars are available in the market at similar lease rates.
- Lessee has made an accounting policy election not to recognize right-of-use assets and lease liabilities arising from short-term leases for any class of underlying asset.

**ANALYSIS**

- Lessee considered all relevant factors at the commencement date and determined that it is not reasonably certain to exercise the renewal option.

**CONCLUSION**

- The lease meets the definition of a short-term lease because the lease term is 12 months or less, there are no purchase options, and it is not reasonably certain that Lessee will exercise the renewal option.
- Lessee does not recognize the right-of-use asset and lease liability arising from the lease. Rather, the lease payments are recognized on a straight-line basis over one year.

**Example 2 - Lease is not a short-term lease - Termination options**

**FACTS**

- Ironside Co. manufactures heavy machinery for construction.
- Lessee enters into a lease with Ironside Co. for the use of two cranes.
- The stated term of the lease is 3 years, with the lessee having the right to terminate it at any time after one year.
- The contract specifies an early termination penalty equal to 15% of the total lease payments.
- Lessee has made an accounting policy election not to recognize right-of-use assets and lease liabilities that arise from short-term leases for any class of underlying asset.

**ANALYSIS**

- Lessee concludes that due to the significant termination penalty and other factors it is reasonably certain not to exercise the termination option.

**CONCLUSION**

- Lessee concludes that the lease term is 3 years. Therefore, the lease does not qualify for the short-term lease exception.
- Accordingly, Lessee applies the general requirements in ASC 842 to this lease, including recognizing a right-of-use asset and lease liability.

**Example 3 - Lease is a short-term lease – Renewal options**

**FACTS**

- Assume the same facts as in Example 2 apply, in which Lessee entered into a lease with Ironside Co. for the use of two cranes, except that the contract does not specify a stated term.
- Instead, the cranes are subject to a daily rental rate, and the lease can be renewed indefinitely.
- Lessee has made an accounting policy election not to recognize right-of-use assets and lease liabilities that arise from short-term leases for any class of underlying asset.

**ANALYSIS**

- Lessee analyzes the lease term considering all relevant factors at the commencement date. Lessee determines the most likely period of use based on expected need is six months, and considers the physical difficulties of replacing a crane during that period with another crane with the same functionality along with the limited number of available cranes of this magnitude in the market.
- Consequently, Lessee determines that it is reasonably certain to exercise the renewal option for a period of six months.

**CONCLUSION**

- Lessee concludes that the lease term is six months and therefore the lease meets the definition of a short-term lease because the lease term is twelve months or less and there are no purchase options.
- Lessee does not recognize the right-of-use asset and lease liability arising from the lease. Rather, the lease payments are recognized on a straight-line basis over the 6-month period.

**Example 4 - Lease is not a short-term lease - Purchase option**

**FACTS**

- Bellamy Inc. manufactures music instruments and related equipment.
- Lessee is a music band (assume it is a legal entity) that enters into a lease with Bellamy Inc. for the use of 3 guitars, 4 amplifiers, 2 loopers, and a drum set for the band's 3-month summer tour.
- The stated term of the lease is 3 months, with the Lessee having the right to purchase the equipment at a 15% discount at the end of the summer tour.
- Lessee has made an accounting policy election not to recognize right-of-use assets and lease liabilities that arise from short-term leases for any class of underlying asset.

**ANALYSIS**

- Lessee considers all relevant factors at the commencement date (including prevailing market prices for similar equipment and the lessee's need for the equipment in future gigs) and determines that it is reasonably certain to exercise the purchase option.

**CONCLUSION**

- Lessee concludes that the leases do not qualify for the short-term lease exception.
- Lessee applies the general requirements in ASC 842 to the leases, including recognizing a right-of-use asset and lease liability.

In some arrangements, the lease will not include a continuous and uninterrupted period of use, but rather will consist of non-consecutive periods of use. This can be due to the availability of the right-of-use asset to the lessee or the specific needs of the lessee. With regards to the definition of a lease, the Master Glossary defines the period of use as:

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

Therefore, the determination of whether a lease is a short-term lease is not performed based on each time increment separately, but rather based on the sum of the nonconsecutive periods for which the lessee uses the underlying asset.

**Example 5 - Lease is not a short-term lease - Non-consecutive periods**

**FACTS**

- Lessee is a basketball association that wishes to host its playoffs in a large venue each season.
- Lessee enters into a lease with Ball-is-Life Co. for the use of 2 basketball arenas.
- Lessee has the right to use the arenas only during the months of May and June every year during a 10-year period.
- The lease contract does not include any options.
- Lessee has made an accounting policy election not to recognize right-of-use assets and lease liabilities that arise from short-term leases for any class of underlying asset.

**ANALYSIS**

- While each time increment (each playoff season) is shorter than 12 months (i.e., two months), Lessee determines that the lease term is 20 months (two months every year times ten years).

**CONCLUSION**

- Lessee concludes that the lease does not qualify for the short-term lease exception.
- Lessee applies the general requirements in ASC 842 to this lease, including recognizing a right-of-use asset and lease liability.

## RECOGNITION AND INITIAL MEASUREMENT

### RECOGNITION

A lessee recognizes a right-of-use asset and a lease liability at the commencement date of the lease, which is the date on which the lessor makes the underlying asset available for use by the lessee. In some arrangements, the lessor may make the underlying asset available for use by the lessee before the lessee begins operations or makes lease payments. See Lease Classification and Key Terms from this series for additional details.

### INITIAL MEASUREMENT

The initial measurement of the lease at the commencement date is the same for operating and financing leases.

A lessee initially measures the lease liability at the present value of the unpaid lease payments, discounted using the discount rate for the lease. The discount rate for the lease is calculated based on information available at the commencement date. A lessee uses the rate implicit in the lease whenever that rate is readily determinable, or otherwise uses its incremental borrowing rate. A lessee that is not a public business entity is permitted to use a riskfree discount rate for the lease, determined using a period comparable with that of the lease term, as an accounting policy election. See Lease Classification and Key Terms from this series for additional details.

The right-of-use asset is initially measured at cost as follows:

Initial measurement of lease liability + Lease payments made on or before the commencement date + Initial direct costs incurred − Lease incentives received = Right-of-use asset

Example 6 below illustrates the initial measurement of a lease on balance sheet.

**Also note that for the illustrations throughout this article:**

- **The fact pattern in Example 6 will serve as the basis for most of the subsequent Examples in 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 6 - Initial measurement of lease liability and right-of-use asset**

**FACTS**

- Retailer Co. enters into a 10-year lease for 10,000 square feet of retail space.
- Annual lease payment is initially $100,000, paid in arrears, and increases 5 percent each year during the lease term.
- The rate implicit in the lease is not readily determinable. Retailer Co's incremental borrowing rate (IBR) at lease commencement is 6 percent.
- The lease does not transfer ownership of the retail space to Retailer Co or grant it an option to purchase the space.
- Retailer Co. does not provide a residual value guarantee.
- At the commencement date, the lessor paid Retailer Co $30,000 as an incentive to enter into the lease.
- Retailer Co. incurred the following costs related to the lease:
  - $10,000 for employee wages for negotiating lease terms and conditions.
  - $20,000 for commissions paid to a broker.
  - $15,000 for external legal fees.
- There are no nonlease components.
- Assume the lease is classified as an operating lease.

**ANALYSIS**

- The lease payments are discounted using a 6% discount rate (that is, Retailer Co's IBR), since the rate implicit in the lease is not readily determinable.
- The lease incentive of $30,000 is reflected in the initial measurement of the right-of-use asset but does not affect the initial measurement of the lease liability, since it was received at the commencement date.
- The lease liability at the commencement date is $904,337, calculated as follows:

| | PMT |
|---|---|
| Year 1 | 100,000 |
| Year 2 | 105,000 |
| Year 3 | 110,250 |
| Year 4 | 115,763 |
| Year 5 | 121,551 |
| Year 6 | 127,628 |
| Year 7 | 134,010 |
| Year 8 | 140,710 |
| Year 9 | 147,746 |
| Year 10 | 155,133 |
| **Undiscounted PMTs** | **1,257,789** |
| **PV(6%) =** | **904,337** |

- Retailer Co. recognizes as initial direct costs only the fees paid to the broker. This is because the external legal fees and employee wages would have been incurred even if Retailer Co. had not obtained the lease.
- Retailer Co. initially measures the right-of-use asset at $894,337, calculated as follows:

| | |
|---|---|
| Initial measurement of the lease liability | $904,337 |
| Plus, prepaid lease payments | - |
| Plus, initial direct costs | 20,000 |
| Less, lease incentive received | (30,000) |
| Initial measurement of ROU asset | $894,337 |

- Accordingly, at the commencement date, Retailer Co records the following entry:

| | $ | $ |
|---|---|---|
| Right-of-use asset | 894,337 | |
| Operating expenses* | 25,000 | |
| Lease liability | | 904,337 |
| Cash** | | 15,000 |

* Legal fees and employee wages. For simplification, this Example assumes that those expenses are incurred at the commencement date.

** All of Retailer Co's expenses less the lease incentive. For simplification, this Example assumes that initial direct costs and the operating expenses were incurred and paid at the commencement date.

- Note that initial measurement of the lease on balance sheet is the same regardless of lease classification.
- Subsequent accounting will be discussed in the following sections.

The definition of initial direct costs is substantially narrower under ASC 842 as compared to legacy guidance. This is due to the alignment with the concept of contract costs for revenue contracts (see ASC 340-40-25-1 through 25-3). That is, lessees may capitalize only incremental costs of a lease that would not have been incurred if the lease had not been obtained. Accordingly, many costs that were previously capitalized as a separate asset under operating leases (or as part of the leased asset for capital leases) are now required to be expensed when incurred.

A lessee may incur costs to ready the leased asset for its intended use, such as shipping, installation and similar costs. If the lessee pays the lessor for those activities, the payments are either part of the consideration in the contract or are variable payments that do not depend on an index or a rate. However, the guidance is not clear when such costs are paid to a party other than the lessor or when the lessee incurs the costs itself. Costs for such activities are not initial direct costs because those are not costs to *obtain* a lease contract. Therefore, a lessee cannot capitalize such costs by applying the guidance on initial direct costs.

However, the SEC staff addressed this question at the 2018 AICPA Conference on Current SEC and PCAOB Developments:

Andrew W. Pidgeon
*Professional Accounting Fellow, Office of the Chief Accountant*

**"Certain lessee and lessor costs**

[…] we have received application questions related to the new leases standard, including questions regarding lessee and lessor accounting for certain costs relating to a lease.

The first of those application questions related to lessee accounting for costs incurred to place a leased asset into use. For example, a lessee may pay a party other than the lessor to ship a leased asset to the lessee's premises. Topic 360 would require capitalization of those costs if the lessee purchased the asset.[9] Since the asset is leased, not purchased, the lessee could determine that the costs are in the scope of other GAAP,[10] or it could determine recognition in current period earnings is appropriate. In lieu of recognizing those costs in current period earnings, the staff did not object to a lessee, as an accounting policy election, analogizing to Topic 360 to capitalize costs incurred to place a leased asset into its intended use.

[…] I encourage lessees and lessors that elect to apply either of those accounting policies to apply the policies consistently and include appropriate disclosure of those policies if material."

[9] FASB ASC Topic No. 360, Property, Plant, and Equipment ("Topic 360"); specifically, ASC 360-10-30-1 states, in part, "… [t]hat the historical cost of acquiring an asset includes the costs necessarily incurred to bring it to the condition and location necessary for its intended use. …"

[10] For example, costs incurred by a lessee could require deferral pursuant to FASB ASC Subtopic No. 340-40, Other Assets and Deferred Costs – Contracts with Customers ("Subtopic 340-40"), or capitalization pursuant to Topic 360, if the leased asset is used by the lessee to deliver goods or services to a customer, or to construct property for the lessee, respectively.

Accordingly, we believe that to the extent the costs are not in the scope of other GAAP, either of the following approaches is acceptable as an accounting policy election applied at the entity level and disclosed if material:

- Expense the costs as incurred, or
- Capitalize the costs by analogy to ASC 360 on property, plant or equipment for the costs incurred to bring the asset to the condition and location necessary for its intended use. In that situation, the costs capitalized under ASC 360 can either be recognized as a separate asset or as part of the ROU asset. Regardless of its choice, the amortization pattern of such costs should be the same and the lessee should include the assets in the same asset group for impairment testing purposes.

## SUBSEQUENT MEASUREMENT

### FINANCE LEASES

After the commencement date, a lessee accounts for its finance leases as follows in its financial statements (absent impairments, modifications and reassessments, which are discussed later):

| | Finance Leases | |
|---|---|---|
| | **ROU Asset** | **Lease Liability** |
| **Balance Sheet** | Amortize the ROU asset on a straight-line basis (unless another systematic basis is more representative of the pattern in which the lessee expects to consume the economic benefits of the ROU asset) from the commencement date to the earlier of the end of its useful life or lease term. However, 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 amortizes the right-of-use asset to the end of the asset's useful life. | Increase the lease liability to reflect interest using the interest method and decrease it for lease payments made during the period. |
| **Income Statement*** | Recognize amortization of the ROU asset. | Recognize interest on the lease liability. |
| | Recognize variable lease payments not included in the lease liability when incurred. If variable lease payments are triggered based on a specified target, recognize costs from those variable lease payments before the achievement of such target if achievement is probable. Such variable lease costs should be reversed when it is probable the specified target will not be met. | |

* Unless the costs are included in the carrying amount of another asset in accordance with other Topics.

As described above and as previously discussed, the accounting for a finance lease is consistent with the accounting for a financed purchase of PP&E. This is because the FASB generally viewed finance leases as economically similar to the purchase of a nonfinancial asset.

The lease liability is measured on an amortized cost basis and essentially reflects at each reporting period the present value of the remaining lease payments discounted using the discount rate established at lease commencement (or at the most recent lease modification not accounted for as a separate contract, or the most recent remeasurement resulting from a reassessment of the lease term or purchase option, as discussed later in this article).

The ROU asset is measured at cost, net of accumulated amortization, and is amortized typically on a straight-line basis, like PP&E under ASC 360.

Variable Lease Payments Based on Achievement of a Target

Lessees recognize variable lease payments in the period in which they are incurred, pursuant to the guidance in ASC 842-20-25-5(b) and 25-6(b). ASC 842-20-55-1 and 55-2 provide additional guidance when such payments are based on a cumulative target. Specifically, if variable lease payments are triggered based on a specified target, then the costs are recognized before achievement of that target assuming achievement is probable. The FASB included this provision to ensure that lease payments are recognized in the periods in which the lessee benefits from use of the leased asset.

For example, consider a situation in which an entity leases a vehicle for three years for $10,000 per year. If the lessee drives the car for more than 12,000 miles during the three-year period, then the lease requires it to pay an extra $1,200. Assume that at lease commencement, it is probable the lessee will drive the car more than 12,000 miles during the lease term. Under the guidance in ASC 842-10-55-1, the lessee must accrue the additional $1,200 payment before it reaches 12,000 miles and therefore would recognize the additional $1,200 over the three-year lease term.

In contrast, if the lease required the lessee to pay $7,000 per year plus $1 for every mile driven, the lessee would not assess probability and instead would recognize the $1 every time it drives one mile, in accordance with ASC 842-20-25-5.

**Example 6.1 - Subsequent measurement of lease liability and right-of-use asset - Finance lease**

**FACTS**

- Assume the same facts as in Example 6 apply, in which the ROU asset and lease liability were initially measured at $894,337 and $904,337 respectively, except that:
  - The lease is for a manufacturing equipment rather than retail space.
  - The remaining economic life of the equipment at lease commencement is 12 years.

**ANALYSIS**

- Retailer Co. classifies the lease as a finance lease in accordance with ASC 842-10-25-2(c) as the lease term (10 years) is for the major part of the remaining economic life of the underlying asset.
- As there is no transfer of ownership or purchase option, the right-of-use asset is amortized from the commencement date to the earlier of the useful life of the right-of-use asset and the lease term, which in this Example is 10 years.
- Lease liability accounting throughout the lease term (assuming no modifications and remeasurements)

| | Beg. balance | Interest (6%) | PMT | Closing balance |
|---|---|---|---|---|
| **Year 1** | 904,337 | 54,260 | -100,000 | 858,598 |
| **Year 2** | 858,598 | 51,516 | -105,000 | 805,114 |
| **Year 3** | 805,114 | 48,307 | -110,250 | 743,170 |
| **Year 4** | 743,170 | 44,590 | -115,763 | 671,998 |
| **Year 5** | 671,998 | 40,320 | -121,551 | 590,767 |
| **Year 6** | 590,767 | 35,446 | -127,628 | 498,585 |
| **Year 7** | 498,585 | 29,915 | -134,010 | 394,491 |
| **Year 8** | 394,491 | 23,669 | -140,710 | 277,450 |
| **Year 9** | 277,450 | 16,647 | -147,746 | 146,352 |
| **Year 10** | 146,352 | 8,781 | -155,133 | 0 |

- Right-of-use asset amortization calculation

  Annual amortization: 894,337/10 = 89,434

- Journal entries (Year 1 shown only)

| | $ | $ |
|---|---|---|
| Interest expense | 54,260 | |
| Lease liability | | 54,260 |
| | | |
| Lease liability | 100,000 | |
| Cash | | 100,000 |
| | | |
| Amortization expense | 89,434 | |
| Right-of-use asset | | 89,434 |

## OPERATING LEASES

After the commencement date, a lessee accounts for its operating leases as follows in its financial statements (absent impairments, modifications and reassessments, which are discussed later):

<table>
<tr><th rowspan="2"></th><th colspan="2">Operating Leases</th></tr>
<tr><th>ROU Asset</th><th>Lease Liability</th></tr>
<tr><td>Balance Sheet</td><td>ROU asset equals the amount of the lease liability, adjusted for prepaid or accrued lease payments, unamortized lease incentives, and unamortized initial direct costs.<br>Alternatively, amortize the ROU asset for the difference between the periodic lease cost and periodic interest on the lease liability (see discussion below).</td><td>Increase the lease liability to reflect interest using the interest method and decrease it for lease payments made during the period.</td></tr>
<tr><td rowspan="2">Income Statement*</td><td colspan="2">Recognize a single lease cost (i.e., lease payments plus initial direct costs) generally on a straight-line basis over the lease term, unless another systematic basis is more representative of the pattern in which the lessee expects to consume the economic benefits of the ROU asset.</td></tr>
<tr><td colspan="2">Recognize variable lease payments not included in the lease liability when incurred. If variable lease payments are triggered based on a specified target, recognize costs from those variable lease payments before the achievement of such target if achievement is probable. Such variable lease costs should be reversed when it is probable the specified target will not be met. Refer to “Variable Lease Payments Based on Achievement of a Target” discussion in Finance Leases section above for additional information.</td></tr>
</table>

* Unless the costs are included in the carrying amount of another asset in accordance with other Topics.

As previously discussed, the FASB concluded that operating leases are different from finance leases and purchases of nonfinancial assets. Consequently, ASC 842 provides for different financial statement reporting of operating leases from that of finance leases. The legacy guidance in ASC 840 required lessees to recognize operating lease expense generally on a straight-line basis. This continues under ASC 842 whereby a lessee recognizes a single lease cost for operating leases based on the pattern in which the benefits conveyed by the lease are consumed, which is generally (though not always) on an equal basis over the lease term.

The lessee’s initial and subsequent accounting for operating lease liabilities is the same as for finance leases (i.e., reflecting the present value of the remaining lease payments), based on the view that the lessee should measure lease liabilities in a manner similar to other similar financial liabilities (that is, on an amortized cost basis), regardless of lease classification.

With the FASB’s intention to retain straight line expense recognition in the income statement while also accreting interest on the lease liability under the interest method like other financial liabilities, the amortization of the ROU asset essentially is the difference between the periodic lease cost and periodic interest accretion. Accordingly, while ASC 842-20-35-3 describes the subsequent measurement of the right-of-use asset as shown in the table above (assuming no impairment of the right-of-use asset), the lessee can determine the carrying value of right-of-use asset in subsequent periods from the periodic lease cost and interest accretion.

Initially, the total lease cost of an operating lease consists of the following:

- The total lease payments (including those paid and those not yet paid); plus
- The initial direct costs attributable to the lease.

Therefore, the periodic lease cost is the total lease cost divided by the lease term. Once the periodic lease cost is determined, the carrying value of the ROU asset at each reporting period can be calculated as follows:

Opening balance of right-of-use asset − Periodic lease cost + Periodic interest expense = Closing balance of right-of-use asset

In other words, the periodic amortization of the right-of-use asset equals the difference between the periodic lease cost and the periodic interest expense.

**Example 6.2 - Subsequent measurement of lease liability and right-of-use asset - Operating lease**

**FACTS**

- Assume the same facts as in Example 6, in which:
  - The ROU asset and lease liability were initially measured at $894,337 and $904,337 respectively,
  - The unpaid lease payments were $1,257,789 on an undiscounted basis,
  - Initial direct costs were $20,000, and lease incentives received were $30,000, and
  - The lease is an operating lease.

**ANALYSIS**

The accounting for the lease liability is the same as in Example 6.1, assuming no modifications and remeasurements, since there are no differences in accounting between operating lease liabilities and finance lease liabilities.

Right-of-use asset accounting

Retailer Co. first calculates the total lease cost to be recognized over the lease term:

| | |
|---|---|
| Total lease payments (paid and not yet paid)* | $1,227,789 |
| Plus, initial direct costs | 20,000 |
| Total lease cost [A] | $1,247,789 |
| **Periodic lease cost** [B] = [A] / 10 | **$124,779** |

* This amount reflects the total lease payments of $1,257,789, less the lease incentive received of $(30,000).

Therefore, the accounting for the ROU asset, assuming no impairment, modifications or reassessments, can be determined as follows:

| | Opening balance [A] | Periodic lease cost [B] | Interest (6%) [C] | Amortization [D] = [B] + [C] | Closing balance [A] + [D] |
|---|---|---|---|---|---|
| Year 1 | 894,337 | -124,779 | 54,260 | -70,519 | 823,819 |
| Year 2 | 823,819 | -124,779 | 51,516 | -73,263 | 750,556 |
| Year 3 | 750,556 | -124,779 | 48,307 | -76,472 | 674,084 |
| Year 4 | 674,084 | -124,779 | 44,590 | -80,189 | 593,895 |
| Year 5 | 593,895 | -124,779 | 40,320 | -84,459 | 509,436 |
| Year 6 | 509,436 | -124,779 | 35,446 | -89,333 | 420,103 |
| Year 7 | 420,103 | -124,779 | 29,915 | -94,864 | 325,239 |
| Year 8 | 325,239 | -124,779 | 23,669 | -101,109 | 224,130 |
| Year 9 | 224,130 | -124,779 | 16,647 | -108,132 | 115,998 |
| Year 10 | 115,998 | -124,779 | 8,781 | -115,998 | 0 |

Journal entries (Year 1 shown only)

| | $ | $ |
|---|---|---|
| Lease liability | 100,000 | |
| Cash | | 100,000 |
| | | |
| Lease expense | 124,779 | |
| Right-of-use asset | | 70,519 |
| Lease liability | | 54,260 |

As illustrated above and previously discussed, the lease cost of an operating lease is comprised of both amortization and interest but it is recognized as a single cost generally on a straight-line basis over the lease term.

Under the interest method, the periodic accretion of interest on the lease liability is higher in the early periods of the lease than in the later periods, and interest amounts accreted decrease over time as lease payments are made.

Accordingly, the amount attributed to the amortization of the right-of-use asset will be correspondingly lower in the early periods and will increase over time. Therefore, in the early periods of the lease, the right-of-use asset balance under operating leases will be higher than the right-of-use asset balance for finance leases. However, the total lease cost recognized over the entire lease term is the same.

ASC 842 also notes that throughout the lease term, the remaining cost of an operating lease for which the right-of-use asset has not been impaired consists of the following:

- The total lease payments (including those paid and those not yet paid), reflecting any adjustment to that total amount resulting from either a remeasurement or a modification (see separate sections below);
- Plus, the initial direct costs attributable to the lease;
- Less, the periodic lease cost recognized in prior periods.

However, if there are no modifications or reassessments and the operating lease ROU asset is not impaired, the periodic lease cost remains the same throughout the lease term as illustrated in Example 6.2 above, and it does not need to be recomputed each reporting period.

For example, the remaining lease cost of the lease in Example 6.2 at the end of Year 2 would be calculated as follows and would result in the same periodic lease cost as in Year 1:

| | | |
|---|---|---|
| Total lease payments (paid and not yet paid) | $1,227,789 | (see table in Example 6.2) |
| Plus, initial direct costs | 20,000 | (same as in Example 6.2) |
| Less, periodic lease cost recognized in Years 1 and 2 | (249,558) | (i.e., $124,779 x 2 years) |
| Total lease cost [A] | $998,231 | |
| **Periodic lease cost** [B] = [A] / 8 years left | **$124,779** | |

Also note that, because the amortization of the ROU asset is the difference between the periodic lease cost and periodic interest accretion, the remaining lease cost (and periodic lease cost) could also be determined as follows:

| | | |
|---|---|---|
| Carrying value of ROU asset at end of Year 2 | $750,556 | (same as in Example 6.2) |
| Plus, sum of interest accretion Years 3 – 10 | 247,675 | |
| Total remaining lease cost [A] | $998,231 | |
| **Periodic lease cost** [B] = [A] / 8 years left | **$124,779** | |

## LEASEHOLD IMPROVEMENTS

Leasehold improvements are amortized over the shorter of the useful life of those improvements and the remaining lease term, unless the lease transfers ownership of the underlying asset to the lessee or the lessee is reasonably certain to exercise an option to purchase the underlying asset, in which case the lessee amortizes the leasehold improvements to the end of their useful life. Also, as discussed in the previous article on **Lease Classification and Key Terms**, the existence of significant leasehold improvements with a useful life longer than the noncancelable term of the lease may indicate that it is reasonably certain that the lessee will exercise a renewal option. Therefore, the useful life of the improvements should be considered when determining the remaining lease term.

Leasehold improvements acquired in a business combination or an acquisition by a not-for-profit entity are amortized over the shorter of the useful life of the assets and the remaining lease term at the date of acquisition.

## REMEASUREMENTS

We discussed above the recognition and initial measurement of a lessee's leases on balance sheet, which are based in part on certain assumptions and judgment, such as assessing lessee options to extend or terminate the lease, or lessee options to purchase the underlying asset. The Board noted in paragraph BC227 of ASU 2016-02 that "users of financial statements receive more relevant information when entities reassess options on a regular basis because reassessment reflects current economic conditions. For example, using a lease term established at lease commencement throughout the lease could be misleading if there has been a change in facts or circumstances from those that existed at lease commencement." But the Board also noted that requiring reassessment of those options at each reporting date would be costly for a lessee with many leases; and therefore, it limited this reassessment to certain specific events.

The FASB also considered situations in which entities might attempt to circumvent the balance sheet recognition of leases. For example, a lease may initially provide for only nominal lease payments, or payments that are variable, but which become fixed for the remainder of the lease term at a later date. Absent a remeasurement, the lessee would continue to report a right-of-use asset and lease liability with little to no value. The FASB therefore requires lessees to also remeasure the lease payments when a contingency on which some or all of the variable lease payments are based is resolved such that the payments become fixed (the payments now meet the definition of lease payments).

Finally, the FASB decided that lessees should reassess amounts probable of being owed under residual value guarantees because it provides more relevant information to users and reflects current economic conditions.

In summary, other than modifications which are discussed later, the FASB decided that after the commencement date, a lessee should remeasure the lease payments only upon the occurrence of any of the following events:

<table>
<tr><th>Remeasurement Event</th><th>General Accounting Applicable to All Remeasurement Events</th><th>Update the Discount Rate?</th><th>Reassess Lease Classification?</th></tr>
<tr><td>A change in the lease term or the assessment of whether the lessee is reasonably certain to exercise a purchase option</td><td rowspan="3">- Remeasure the lease payments and the consideration in the contract,<br>- Reallocate the consideration to the lease and nonlease components (unless the practical expedient not to separate is elected), and<br>- Remeasure the lease liability and recognize the remeasurement amount as an adjustment to the ROU asset. However, if the carrying amount of the ROU asset is reduced to zero, the remaining amount is recognized in profit or loss.</td><td>Yes, unless the discount rate already reflects a lessee's extension, termination or purchase option</td><td>Yes</td></tr>
<tr><td>A contingency upon which some or all of the variable lease payments in the lease are based is resolved such that those payments become fixed</td><td>No</td><td>No</td></tr>
<tr><td>A change in the amount probable of being owed to the lessor under a residual value guarantee</td><td>No</td><td>No</td></tr>
</table>

Note the following as well:

- When the lessee updates the discount rate, it is performed at the remeasurement date based on the remaining lease term and the remaining lease payments.
- When lease classification is reassessed, it is done based on the facts and circumstances at the reassessment date (e.g., based on the fair value and remaining economic life of the underlying asset at that date).
- A lessee does not remeasure variable lease payments that depend on an index or a rate unless the lease liability is remeasured for another reason (i.e., based on one of the above remeasurement events).

## CHANGE IN LEASE TERM OR ASSESSMENT OF PURCHASE OPTION

A lessee is required to reassess the lease term or its option to purchase the underlying asset only if and at the point in time that any of the following occurs:

- A significant event or change in circumstances within the lessee's control directly affects whether the lessee is reasonably certain to exercise (or not to exercise) an option
- There is an event written into the contract that obliges the lessee to exercise (or not to exercise) an option to extend or terminate the lease
- The lessee elects to exercise an option even though the entity had previously determined that the lessee was not reasonably certain to do so
- The lessee elects not to exercise an option even though the entity had previously determined that the lessee was reasonably certain to do so

Examples of significant events or changes in circumstances within the lessee's control include:

- Constructing leasehold improvements that are expected to have significant value when the option becomes exercisable;
- Making significant modifications or customizations to the underlying asset;
- Making a business decision that is directly relevant to the ability to exercise an option such as extending the lease of a complementary asset; and
- Subleasing the underlying asset for a period beyond the exercise date of the option.

However, note that:

- Changes in market factors, such as market rates to lease comparable assets, do not in isolation trigger a reassessment.
- A requirement to test an asset group that includes the right-of-use asset for impairment does not necessarily result in a requirement to reassess the lease term or purchase options. Rather, the lessee should determine whether the impairment triggering event represents a requirement to reassess the lease term or purchase option. For example, an asset group that is tested for impairment because of a history of cash flow losses or because of a significant decrease in the market price of a long-lived asset in isolation may not require a reassessment of the lease term or purchase options.

Business decisions affect key estimates such as the lease term and the assessment of lessee purchase options. Therefore, a lessee should work with business partners in the organization to develop a process to identify and track which type of decisions are relevant to the assessment and when these decisions are made, such that these estimates affecting the lease liability are updated timely for the financial statements. These decisions may not have a formal paper trail and will need to be documented to arrive at key decisions regarding these estimates.

The requirements for a lessee to remeasure the lease payments for changes in the lease term and assessment of lessee purchase options, remeasure and reallocate the consideration in the contract, remeasure the lease liability, update the discount rate (except when the discount rate already reflects a lessee's option), and reassess lease classification will therefore require an entity to implement robust processes and controls to completely and timely identify events requiring such remeasurements.

**Example 6.3A - Reassessment of the lease term - Operating lease**

**FACTS**

- Assume the same facts as in Example 6 and Example 6.2 apply, in which the lease of the retail space is an operating lease. Also assume the following:
  - The contract provides Retailer Co. with the option to extend the lease for an additional 10 years.
  - Annual lease payments during the optional period are $150,000.
  - At the commencement date, Retailer Co. concluded it was not reasonably certain to exercise the extension option because payments in the renewal period are substantially the same as the amount otherwise due in the final year of the initial period, there is significant uncertainty as to whether Retailer Co. will need the underlying asset after ten years, and Retailer Co. did not construct improvements with an economic life longer than the initial term. Therefore, Retailer Co. determined that the lease term was 10 years.
  - The discount rate for the lease of 6 percent at the commencement date does not reflect that Retailer Co. has an option to extend the lease.
  - At the beginning of Year 6 of the lease, the financial performance of the retail space is higher than initially expected, and Retailer Co. installs significant leasehold improvements. Those improvements are expected to have significant economic value for Retailer Co. at the end of Year 10. Consequently, construction of the leasehold improvements is considered a significant event or change in circumstances that directly affects whether Retailer Co. is reasonably certain to exercise the extension option.
- The initial accounting for the lease throughout the lease term, absent a remeasurement or modification, was discussed in the prior examples and is summarized in the following table:

| | Lease Liability | | | | ROU Asset | | |
|---|---|---|---|---|---|---|---|
| | **Beg. Bal.** | **Interest** | **PMT** | **Ending Bal.** | **Beg. Bal.** | **Amort.** | **Ending Bal.** |
| **Year 1** | 904,337 | 54,260 | -100,000 | 858,598 | 894,337 | -70,519 | 823,819 |
| **Year 2** | 858,598 | 51,516 | -105,000 | 805,114 | 823,819 | -73,263 | 750,556 |
| **Year 3** | 805,114 | 48,307 | -110,250 | 743,170 | 750,556 | -76,472 | 674,084 |
| **Year 4** | 743,170 | 44,590 | -115,763 | 671,998 | 674,084 | -80,189 | 593,895 |
| **Year 5** | 671,998 | 40,320 | -121,551 | 590,767 | 593,895 | -84,459 | 509,436 |
| **Year 6** | 590,767 | 35,446 | -127,628 | 498,585 | 509,436 | -89,333 | 420,103 |
| **Year 7** | 498,585 | 29,915 | -134,010 | 394,491 | 420,103 | -94,864 | 325,239 |
| **Year 8** | 394,491 | 23,669 | -140,710 | 277,450 | 325,239 | -101,109 | 224,130 |
| **Year 9** | 277,450 | 16,647 | -147,746 | 146,352 | 224,130 | -108,132 | 115,998 |
| **Year 10** | 146,352 | 8,781 | -155,133 | 0 | 115,998 | -115,998 | 0 |

**ANALYSIS**

- Upon reassessing the lease term at the beginning of Year 6, Retailer Co. concludes that it is reasonably certain to exercise the option to extend the lease for an additional 10 years.
- Retailer Co. remeasures the lease payments (the consideration in the contract) to reflect the revised lease term. Since there are no nonlease components and there is only one lease component, there is no reallocation of the consideration necessary.
- Since the discount rate at commencement did not reflect Retailer Co. having the extension option, the discount rate is updated at the reassessment date. Considering the extended remaining lease term (15 years in total) and remaining lease payments, Retailer Co. determines that its incremental borrowing rate at the beginning of Year 6 is 8 percent.
- Retailer Co. reassesses lease classification based on the fair value of the underlying asset and remaining economic life at the beginning of Year 6. Assume the lease continues to be an operating lease.
- Retailer Co. remeasures the lease liability using the revised lease payments and updated discount rate. This results in an updated lease liability of $1,243,959, or an increase of $653,192 (1,243,959 – 590,767).
- The remeasurement of the lease liability is recognized as an adjustment to the ROU asset. Accordingly, the carrying value of the ROU asset immediately after the remeasurement is $1,162,628 (509,436 + 653,192).
- Retailer Co. updates the periodic lease cost for the remainder of the lease (15 years) as follows:

| | |
|---|---|
| Total lease payments (paid and not yet paid)* | $2,727,789 |
| Plus, initial direct costs | 20,000 |
| Less, periodic lease cost recognized in prior periods** | (623,895) |
| Total remaining lease cost [A] | $2,123,894 |
| **Periodic lease cost** [B] = [A] / 15y | **$141,593** |

* This amount reflects the total lease payments (including those paid in Years 1-5 and those not yet paid for Years 6-20), less the lease incentive received at the commencement date of $30,000.

** Prior periodic lease cost of $124,779 x 5 years

- Following the remeasurement, Retailer Co. recognizes a single lease expense of $141,593 each year for the remainder of the lease term assuming no impairment, modifications, or other reassessments.
- The amortization of the right-of-use asset is determined as the difference between the single lease cost of $141,593, and the periodic interest accretion on the lease liability. For example, for Year 6 amortization of the right-of-use asset is $42,076 (141,593 – 99,517).

The accounting for the lease after the remeasurement, and throughout the lease term (assuming no impairment, modifications, or other reassessments) is summarized in the following table:

| | Lease Liability | | | | ROU Asset | | |
|---|---|---|---|---|---|---|---|
| | Beg. Bal. | Interest | PMT | Ending Bal. | Beg. Bal. | Amort. | Ending Bal. |
| Year 6 | 1,243,959 | 99,517 | -127,628 | 1,215,848 | 1,162,628 | -42,076 | 1,120,552 |
| Year 7 | 1,215,848 | 97,268 | -134,010 | 1,179,106 | 1,120,552 | -44,325 | 1,076,227 |
| Year 8 | 1,179,106 | 94,329 | -140,710 | 1,132,725 | 1,076,227 | -47,264 | 1,028,962 |
| Year 9 | 1,132,725 | 90,618 | -147,746 | 1,075,597 | 1,028,962 | -50,975 | 977,987 |
| Year 10 | 1,075,597 | 86,048 | -155,133 | 1,006,512 | 977,987 | -55,545 | 922,442 |
| Year 11 | 1,006,512 | 80,521 | -150,000 | 937,033 | 922,442 | -61,072 | 861,370 |
| Year 12 | 937,033 | 74,963 | -150,000 | 861,996 | 861,370 | -66,630 | 794,740 |
| Year 13 | 861,996 | 68,960 | -150,000 | 780,956 | 794,740 | -72,633 | 722,106 |
| Year 14 | 780,956 | 62,476 | -150,000 | 693,432 | 722,106 | -79,117 | 642,990 |
| Year 15 | 693,432 | 55,475 | -150,000 | 598,907 | 642,990 | -86,118 | 556,871 |
| Year 16 | 598,907 | 47,913 | -150,000 | 496,819 | 556,871 | -93,680 | 463,191 |
| Year 17 | 496,819 | 39,746 | -150,000 | 386,565 | 463,191 | -101,847 | 361,343 |
| Year 18 | 386,565 | 30,925 | -150,000 | 267,490 | 361,343 | -110,668 | 250,676 |
| Year 19 | 267,490 | 21,399 | -150,000 | 138,889 | 250,676 | -120,194 | 130,482 |
| Year 20 | 138,889 | 11,111 | -150,000 | 0 | 130,482 | -130,482 | 0 |

**Example 6.3B - Reassessment of the lease term - Operating lease**

**FACTS**

- Assume the same as in Example 6.3A, except that at the beginning of Year 6, Retailer Co. only refreshes the store and spends $40,000 to repaint the interior of the store and reconfigure the floor space, including relocating the registers and certain fixed display racks.

**ANALYSIS**

- Although judgement would need to be applied, these expenditures are not typically considered leasehold improvements, but rather typical maintenance activities that should be expected in the life cycle of an asset. As such, in the above specific facts and circumstances, these expenditures would not trigger a reassessment event for Retailer Co. and would be expensed as incurred.

The accounting for a lease that is remeasured because of a change in the assessment of the lease term or a purchase option is essentially like the accounting for a new lease, since the lessee reperforms all steps required for a new lease (e.g., measure and allocate the consideration in the contract, determine the discount rate, assess lease classification, etc.). This was illustrated in Example 6.3A above.

## RESOLUTION OF A CONTINGENCY UPON WHICH VARIABLE LEASE PAYMENTS ARE BASED

**Example 6.4 - Resolution of a contingency - Operating lease**

**FACTS**

- Assume the same facts as in Example 6 and Example 6.2 apply, in which the lease of the retail space is an operating lease. Also assume the following:
  - At lease inception, Retailer Co. was selling only Product A and was in the process of developing Product B, a product that would complement the use of, and increase the customer experience with, Product A.
  - In addition to the fixed annual payments described in Example 6, the contract requires Retailer Co. to pay annually as additional rent an amount equal to 2% of Retailer Co.'s sales. However, upon its launch of Product B, Retailer Co. will pay an additional annual payment amount for the remainder of the lease term of $20,000 instead of the 2% payment on sales.
  - Retailer Co.'s sales in Years 1 and 2 are $350,000 and $500,000, respectively.
  - At the beginning of Year 3, Retailer Co. launches Product B in the market and starts selling it in the retail store.

**ANALYSIS**

- The payment determined as a percentage of sales is a variable lease payment that does not depend on an index or a rate. Therefore, it is recorded as a periodic variable lease expense and it does not affect the measurement of the lease liability. Retailer Co. recognizes variable lease expense of $7,000 and $10,000 in Years 1 and 2, respectively.
- At the beginning of Year 3 (when the contingency is resolved), Retailer Co. remeasures the lease payments in accordance with ASC 842-10-35-4(b) and discounts the revised lease payments using the original discount rate consistent with ASC 842-20-35-5(c). The remeasurement amount is recognized as an adjustment to the ROU asset.
- At the beginning of Year 3, the carrying value of the lease liability and ROU asset are $805,114 and $750,556, respectively.
- Retailer Co. remeasures the lease liability to $929,309 as follows:

| | PMT | Interest (6%) | Principal Amort. | Closing balance |
|---|---|---|---|---|
| Year 3 | -130,250 | 55,759 | -74,491 | 854,818 |
| Year 4 | -135,763 | 51,289 | -84,473 | 770,345 |
| Year 5 | -141,551 | 46,221 | -95,330 | 675,015 |
| Year 6 | -147,628 | 40,501 | -107,127 | 567,887 |
| Year 7 | -154,010 | 34,073 | -119,936 | 447,951 |
| Year 8 | -160,710 | 26,877 | -133,833 | 314,118 |
| Year 9 | -167,746 | 18,847 | -148,898 | 165,220 |
| Year 10 | -175,133 | 9,913 | -165,220 | 0 |
| **Undiscounted PMTs** | **-1,212,789** | | | |
| **PV(6%)=** | **-929,309** | | | |

- This results in an increase to the lease liability of $124,195 ($929,309 - 805,114). The amount of the remeasurement is recognized as an adjustment to the ROU asset.

| | $ | $ |
|---|---|---|
| Right-of-use asset | 124,195 | |
| Lease liability | | 124,195 |

- The updated balance of the right-of-use asset is therefore $874,751 ($750,556 + $124,195).
- Because the lease liability was remeasured, Retailer Co. updates the periodic lease cost for the remainder of the lease term (8 years):

| | |
|---|---|
| Total lease payments (paid and not yet paid)* | $1,387,789 |
| Plus, initial direct costs | 20,000 |
| Less, periodic lease cost recognized in prior periods** | (249,558) |
| Total remaining lease cost [A] | $1,158,231 |
| **Periodic lease cost** [B] = [A] / 8y | **$144,779** |

* This amount reflects the total revised lease payments. It includes those paid in Year 1 of $100,000 and Year 2 of $105,000, plus the revised lease payments for the remaining lease term of $1,212,789, less the lease incentive received at commencement of $(30,000).

- ** Represents prior periodic lease cost of $124,779 x 2 years (See Example 6.2)
- Following the remeasurement, Retailer Co. recognizes a single lease expense of $144,779 each year for the remainder of the lease term assuming no impairment, modifications, or other reassessments.
- The accounting for the right-of-use asset after the remeasurement, and throughout the lease term (assuming no impairment, modifications, or other reassessments) can be determined as follows:

| | Opening balance | Periodic lease cost | Interest (6%) | Amortization | Closing balance |
|---|---|---|---|---|---|
| | [A] | [B] | [C] | [D] = [B] + [C] | [A] + [D] |
| **Year 3** | 874,751 | -144,779 | 55,759 | -89,020 | 785,730 |
| **Year 4** | 785,730 | -144,779 | 51,289 | -93,490 | 692,240 |
| **Year 5** | 692,240 | -144,779 | 46,221 | -98,558 | 593,682 |
| **Year 6** | 593,682 | -144,779 | 40,501 | -104,278 | 489,404 |
| **Year 7** | 489,404 | -144,779 | 34,073 | -110,706 | 378,698 |
| **Year 8** | 378,698 | -144,779 | 26,877 | -117,902 | 260,797 |
| **Year 9** | 260,797 | -144,779 | 18,847 | -125,932 | 134,865 |
| **Year 10** | 134,865 | -144,779 | 9,913 | -134,865 | 0 |

## VARIABLE LEASE PAYMENTS THAT DEPEND ON AN INDEX OR A RATE

As discussed in the Lease Classification and Key Terms, variable lease payments that depend on an index or a rate are included in the lease payments and are initially measured using the index or rate at the commencement date. Other variable payments (for example, those based on sales of the lessee) typically are not included in the lease payments.

Subsequent changes in the index or rate do not represent the resolution of a contingency and, therefore, absent another event requiring remeasurement of the lease payments, the amounts resulting from the difference between the index or rate at commencement and subsequent changes are recognized as variable lease payments. Variable lease payments based on an index or a rate are remeasured only when the lessee remeasures the lease payments for another reason (for example, when there is a change in the lease term) and, if so, are remeasured using the index or rate at the remeasurement date. The FASB considered, but rejected, an approach in IFRS 16, *Leases* in which the lessee remeasures the lease payments when there is a change in the cash flows (when the adjustment to the lease payments takes effect).

The following table summarizes the accounting for variable lease payments based on an index or a rate under ASC 842:

| Accounting Under ASC 842 |
|---|
| ▶ Variable lease payments based on an index or a rate are not remeasured after the commencement date, and subsequent changes in the index or rate are recognized as variable lease payments, unless the lessee remeasures the lease payments for another reason.<br>▶ When lease payments are remeasured for another reason (for example, when there is a change in the lease term), a lessee remeasures variable lease payments that depend on an index or a rate using the index or rate at the remeasurement date.<br>▶ A lessee updates the discount rate if the lease payments are remeasured because of (a) a modification not accounted for as a separate contract, or (b) a change in the lease term or the assessment of a purchase option. |

**Example 6.5 - Remeasurement of variable lease payments that depend on an index or a rate**

**FACTS**

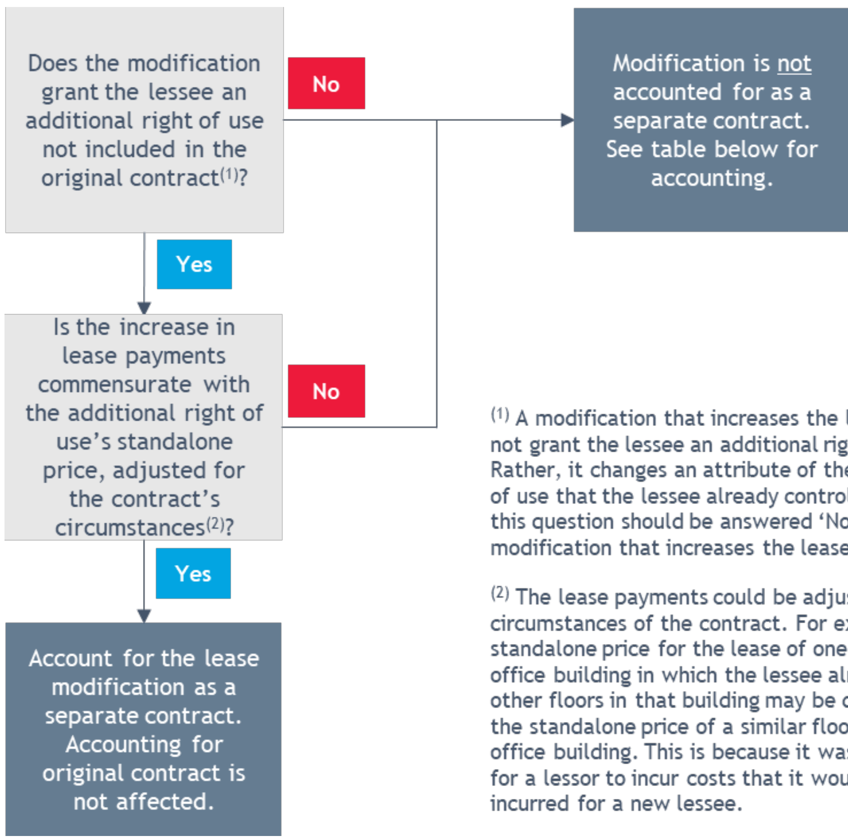
- Assume Retailer Co. entered into another lease of retail space with the following terms:
  - The noncancellable period of the lease is five years, and Retailer Co. has an option to renew the term for an additional five years.
  - At the commencement date, Retailer Co. determines it is not reasonably certain to exercise the renewal option. Accordingly, the lease term at the commencement date is five years.
  - Annual lease payments are $100,000, payable at the beginning of each year.
  - Lease payments for each year will increase based on the increase in the Consumer Price Index (CPI) for the preceding 12 months.
  - The lease is classified as an operating lease.
  - There are no nonlease components.
- Retailer Co. paid $20,000 of initial direct costs and received at the commencement date a lease incentive of $30,000.
- The rate implicit in the lease is not readily determinable. Therefore, Retailer Co. uses its incremental borrowing rate, which is 7% at the commencement date.
- Assume that at the end of the first year of the lease, CPI has increased by 2%.

**ANALYSIS**

- The initial measurement of the lease liability after the first payment is $338,721 (present value of four payments of $100,000 due at the beginning of Years 2 to 5, discounted at $7%).
- The initial measurement of the right-of-use asset is $428,721 (amount of lease liability of $338,721, plus lease prepayment of $100,000, plus initial direct costs of $20,000, less lease incentive of $30,000).
- In Year 1, Retailer Co. recognizes a single lease cost of $98,000 (the total lease payments of $470,000 [$500,000 – lease incentive of $30,000], plus initial direct costs of $20,000 equals total lease costs of $490,000, which is divided by the lease term of five years).
- If Retailer Co. is not required to remeasure the lease liability for another reason, Retailer Co. does not make an adjustment to the lease liability to reflect the increase in payments due to the increase in CPI at the end of the reporting period. In other words, the measurement of the lease liability continues to reflect annual lease payments of $100,000.
- For example, the Year 2 payment amount is $102,000. However, the $100,000 annual fixed payment continues to be recognized as a reduction in the lease liability, while the $2,000 variable lease payment will be recognized in profit or loss for Year 2 of the lease along with the single lease cost of $98,000. The lease liability is not remeasured.

## MODIFICATIONS

A lease modification is a change to the terms and conditions of a contract that results in a change in the scope of or the consideration for a lease (for example, a change to the terms of the contract that adds or terminates the right to use one or more underlying assets or extends or shortens the contractual lease term). Modifications only include changes to the terms and conditions that did not exist in the original contract. For example, the exercise of an option that was included in the original lease does not constitute a modification. Lessees are required to account for modifications at the date that the lease modification is approved by the lessee and the lessor, which is the effective date of the modification under ASC 842. ASC 842 differentiates between modifications that result in a separate contract and which therefore do not affect the accounting for the original contract, and other modifications that should be accounted for as part of the original contract. That determination can be made by using the following steps:




(1) A modification that increases the lease term does not grant the lessee an additional right-of-use. Rather, it changes an attribute of the original right of use that the lessee already controls. Accordingly, this question should be answered 'No' for a modification that increases the lease term.

(2) The lease payments could be adjusted for the circumstances of the contract. For example, the standalone price for the lease of one floor of an office building in which the lessee already leases other floors in that building may be different from the standalone price of a similar floor in a different office building. This is because it was not necessary for a lessor to incur costs that it would have incurred for a new lessee.

ASU 2020-04 provides optional expedients and exceptions for applying U.S. GAAP to contracts and transactions affected by the reference rate reform (i.e. discontinuation of LIBOR as a reference rate or other reference rate expected to be discontinued as a result of reference rate reform). Accordingly, modifications to contracts within the scope of ASC 842 may be accounted for as a continuation of the existing contract with no reassessment of lease classification and discount rate, and no remeasurement of lease payments that otherwise would be required for modifications not accounted for as separate contracts. Instead, the change in reference rate is treated as variable lease payments that were based on the reference rate in the original lease. However, to qualify for the optional expedient, other terms being concurrently modified, if any, need to be related to the replacement of a reference rate because of reference rate reform. For example, changes to the contractual term of the lease, additions or terminations of right-to-use underlying assets, changes to renewal, termination or purchase options are deemed unrelated to the replacement of a reference rate and, therefore, are not eligible for the expedient. See ASC 848-20-15-2 through 15-6 for additional information about scope of the expedient, and ASC 848-20-35-11 through 35-13 for application of the expedient to leases.

If a modification is not accounted for as a separate contract, the lessee accounts for the modification as follows at the modification's effective date:

<table>
<tr><th>Modification</th><th>General Accounting</th><th>Additional Guidance</th></tr>
<tr><td>Grants the lessee an additional right-of-use not included in the original contract and the lease payments are not commensurate with standalone price</td><td rowspan="4">▶ Remeasure the lease payments and the consideration in the contract,<br>▶ Reallocate the remaining consideration to the lease and nonlease components (unless the practical expedient to not separate is elected),<br>▶ Update the discount rate for the lease,<br>▶ Remeasure the lease liability, and<br>▶ Reassess lease classification and update the subsequent accounting for the lease accordingly.</td><td rowspan="3">▶ Recognize the remeasurement amount of the lease liability as an adjustment to the right-of-use asset.<br>▶ However, if the carrying amount of the right-of-use asset is reduced to zero, the remaining amount is generally recognized in profit or loss.</td></tr>
<tr><td>Extends or reduces the term of an existing lease, other than through exercise of an option in the original contract</td></tr>
<tr><td>Changes the consideration in the contract only</td></tr>
<tr><td>Fully or partially terminates an existing lease (for example, reduces the assets subject to the lease)</td><td>▶ Decrease the carrying amount of the ROU asset on a basis proportionate to the full or partial termination. Any difference between the reduction in lease liability and proportionate reduction in ROU asset is recognized as a gain or loss at the modification's effective date.<br>▶ ASC 842 provides two acceptable methods for determining the proportional reduction in the ROU asset (see illustration in Example 6.9).</td></tr>
</table>

The following is also important to note:

- Initial direct costs, lease incentives, and any other payments made to or by the entity in connection with a modification to a lease should be accounted for in the same manner as those items would be accounted for in connection with a new lease.
- If a finance lease is modified and the modified lease is classified as an operating lease, any difference between the adjusted carrying amount of the right-of-use asset and the carrying amount of the right-of-use asset that would result from applying the initial operating right-of-use asset measurement guidance to the modified lease should be accounted for like a rent prepayment or lease incentive (see Example 6.8B).
- If a master lease agreement permits the lessee to gain control over the use of additional underlying assets during the contract's term but does not obligate the lessee to do so, the lessee taking control over the use of an additional asset should be accounted for as a lease modification as described above (i.e., apply the flowchart above, and if applicable, the accounting in the above table). In contrast, a master lease agreement that specifies a minimum number of units or dollar value of equipment does not result in a lease modification when the lessee obtains control over the use of those additional assets. Rather, there may be separate lease components in the original contract, and potentially multiple commencement dates.

When a modification is not accounted for as a separate contract, the lessee remeasures the lease liability for the modified, existing lease as of the modification's effective date as if the modified lease were a new lease that commenced on that date. Therefore, the lessee reassesses lease classification and remeasures the right-of-use asset and the lease liability based on the changed terms and conditions of the modified contract (including the changed lease payments).

**Example 6.6 - Modification is accounted for as a separate lease**

**FACTS**

- Assume the same facts as in Examples 6 and 6.2 apply, in which the lease of the retail space is an operating lease. Also assume the following:
  - At the end of Year 5 of the lease, Retailer Co. and the lessor agree to modify the contract to include an additional 9,000 square feet of retail space in an adjacent building for the remaining 5 years of the original 10-year lease term. No costs are incurred with the modification.
  - The additional space is made available for use by Retailer Co. at the beginning of Year 6.
  - The annual lease payments in Years 6-10 increase by $140,000, payable in arrears.
  - Retailer Co.'s incremental borrowing rate at the effective date of the modification is 7%.

**ANALYSIS**

- Retailer Co. notes that the modification grants it an additional right-of-use not included in the original contract. Retailer Co. also assesses the corresponding increase in lease payments and determines that the increase is commensurate with the market lease rate for similar space at the modification date. Retailer Co. therefore concludes that the modification should be accounted for as a separate contract.
- This means that the accounting for the original 10-year lease of 10,000 square feet is not affected by the modification (see Example 6.2 for the accounting).
- Retailer Co. determines that the separate lease is an operating lease.
- The accounting for the lease liability for the new 9,000 square feet of retail space lease is as follows:

| | PMT | Interest (7%) | Principal Amort. | Closing balance |
|---|---|---|---|---|
| **Year 1** | -140,000 | 40,182 | -99,818 | 474,210 |
| **Year 2** | -140,000 | 33,195 | -106,805 | 367,404 |
| **Year 3** | -140,000 | 25,718 | -114,282 | 253,123 |
| **Year 4** | -140,000 | 17,719 | -122,281 | 130,841 |
| **Year 5** | -140,000 | 9,159 | -130,841 | 0 |
| **PV(7%) =** | **574,028** | | | |

- Retailer Co. initially measures the ROU asset at the same amount as the lease liability (since there are no initial direct costs, or lease incentives received, for the additional right-of-use).

| | $ | $ |
|---|---|---|
| Right-of-use asset | 574,028 | |
| Lease liability | | 574,028 |

- Retailer Co. accounts for the right-of-use asset as follows, assuming no impairment and remeasurements.

| | Opening balance [A] | Periodic lease cost [B] | Interest (7%) [C] | Amortization [D] = [B] + [C] | Closing balance [A] + [D] |
|---|---|---|---|---|---|
| **Year 1** | 574,028 | -140,000 | 40,182 | -99,818 | 474,210 |
| **Year 2** | 474,210 | -140,000 | 33,195 | -106,805 | 367,404 |
| **Year 3** | 367,404 | -140,000 | 25,718 | -114,282 | 253,123 |
| **Year 4** | 253,123 | -140,000 | 17,719 | -122,281 | 130,841 |
| **Year 5** | 130,841 | -140,000 | 9,159 | -130,841 | 0 |

**Example 6.7 - Modification is not accounted for as a separate lease - Lease classification unchanged**

**FACTS**

- Assume the same facts as in Examples 6 and 6.2 apply in which Retailer Co's lease of retail space is classified as an operating lease. Also assume the following:
  - At the beginning of Year 6, Retailer Co. and the lessor agree to extend the term of the lease by 5 years for fixed annual lease payments of $140,000.
  - At the beginning of Year 6, the carrying amount of the lease liability and right-of-use assets are $590,767 and $509,436, respectively.
  - Retailer Co.'s incremental borrowing rate at the effective date of the modification is 7%.

**ANALYSIS**

- The modification does not grant Retailer Co. an additional right of use. It merely changes an attribute of the original lease by extending the period of use for the original ROU asset. That is, Retailer Co. still controls only a single right of use it received at lease commencement.
- Therefore, the modification cannot be accounted for as a separate contract.
- At the effective date of the modification, Retailer Co. reassesses lease classification using the revised lease term and lease payments, remaining economic life, current fair value and updated discount rate, and concludes that it continues to be an operating lease.
- Retailer Co. remeasures the lease liability based on the remaining 10-year lease term and 10 remaining payments using its incremental borrowing rate at the modification date of 7%.

| | PMT | Interest (7%) | Principal Amort. | Closing Balance |
|---|---|---|---|---|
| **Year 6** | -127,628 | 68,865 | -58,763 | 925,022 |
| **Year 7** | -134,010 | 64,752 | -69,258 | 855,764 |
| **Year 8** | -140,710 | 59,903 | -80,807 | 774,957 |
| **Year 9** | -147,746 | 54,247 | -93,499 | 681,458 |
| **Year 10** | -155,133 | 47,702 | -107,431 | 574,028 |
| **Year 11** | -140,000 | 40,182 | -99,818 | 474,210 |
| **Year 12** | -140,000 | 33,195 | -106,805 | 367,404 |
| **Year 13** | -140,000 | 25,718 | -114,282 | 253,123 |
| **Year 14** | -140,000 | 17,719 | -122,281 | 130,841 |
| **Year 15** | -140,000 | 9,159 | -130,841 | 0 |
| **PV(7%)=** | **983,785** | | | |

- Consequently, the modified lease liability equals $983,785 (or an increase of $393,017).
- The increase to the lease liability is recorded as an adjustment to the right-of-use asset (that is, there is no income or loss recognized at the modification date). The updated balance of the right-of-use asset is $902,453 ($509,436 + $393,017).
- Retailer Co. updates the periodic lease cost for the remainder of the lease (10 years):

| | |
|---|---|
| Total lease payments (paid and not yet paid)* | $1,927,789 |
| Plus, initial direct costs | 20,000 |
| Less, periodic lease cost recognized in prior periods** | (623,895) |
| Total remaining lease cost [A] | $1,323,894 |
| **Periodic lease cost** [B] = [A] / 10y | **$132,389** |

* This amount reflects the total revised lease payments. It includes those paid in Years 1 – 5, the revised lease payments for the remaining lease term, less the lease incentive received at commencement date of $30,000.

** Represents period lease cost of $124,779 for 5 years.

- Retailer Co. recognizes annual straight-line lease expense of $132,389 for the remainder of the lease term.
- The accounting for the ROU asset after the remeasurement is summarized in the following table, assuming no impairment and remeasurements:

| | Opening balance [A] | Periodic lease cost [B] | Interest on lease liability [C] | Amortization [D] = [B] + [C] | Ending Balance [A] + [D] |
|---|---|---|---|---|---|
| **Year 6** | 902,453 | -132,389 | 68,865 | -63,525 | 838,929 |
| **Year 7** | 838,929 | -132,389 | 64,752 | -67,638 | 771,291 |
| **Year 8** | 771,291 | -132,389 | 59,903 | -72,486 | 698,805 |
| **Year 9** | 698,805 | -132,389 | 54,247 | -78,142 | 620,662 |
| **Year 10** | 620,662 | -132,389 | 47,702 | -84,687 | 535,975 |
| **Year 11** | 535,975 | -132,389 | 40,182 | -92,208 | 443,767 |
| **Year 12** | 443,767 | -132,389 | 33,195 | -99,195 | 344,573 |
| **Year 13** | 344,573 | -132,389 | 25,718 | -106,671 | 237,901 |
| **Year 14** | 237,901 | -132,389 | 17,719 | -114,671 | 123,231 |
| **Year 15** | 123,231 | -132,389 | 9,159 | -123,231 | 0 |

**Example 6.8A - Modification is not accounted for as a separate lease - Lease classification changes from operating to finance**

**FACTS**

- Assume the same facts as in Example 6.7 above apply, except that at the effective date of the modification, Retailer Co. concludes that lease classification changes from operating to finance.

**ANALYSIS**

- The assessment of the modification is the same as in Example 6.7, and therefore the modification cannot be accounted for as a separate contract.
- The remeasurement of the lease liability and adjustment to the ROU asset is also the same as in Example 6.7. That is, after the remeasurement, the carrying value of the lease liability and ROU asset are $983,785 and $902,453, respectively.
- However, unlike Example 6.7, Retailer Co. does not calculate the updated straight-line lease expense. Instead, as of the effective date of the lease modification, the ROU asset is amortized on a straight-line basis to the earlier of the end of the underlying asset's useful life or lease term. However, 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 amortizes the right-of-use asset to the end of the asset's useful life.

**Example 6.8B - Modification is not accounted for as a separate lease - Lease classification changes from finance to operating**

**FACTS**

- Assume the same facts as in Examples 6 and 6.1 apply, in which Retailer Co's lease of manufacturing equipment was a finance lease. Also assume the following:
  - At the beginning of Year 6, Retailer Co. and the lessor agree to modify the lease to reduce the remaining lease term by two years and for revised annual lease payments of $130,000 for the remaining three years of the lease.
  - At the beginning of Year 6, the carrying amount of the lease liability and right-of-use assets are $590,767 and $447,169 (894,337*[5/10]), respectively.
  - Retailer Co.'s incremental borrowing rate at the effective date of the modification is 7%.

## ANALYSIS

- The modification reduces the term of the lease, and the term is an attribute of the lease. Therefore, the modification cannot be accounted for as a separate contract and Retailer applies ASC 842-10-25-11(b).
- Retailer Co. remeasures the lease liability based on the remaining 3-year lease term, 3 remaining payments using its incremental borrowing rate at the modification date of 7%.

| | PMT | Interest (7%) | Principal Amort. | Closing Balance |
|---|---|---|---|---|
| **Year 6** | -130,000 | 23,881 | -106,119 | 235,042 |
| **Year 7** | -130,000 | 16,453 | -113,547 | 121,495 |
| **Year 8** | -130,000 | 8,505 | -121,495 | 0 |
| **PV(7%)=** | **341,161** | | | |

- Consequently, the remeasured lease liability equals $341,161 (or a decrease of $249,606).
- The decrease in lease liability is recorded as an adjustment to the ROU asset (that is, there is no income or loss recognized at the modification date). The updated balance of the right-of-use asset is $197,562.
- Retailer Co. accounts for the lease at the modification date as an operating lease; e.g. the revised lease term is not for the major part of the remaining economic life of the underlying asset (3/7= 42.86%). Accordingly, Retailer Co. will record a single lease cost over the remaining lease term (3 years).
- In addition, in accordance with ASC 842-10-25-14, Retailer Co. accounts for the difference between the updated carrying amount of the ROU asset and the carrying amount of the ROU asset that would result from applying the initial measurement guidance for operating ROU assets, as either a rent prepayment or a lease incentive. Retailer Co. calculates that amount as follows:

| | |
|---|---|
| Updated ROU asset carrying amount | $197,562 |
| ROU operating lease carrying amount* | 341,161 |
| **Lease incentive** | **$(143,599)** |

* This amount represents the amount of the lease liability after remeasurement. There are no initial direct costs or lease incentives for the modification and, therefore, no further adjustments under ASC 842-20-30-5.

- Next, Retailer Co. calculates the remaining cost for the lease as follows*:

| | |
|---|---|
| Sum of remaining lease payments** | $390,000 |
| Less, lease incentive adjustment from above | (143,599) |
| Total remaining lease cost [A] | $246,401 |
| **Periodic lease cost** [B] = [A] / 3y | **$82,134** |

* Approach illustrated is based on application of ASC 842-10-25-14. Alternatively, Retailer Co. could determine the remaining lease cost by applying ASC 842-20-25-8. In doing so, the lease incentive calculated above of $143,599 would not be included under ASC 842-20-25-8(a) (it only relates to application of the method described in ASC 842-10-25-14), and the periodic lease cost previously recognized under ASC 842-20-25-8(c) would be determined as the sum of periodic interest and amortization of the ROU asset. Regardless of the approach selected, the total remaining lease cost should be the same.

** This amount reflects the remaining (modified) lease payments ($130,000 x 3 years).

- Retailer Co. recognizes annual straight-line lease expense of $82,134 for the remainder of the lease term.

- The accounting for the ROU asset after the remeasurement is summarized in the following table:

| | Opening balance [A] | Periodic lease cost [B] | Interest on lease liability [C] | Amortization [D] = [B] + [C] | Ending Balance [A] + [D] |
|---|---|---|---|---|---|
| Year 6 | 197,562 | -82,134 | 23,881 | -58,253 | 139,310 |
| Year 7 | 139,310 | -82,134 | 16,453 | -65,681 | 73,629 |
| Year 8 | 73,629 | -82,134 | 8,505 | -73,629 | 0 |

**Example 6.9A - Modification is not accounted as a separate lease - Partial termination**

**FACTS**

- Assume the same facts as in Examples 6 and 6.2 apply, in which the lease is an operating lease. Also assume the following:
    - At the beginning of Year 6 of the lease, Retailer Co. and the lessor agree to modify the original lease for the remaining 5 years to immediately reduce the leased retail space to only 5,000 square feet. In addition, the annual lease payments in Years 6-10 are reduced to $65,000.
    - At the beginning of Year 6, the carrying amount of the lease liability and right-of-use assets are $590,767 and $509,436, respectively.
    - Retailer Co.'s incremental borrowing rate at the effective date of the modification is 7%.

**ANALYSIS**

- Retailer Co. concludes that the modification should not be accounted for as a separate contract, as it does not grant Retailer Co. an additional right of use but rather decreases the original scope of the lease (from 10,000 square feet to 5,000 square feet).

- At the effective date of the modification, Retailer Co. reassesses lease classification and concludes that the lease continues to be an operating lease.

- Retailer Co. remeasures the lease liability based on the remaining 5-year lease term and discounts the remaining payments using its incremental borrowing rate at that date.

| | PMT | Interest (7%) | Principal Amort. | Closing Balance |
|---|---|---|---|---|
| Year 6 | -65,000 | 18,656 | -46,344 | 220,169 |
| Year 7 | -65,000 | 15,412 | -49,588 | 170,581 |
| Year 8 | -65,000 | 11,941 | -53,059 | 117,521 |
| Year 9 | -65,000 | 8,226 | -56,774 | 60,748 |
| Year 10 | -65,000 | 4,252 | -60,748 | 0 |
| | | | | |
| **PV(7%)=** | **266,513** | | | |

- The carrying amount of the right-of-use asset is determined using either of the following approaches:

<table>
<tr><th>Method A - Remeasuring the ROU asset based on the change in lease liability</th><th>Method B - Remeasuring the ROU asset based on the remaining right-of-use</th></tr>
<tr><td>
Lease liability after modification 266,513<br>
Lease liability before modification (590,767)<br>
Remeasurement adjustment (324,254)<br>
Percentage change in liability (54.89)%<br><br>
Pre-modification ROU asset: 509,436<br>
Percentage of change in liability (54.89)%<br>
Reduction ROU asset (279,614)<br><br>
| | $ | $ |<br>
Lease liability 324,254<br>
Other income/gain 44,640<br>
Right-of-use asset 279,614<br><br>
The updated balance of the lease liability and of the right-of-use asset after the above journal entry are $266,513 and $229,822, respectively.
</td><td>
Reduction in ROU (5,000)/10,000SF = (50.00)%<br>
Pre-modification ROU asset 509,436<br>
Percentage of change in ROU (50.00)%<br>
Reduction to ROU asset (254,718)<br><br>
Pre-modification lease liability 590,767<br>
Percentage of change in ROU (50.00)%<br>
Reduction to lease liability (295,384)<br><br>
| | $ | $ |<br>
Lease liability 295,384<br>
Other income/gain 40,666<br>
Right-of-use asset 254,718<br><br>
The difference between the remeasurement of the lease liability of $266,513 (reflecting the revised lease payments and updated discount rate) and the remaining lease liability of $295,383 (590,767 - 295,384) after the above journal entry is recorded as an adjustment to the ROU asset:<br><br>
| | $ | $ |<br>
Lease liability 28,870<br>
Right-of-use asset 28,870<br><br>
The updated balance of the lease liability and of the right-of-use asset after the above journal entries are $266,513 and $225,848, respectively.
</td></tr>
</table>

- Retailer Co. then updates the periodic lease cost for the remainder of the lease (10 years):

**If Method A (change in lease liability) was used**

| | |
|---|---|
| Total lease payments (paid and not yet paid)* | $560,744 |
| Plus, initial direct costs** | 9,023 |
| Less, periodic lease cost recognized in prior periods*** | (281,458) |
| Total remaining lease cost [A] | $288,309 |
| **Periodic lease cost** [B] = [A] / 5y | **$57,662** |

* This amount reflects the total revised lease payments. It includes the relative portion (100% - 54.89% reduction in ROU = 45.11%) after remeasurement of the payments paid in Years 1-5 (552,563 * 45.11% = $249,278), plus the revised lease payments for the remaining lease term ($325,000), less the relative balance of the lease incentive received at commencement date of $13,534 ($30,000 x 45.11%).

** Represents the relative portion of the initial direct costs after remeasurement ($20,000 * 45.11%)

*** Represents the relative portion of the periodic lease cost recognized in Years 1-5 ($124,779 * 45.11% * 5).

| | Opening balance [A] | Periodic lease cost [B] | Interest on lease liability [C] | ROU Amortization [D] = [B] + [C] | Ending Balance [A] + [D] |
|---|---|---|---|---|---|
| Year 6 | 229,822 | -57,662 | 18,656 | -39,006 | 190,816 |
| Year 7 | 190,816 | -57,662 | 15,412 | -42,250 | 148,566 |
| Year 8 | 148,566 | -57,662 | 11,941 | -45,721 | 102,845 |
| Year 9 | 102,845 | -57,662 | 8,226 | -49,435 | 53,410 |
| Year 10 | 53,410 | -57,662 | 4,252 | -53,410 | 0 |
| | | | 58,487 | | |

*Note:* Retailer Co. could also have determined the remaining lease cost based on the updated ROU asset of $229,822, plus the sum of periodic interest accretion in Years 6-10 of $58,487 (per above table), which equals $288,309, or an annual lease cost of $57,662. This could be used as an independent recalculation of the remaining lease cost for accuracy purposes.

**If Method B (Percentage of the remaining right of use) was used**

| | |
|---|---|
| Total lease payments (paid and not yet paid)* | $586,282 |
| Plus, initial direct costs** | 10,000 |
| Less, periodic lease cost recognized in prior periods*** | (311,947) |
| Total remaining lease cost [A] | $284,335 |
| **Periodic lease cost** [B] = [A] / 5y | **$56,867** |

* This amount reflects the total revised lease payments. It includes the relative portion (100% - 50.00% reduction in ROU = 50.00%) after remeasurement of the payments paid in Years 1-5 (552,563 * 50% = $276,282), plus the revised lease payments for the remaining lease term ($325,000), less the relative balance of the lease incentive received at commencement date of $15,000 ($30,000 * 50%).

** Represents the relative portion of the initial direct costs after remeasurement ($20,000 * 50%).

*** Represents the relative portion of the periodic lease cost recognized in Years 1-5 ($124,779 * 50% * 5).

| | Opening balance | Periodic lease cost | Interest on lease liability | ROU Amortization | Ending Balance |
|---|---|---|---|---|---|
| | [A] | [B] | [C] | [D] = [B] + [C] | [A] + [D] |
| Year 6 | 225,848 | -56,867 | 18,656 | -38,211 | 187,637 |
| Year 7 | 187,637 | -56,867 | 15,412 | -41,455 | 146,182 |
| Year 8 | 146,182 | -56,867 | 11,941 | -44,926 | 101,255 |
| Year 9 | 101,255 | -56,867 | 8,226 | -48,640 | 52,615 |
| Year 10 | 52,615 | -56,867 | 4,252 | -52,615 | 0 |
| | | | 58,487 | | |

*Note:* Retailer Co. could also have determined the remaining lease cost based on the updated ROU asset of $225,848, plus the sum of periodic interest accretion in Years 6-10 of $58,487 (per above table), which equals $284,335, or an annual lease cost of $56,867. This could be used as an independent recalculation of the remaining lease cost for accuracy purposes.

Example 18 in ASC 842-10-55-177 through 55-185 provides two different methodologies for determining the proportionate reduction in the right-of-use asset in a partial termination and for calculating the gain or loss on partial termination. We illustrated this accounting in Example 6.9A above. The FASB noted in paragraph BC177 of ASU 2016-02 that both approaches are acceptable to the Board. Consistent with ASC 842-10-10-1, we believe an entity should apply an approach consistently to lease modifications with similar characteristics and in similar circumstances.

**Example 6.9B - Modification is not accounted as a separate lease - Partial termination and extension of the lease term**

**FACTS**

- Assume the same facts as in Examples 6 and 6.2 apply, in which the lease of the retail space is an operating lease. Also assume the following:
  - At the beginning of Year 6 of the lease, Retailer Co. and the lessor agree to modify the original lease such that the retail space Retailer Co. uses is reduced from 10,000 square feet to 5,000 square feet effective at the modification date, the term of the lease is extended by three years, and lease payments are reset to $68,000 annually, with a 5% annual increase for the remainder of the revised term.
  - At the beginning of Year 6, the carrying amount of the lease liability and right-of-use asset are $590,767 and $509,436, respectively.
  - Retailer Co.'s incremental borrowing rate at the effective date of the modification is 7%.

**ANALYSIS**

- Retailer Co. concludes that the modification cannot be accounted for as a separate contract, as it does not grant Retailer Co. an additional right of use but rather decreases the original scope of the lease (from 10,000 square feet to 5,000 square feet) and also extends the lease term for the remaining right of use (an attribute of the original lease).
- Retailer Co. should account for the partial termination and the extension of the term, considering the change in lease payments. To do so, we believe Retailer Co. can first account for the partial termination (in the same manner as in Example 6.9A), and then account for the term extension.
- Assume Retailer Co. applies Method B described in Example 6.9A (remeasuring the ROU asset based on the remaining right of use).
- Regardless of the method used to account for the reduction in the ROU asset, the remeasured lease liability after accounting for the partial termination and term extension is the same, and is based on the remaining lease term and payments, discounted using Retailer Co.'s incremental borrowing rate at the modification date.

| | PMT | Interest (7%) | Principal Amort. | Closing Balance |
|---|---|---|---|---|
| **Year 6** | -68,000 | 33,346 | -34,654 | 441,711 |
| **Year 7** | -71,400 | 30,920 | -40,480 | 401,231 |
| **Year 8** | -74,970 | 28,086 | -46,884 | 354,347 |
| **Year 9** | -78,719 | 24,804 | -53,914 | 300,433 |
| **Year 10** | -82,654 | 21,030 | -61,624 | 238,809 |
| **Year 11** | -86,787 | 16,717 | -70,071 | 168,738 |
| **Year 12** | -91,127 | 11,812 | -79,315 | 89,423 |
| **Year 13** | -95,683 | 6,260 | -89,423 | 0 |
| **PV(7%)=** | **476,365** | | | |

- Retailer Co. applies the following steps to account for the partial termination and term extension:

**Worksheet for partial termination accounting:**

| | |
|---|---|
| Reduction in ROU (5,000)/10,000SF = | (50.00)% |
| Pre-modification ROU asset | 509,436 |
| Percentage change in ROU | (50.00)% |
| Reduction to ROU asset | (254,718) |

| | |
|---|---|
| Pre-modification lease liability | 590,767 |
| Percentage change in ROU | (50.00)% |
| Reduction to lease liability | (295,384) |

| | $ | $ |
|---|---|---|
| Lease liability | 295,384 | |
| Other income/gain | | 40,666 |
| Right-of-use asset | | 254,718 |

**Worksheet for term extension accounting:**

| | | |
|---|---|---|
| Lease liability before modification | $590,767 | |
| Partial termination adjustment (journal entry above) | (295,384) | |
| Lease liability balance after partial termination | 295,383 | [A] |
| Remeasured lease liability amount (see table above) | 476,365 | [B] |
| Remaining adjustment [B] – [A] | $180,982 | |

The difference between the remeasured lease liability of $476,365 and the lease liability balance after the partial termination entry of $295,383 is recorded as an adjustment to the ROU asset:

| | $ | $ |
|---|---|---|
| Right-of-use asset | 180,982 | |
| Lease liability | | 180,982 |

Following the above entries, the carrying amounts of the lease liability and right-of-use asset are $476,365 and $435,700, respectively.

# IMPAIRMENT

## IMPAIRMENT ASSESSMENT OVERVIEW

The FASB determined that a right-of-use asset is a long-lived nonfinancial asset and, therefore, should be within the scope of the Impairment or Disposal of Long-Lived Assets Subsection of ASC 360. Therefore, right-of-use assets must be monitored for impairment, like other long-lived nonfinancial assets, regardless of whether the lease is an operating lease or a finance lease.

The impairment assessment is performed at the asset group level, which is the lowest level for which identifiable cash flows are largely independent of the cash flows of other groups of assets and liabilities.

An asset group is tested for impairment when events or changes in circumstances indicate that the asset group may not be recoverable. ASC 360-10-35-21 provides the following examples:

| | | |
|---|---|---|
| A significant decrease in the market price of a long-lived asset (asset group) | A significant adverse change in the extent or manner in which a long-lived asset (asset group) is being used or in its physical condition | A significant adverse change in legal factors or in the business climate that could affect the value of a long-lived asset (asset group), including an adverse action or assessment by a regulator |
| An accumulation of costs significantly in excess of the amount originally expected for the acquisition or construction of a long-lived asset (asset group) | A current period operating or cash flow loss combined with a history of operating or cash flow losses or a projection or forecast that demonstrates continuing losses associated with the use of a long-lived asset (asset group) | A current expectation that, more likely than not, a long-lived asset (asset group) will be sold or otherwise disposed of significantly before the end of its previously estimated useful life. The term more likely than not refers to a level of likelihood that is more than 50 percent |

When impairment indicators exist, an asset (asset group) should be tested to determine whether there is an impairment. The impairment test is a two-step process as follows:

***Step 1 - Determine if the asset group is recoverable***. To do so, compare (a) the carrying value of the asset group with (b) the undiscounted cash flows expected from the asset group's direct use and eventual disposal. If (a) exceeds (b), the asset group is not recoverable and the entity moves to Step 2.

***Step 2 - Determine the impairment loss***. To do so, determine the asset group's fair value and recognize an impairment loss, if any, for the excess of the asset group's carrying amount over its fair value.

- The impairment loss reduces only the carrying amounts of a long-lived asset or assets of the group.
- The impairment loss is allocated to the long-lived assets in the asset group (including ROU assets) on a pro rata basis using the relative carrying amounts of those assets, except that individual long-lived assets cannot be written down below their individual fair values whenever that fair value is determinable without undue cost and effort.

The impairment model under ASC 360-10-35 is not new but the recognition of new right-of-use assets associated with operating leases has resulted in questions about the application of ASC 360.

For finance leases, consistent with capital leases under ASC 840, lease liabilities are excluded when testing an asset group for impairment. This is because debt related to financing of long-lived assets generally is excluded. Because the finance lease liability is excluded from the asset group, the finance lease payments also are excluded when determining the undiscounted cash flows of the asset group.

## IMPAIRMENT ASSESSMENT FOR OPERATING LEASES

Because ASC 842 and ASC 360 do not specify whether the related lease liability for operating leases should be included in an asset group for impairment testing purposes, we believe there are multiple acceptable approaches which we summarize in the following table.

| | Approach A | Approach B | Approach C |
|---|---|---|---|
| Step 1 - In determining the carrying amount of the asset group: | *Exclude* operating lease liability | *Include* operating lease liability | *Include* operating lease liability |
| Step 1 - In determining the undiscounted cash flows:[a,b] | *Exclude* lease payments | *Include* lease payments but *exclude* the portion related to interest accretion | *Include* lease payments, with *inclusion* of the portion related to interest accretion |
| Step 2 - In determining the fair value of the asset group under a discounted cash flow approach:[a,b,c] | Same approach as Step 1 above | Same approach as Step 1, but include *total* lease payments (since the cash flows will be discounted) | Same approach as Step 1 above |

Note a - Use entity specific assumptions in Step 1, and market participant assumptions (highest and best use) in Step 2.

Note b – Cash flows include variable lease payments not included in the measurement of the lease liability.

Note c - In allocating the impairment loss to the long-lived assets in the asset group (i.e., the pro rata allocation subject to the individual fair value limitation), consider the right-of-use asset without the lease liability.

We believe each of the above approaches is acceptable because:

- For Approach A, the operating lease liability is akin to a financial liability and it is measured the same way as finance lease liabilities. Therefore, under that view, the approach under ASC 360 should be the same whether the lease is an operating lease or a finance lease.
- For Approach B, the lease is classified as an operating lease, and the related liability may be viewed as an operating liability, rather than debt (see paragraph BC14 of ASU 2016-02). Therefore, like other operating liabilities, the operating lease liability is included in determining the carrying amount of the asset group. However, the lease payments should exclude the portion related to interest accretion on the lease liability as it relates to capitalization/ financing of the entity, not its operations.
- For approach C, this is consistent with approach B, except that the lease payments included in the undiscounted cash flows are the total operating lease payments (because the operating lease cost is recognized as a single lease cost).

Because the different approaches are consistent in how they treat the liability and related cash flows (either both are included or both are excluded), the approach selected generally should not significantly change whether an asset group is impaired, and an entity should select an approach and apply it consistently.

**Additional Complexities Related to Application of ASC 360 to Right-of-use Assets - Abandonments and Subleases**

As described above, ASC 842 requires an entity to apply the guidance on impairment of long-lived assets in ASC 360 to right-of-use assets. Now that operating leases are recognized on balance sheet, there are additional complexities related to impairment and other standards that an entity will need to consider. For example, after a lease has begun, an entity may consider subleasing or abandoning either the leased asset or a portion of the underlying asset. These may be necessary business decisions, but they will result in additional accounting questions that need to be addressed. Some of those questions include:

**Did the entity appropriately identify its lease components (the unit of account under ASC 842)?**

A lessee may have initially assumed that the unit of account under ASC 842 was a single lease component (for example, one lease component for a lease of multiple floors in an office building). This may have been because the accounting outcome under ASC 842 was the same whether the contract included a single lease component or a lease component for each floor leased. However, entering into a sublease or deciding to abandon a portion of a right-of-use asset raises a unit of account question. Because of the sublease or abandonment, the lessee should determine how many lease components the lease contract includes, as it may for example affect asset groupings under ASC 360, and whether impairment triggers exist, among other aspects.

**Does it affect asset groupings for impairment testing purposes?**

ASC 360 requires an entity to group assets at the lowest level for which identifiable cash flows are largely independent of the cash flows of other groups of assets and liabilities. There generally is judgment in determining asset groupings, although entering into a sublease will usually result in that asset being deemed its own asset group, as it will generate standalone cash flows from the sublease. A lessee should have processes in place to evaluate whether, and if so, when, asset groupings would change due to sublease and abandonment decisions.

**Is the entity required to test the asset group for impairment?**

Subleasing the underlying asset for the remainder of the lease term is not considered abandoning the asset because the lessee continues to derive economic benefits from use of the asset (through the cash flows on the sublease). However, ASC 842-20-35-14 provides that if a lessee enters into a sublease for which the lease cost for the term of the sublease exceeds the anticipated sublease income for that same period, the original lessee should treat that circumstance as an indicator that the carrying amount of the right-of-use asset associated with the original lease may not be recoverable.

The decision to abandon a right-of-use asset may also be an indicator that an impairment test is required for the asset group, as it represents a significant adverse change in the extent or manner in which the asset is being used. Whether an impairment test is performed will depend on how significant the asset to be abandoned is to the asset group, which will require the use of professional judgment.

**Should the entity revise the useful life of some of the long-lived assets, including the leased asset?**

ASC 360-10-35-22 notes that when a long-lived asset is tested for recoverability, it also may be necessary to review depreciation estimates and method as required by ASC 250 (see ASC 250-10-45-17 through 45-20 and 250-10-50-4). Any revision to the remaining useful life of a long-lived asset resulting from that review also should be considered in developing future cash flow estimates when testing the asset (asset group) for recoverability.

Also, if an entity commits to a plan to abandon a long-lived asset before the end of its previously estimated useful life, ASC 360-10-35-47 notes that depreciation estimates should be revised to reflect the asset's use over its shortened useful life.

See also ASC 360-10-S99-2 (SAB Topic 5.CC, Impairments) for an example related to a mainframe computer to be abandoned for additional considerations, including timing of revision of estimated useful lives, and below for an SEC staff speech on this topic.

**Should the entity record additional liabilities under other standards, such as exit or disposal cost obligations (ASC 420, Exit or Disposal Cost Obligations)?**

While charges that are considered lease payments (whether fixed or variable) are excluded from the guidance in ASC 420 on exit or disposal cost obligations, if the lease contract includes nonlease components and the lessee elected to separate the lease and non-lease components, the lessee should accrue the portion of fixed payments and estimated variable payments allocated to the non-lease components on the cease-use date of an underlying asset subject to a lease. This is summarized in the following table:

| | |
|---|---|
| **Lessee elected non-separation practical expedient.** | Payments for non-lease components or non-components (e.g. taxes, insurance) are all lease payments (whether fixed or variable), and therefore are outside the scope of ASC 420. |
| **Lessee did not elect non-separation practical expedient.** | The lessee should accrue the portion of the fixed payments and estimated variable payments allocable to the nonlease component (for example, common area maintenance). |

**Operating Lease Right-of-use Asset Not Impaired, But for Which Estimated Useful Life Is Shortened**

If a right-of-use asset is determined to not be impaired under ASC 360, there is no basis to write down the carrying amount of the right-of-use asset. However, as previously discussed, a lessee may have to revise (shorten) the previously estimated useful life of the asset when a lessee anticipates abandoning it prior the end of the lease term. When this occurs, the link between the economic benefits to be derived from the lease and the lease payments is broken, similar to the FASB's view described below in Accounting for Operating Leases Once Impaired.

In those situations, while not explicit in ASC 842, we believe it may be appropriate for the lessee to account for the operating lease as if the right-of-use asset has been impaired. This is also consistent with the SEC staff speech reproduced below.

The SEC staff discussed the accounting for abandonment of right-of-use assets under the leases standard at the [2020 AICPA Conference on Current SEC and PCAOB Developments]:

Geoff Griffin
*Professional Accounting Fellow, Office of the Chief Accountant*

**"Right-of-use asset guidance**

[…] Consider a fact pattern where the registrant identified leases for abandonment, but expected there to be an extended period of time between the identification of abandonment and the actual abandonment date. The registrant noted that the leases standard requires a lessee to recognize any impairment loss for a right-of-use asset in accordance with existing guidance on impairment or disposal of long-lived assets;[9] however, upon performing an impairment assessment of the asset group, the registrant concluded there was no impairment. In this fact pattern, the registrant's identification of specific leases for abandonment did not result in a change to the asset group (i.e., the lowest level of identifiable cash flows) for which it assessed impairment.

The registrant noted that the leases standard did not provide explicit guidance to address its unique circumstances. The registrant identified a number of alternatives that it believed could be acceptable but ultimately concluded that it would be appropriate to adjust the amortization period of the right of use assets associated with the leases identified for abandonment. Given its plans to abandon these leases, and in the absence of any impairment, the registrant re-evaluated the economic life of the associated right-of-use assets and determined that the remaining right-of-use assets should be amortized ratably over the period between identification of abandonment and the actual abandonment date.

The staff did not object to the registrant's conclusion."

[9] See ASC 842-20-35-9.

## ACCOUNTING FOR OPERATING LEASES ONCE IMPAIRED

After a right-of-use asset has been impaired, it is subsequently measured at its carrying amount immediately after the impairment less any accumulated amortization, and is amortized from the impairment date to the earlier of the end of its useful life or the end of the lease term. A previously recognized impairment loss cannot be reversed.

For an operating lease, this means that the updated single lease cost following an impairment is calculated as the sum of the following:

- Amortization of the remaining balance of the right-of-use asset after the impairment, generally on a straight-line basis (unless another systematic basis is more representative of the pattern in which the lessee expects to consume the remaining economic benefits from its right to use the underlying asset),
- Accretion of the lease liability using the interest method, as before the impairment.

When an operating lease ROU asset is impaired, the FASB concluded in paragraph BC259 of ASU 2016-02 "that the link that many perceive between the economic benefits to be derived from the lease and the lease payments, and reference in support of a single, generally straight-line lease cost for operating leases, is effectively "broken" after the right-of-use asset is impaired because the lessee will no longer obtain future economic benefits from the lease equal to (or greater than) the payments it is required to make to the lessor. In other words, the lease payments no longer have any direct correlation to the economic benefits the lessee is able to derive from the lease but, instead, represent a liability reflective of a past expectation of economic benefits that could be derived from the lease."

Therefore, while a lessee will continue to recognize a single lease cost for an operating lease following an impairment, it will no longer be recognized on a straight-line basis.

**Operating Lease Right-of-use Asset Impaired and Subsequently Modified or Remeasured**

After a right-of-use asset is impaired, the lease may be subsequently modified (and that modification is not accounted for as a separate contract), or the lease may be remeasured (for example, because of a reassessment of the lease term or purchase option). As discussed in Reassessments and Modifications, certain reassessment events and modifications not accounted for as a separate contract result in accounting for the lease essentially in the same way as a new lease. Even so, we believe the lessee should continue to apply the guidance on operating leases that have been impaired. This is because the link between the economic benefits to be derived from the lease and the lease payments continues to be "broken" even after a modification or reassessment. That is, the lessee continues to no longer obtain future economic benefits from the lease equal to (or greater than) the revised lease payments. Therefore, the lessee continues to amortize the remeasured right-of-use asset on a straight-line basis.

**Example 6.10 - Impairment of right-of-use asset - Operating lease**

**FACTS**

- Assume the same facts as in Examples 6 and 6.2 apply, in which the lease of retail space is an operating lease. Also assume the following:
  - For impairment testing purposes, the leased retail space is part of Asset Group A, which includes the operating lease right-of-use asset, leasehold improvements, inventory and operating payables.
  - At the end of Year 2 of the lease, there is a significant adverse change in the business climate and lower financial performance than initially anticipated, and Retailer Co. tests Asset Group A for recoverability.
  - The asset group is comprised of the right-of-use asset with an ending balance of $750,556, unamortized leasehold improvements of $100,000, and the carrying value of inventory and operating payables offset each other. The ending balance of the lease liability is $805,114.
  - Retailer Co. elected to assess impairment by applying Approach C (explained below).
  - Based on that approach, assume that the undiscounted expected cash flows associated with Asset Group A are determined to be $40,000 over the remaining lease term, and the fair value of Asset Group A is $35,000.

**ANALYSIS**

- Retailer Co. applies Approach C as follows:

| Approach C | |
|---|---|
| **Step 1 - Determine the carrying amount of the asset group by including the operating lease liability** | $45,442 (ROU asset of $750,556, less lease liability of $805,114, plus unamortized leasehold improvements of $100,000). |
| **Step 1 - Determine the undiscounted expected cash flows which include the entire amount of the lease payments** | $40,000.<br>The asset group is considered not recoverable as the carrying value of the asset group of $45,442 is higher than the undiscounted cash flows of $40,000. Retailer Co. proceeds to Step 2. |
| **Step 2 - Determine the impairment loss using a fair value approach such as the DCF analysis.** | $10,442 (carrying value of $45,442 less fair value of $35,000). |

- Retailer Co. records an impairment charge of $10,442. The impairment loss is applied on a pro rata basis only to the long-lived assets in the asset group, which in this Example are the operating lease right-of-use asset and the leasehold improvements. The impairment loss does not reduce each long-lived asset's carrying value below their respective fair value and therefore Retailer Co. records a journal entry as follows:

| | $ | $ | |
|---|---|---|---|
| Impairment loss | 10,442 | | |
| Right-of-use asset | | 9,215 | = 10,442 * (750,556/850,556) |
| Leasehold improvements | | 1,227 | = 10,442 * (100,000/850,556) |

- The carrying amount of the right-of-use asset after impairment is $741,341.
- Retailer Co. determines that amortizing the right-of-use asset over the remaining lease term remains appropriate (that is, the useful life is not shortened).
- Retailer Co. recognizes a single lease cost as determined under ASC 842-20-25-7. Therefore, the single lease cost in each period following the impairment is calculated as the sum of (a) the straight-line amortization of the remaining carrying amount of the right-of-use asset over the remaining lease term of 8 years, and (b) the interest accretion of the lease liability in each of the remaining years (which is unchanged). This results in the single lease cost no longer being fixed at each of the remaining periods, as illustrated in the following table.

| | Opening balance | Amortization | Closing balance | Interest on liability | Periodic lease cost |
|---|---|---|---|---|---|
| | [A] | [B] | [A] + [B] | [C] | [B] + [C] |
| Year 3 | 741,341 | -92,668 | 648,673 | -48,307 | -140,974 |
| Year 4 | 648,673 | -92,668 | 556,006 | -44,590 | -137,258 |
| Year 5 | 556,006 | -92,668 | 463,338 | -40,320 | -132,988 |
| Year 6 | 463,338 | -92,668 | 370,671 | -35,446 | -128,114 |
| Year 7 | 370,671 | -92,668 | 278,003 | -29,915 | -122,583 |
| Year 8 | 278,003 | -92,668 | 185,335 | -23,669 | -116,337 |
| Year 9 | 185,335 | -92,668 | 92,668 | -16,647 | -109,315 |
| Year 10 | 92,668 | -92,668 | 0 | -8,781 | -101,449 |

## DERECOGNITION

ASC 842 provides specific derecognition requirements for the following events:

| | Accounting |
|---|---|
| **Lease termination before expiration of lease term** | ▶ Derecognize right-of-use asset and lease liability<br>▶ Recognize any difference in profit or loss |
| **Purchase of the underlying asset** | ▶ Adjust the carrying amount of the asset for any difference between the purchase price and the carrying amount of the lease liability immediately before the purchase.<br>▶ This accounting does not apply for underlying assets acquired in a business combination, which are initially measured at fair value in accordance with ASC 805-20-30-1. |
| **Sublease in which the original lessee is relieved of primary obligation under the original lease** | ▶ Derecognize right-of-use asset and lease liability<br>▶ Recognize any difference in profit or loss<br>▶ Any consideration paid or received upon termination that was not already included in the lease payments (for example, a termination payment) is included in the determination of profit or loss to be recognized.<br>▶ If original lessee is secondarily liable, the lessee also recognizes a guarantee obligation in accordance with ASC 405-20-40-2. |

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