BDO KNOWS:

Topic 842, Leases - A View from the Check-out Lane

INTRODUCTION

In 2016, the Financial Accounting Standards Board (FASB) issued its new standard for the accounting of leases.[1] For calendar-year public business entities the new standard is effective now in 2019, including interim periods. On October 16, 2019, the FASB affirmed a one-year deferral for non-public entities which may move the effective date for the non-public, calendar year entities from 2020 to 2021, and interim periods within 2022.

In this newsletter, we will assess the provisions most applicable to companies in the retail and restaurant sectors, focusing primarily from the perspective of lessees under generally accepted accounting principles (GAAP) in the US. Accounting for lessors under this new standard had limited changes from previous GAAP, and sublessors are required to follow the same accounting treatment as lessors. Refer to BDO's Newsletter for more information on lessor accounting, which is available **here**.

OVERVIEW

More and more retailers and restaurants choose to lease their store locations rather than buy them. This trend has accelerated over the last five to ten years, as exemplified by various brands spinning off their owned real estate into separate REITs or entering into master sale-leasebacks for the properties. However, leasing isn't limited to real estate, as many companies also choose to rent various equipment, including smart safes, security cameras and other operating equipment. As a result, leasing is now a significant activity for most retail and restaurant companies, and the adoption of the

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1 ASU 2016-02, Leases which has been amended by the following updates:

- Accounting Standards Update (ASU) 2018-01, Land Easement Practical Expedient for Transition to Topic 842
- ASU 2018-10 Codification Improvements to Topic 842
- ASU 2018-11, Targeted Improvements.
- ASU 2018-20 Narrow-Scope Improvements for Lessors
- ASU 2019-01 Codification Improvements.

new leasing standard will likely result in a significant change to their balance sheets.

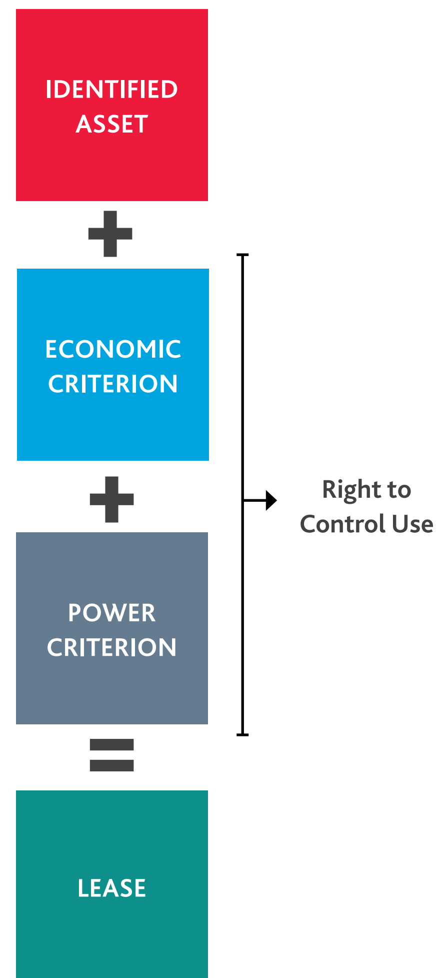
Under previous GAAP, lessees recognized capital leases on the balance sheet and disclosed operating leases as off-balance sheet arrangements. As such, there were no major differences in the accounting treatment for an operating lease versus a service contract, and, accordingly, lessees may not have historically put significant focus on contracts that may contain elements of lease and service arrangements. Conversely, lessees often put considerable time and effort into structuring leases to achieve operating lease treatment. The new standard requires virtually all leases to be recognized on the balance sheet by lessees, which is a significant change. Under Topic 842, a lessee will recognize right-of-use (ROU) assets and related lease liabilities on the balance sheet for virtually all leases regardless of classification. As such, the key determination will be whether a contract is or contains a lease as that will drive whether a contract is recognized on the balance sheet.

As mentioned previously, lessor accounting remains largely consistent with previous GAAP but has been updated for consistency with the new lessee accounting model and with the new revenue standard, ASU 2014-09.[2]

SCOPE

Topic 842 is to be applied to leases of property, plant or equipment, which is generally consistent with previous GAAP. As such, certain lease arrangements, such as those for intangible assets and inventory, are excluded from the scope of the standard. As a result, those other arrangements will continue to be accounted for under Topic 350 and Topic 330, respectively. Note, this does not preclude an entity from reviewing its population of contracts to ascertain if certain of these arrangements that relate to scope exceptions, such as inventory, contain elements for a lease of property, plant and equipment. Examples of contracts that should be evaluated include warehouse and distribution arrangements for goods and raw produce.

For a contract to be or include a lease, there must be an identified asset and the contract must grant to the customer both (a) the right to obtain substantially all of the economic benefits from the asset's use (the economic criterion), and (b) the right to direct the use of the identified asset (the power criterion) throughout the period of use.



Identified Asset

In order to have an identified asset, a contract must either explicitly or implicitly specify the asset. Similar to requirements under previous GAAP, an asset is not considered specified if the supplier has the right to substitute similar assets during the term of the contract and therefore maintain control. However, under the new standard substitution rights are considered substantive as described in ASC 842-10-15-10 only if the lessor (a) has the practical ability to substitute alternative assets throughout the period of use and (b) would benefit economically from the substitution. If a supplier's substitution rights are substantive, then the contract does not specify an identified asset, and thus does not contain a lease.

2 Revenue from Contracts with Customers

The ability for the supplier to substitute the asset only on or after a particular date or event, for repairs and maintenance or based on the availability of a technical upgrade, are not considered substantive. Further, the standard states that if the asset is located at the customer's premises, the costs associated with substituting the asset are generally higher than when located at the supplier's premises, and therefore are more likely to exceed the related benefits, and thus the substitution right would not be substantive. Generally, if the customer cannot determine whether a substitution right is substantive, the customer must presume that the substitution right is not substantive (that is, there is an identified asset, and the entity must evaluate the economic and power criteria to determine whether there is a lease).

BDO Observation: In addition to reviewing legal contracts to assess for embedded leases, discuss with business partners the types of equipment that suppliers or service providers may keep on-site. Examples might include fleet trucks and/ or security equipment.

Right to Control Use (Economic and Power Criteria)

In addition to an identified asset, a contract must convey to the customer the right to control the use of the asset, which is met when the customer has both (a) the right to obtain substantially all the economic benefits from the use of the asset (the economic criterion), and (b) the right to direct the use of the asset (the power criterion) throughout the period of use. A customer meets the power criterion if (1) it can direct, including change, how and for what purpose the asset is used throughout the period of use, or (2) when all the relevant decisions are predetermined, if the customer either designed the asset in a way that predetermined its use or the customer has the right to operate (or direct others in operating) the asset throughout the period of use.

Both the economic and control criteria are evaluated within the defined scope of the customer's right to use the asset. Terms that limit the use of the asset a certain way (for example specifying a maximum amount of usage of the asset) or that protect the supplier's interest in the asset (such as requiring the customer to follow industry-standard operating procedures, or requiring notification of changes in how or where the asset will be used) do not, in isolation, prevent the customer from having the right to direct the use of the identified asset. On the next few pages are several examples that apply the aforementioned criteria.

EXAMPLE 1 (ADAPTED FROM PARAGRAPH 842-10-55-63 THROUGH 55-71)

FACTS

Retailer enters into a contract with Airport Operator for the use of retail unit A for a five-year period. Retail unit A is part of a larger airport terminal with many retail units. Retailer is required to use retail unit A to operate its well-known store brand to sell its goods during the hours that the airport terminal is open. Retailer makes all of the decisions about the use of retail unit A during the period of use (e.g., deciding on the mix of goods and at what price to sell them), and controls physical access to the unit throughout the term. Retailer will pay Airport Operator $50,000 per month plus 6% of monthly net sales.

Airport Operator can require Retailer to relocate to another retail unit in the terminal. In that case, Airport Operator is required to provide Retailer with a retail unit of similar quality and specifications as retail unit A and to pay for Retailer's relocation costs, including reimbursement for any leasehold improvements that cannot be relocated. Airport Operator would benefit economically from relocating Retailer only if a major new tenant were to decide to occupy a large amount of retail space at a rate sufficiently favorable to cover the costs of relocating Retailer and other tenants in the space that the new tenant will occupy. Although it is possible that those circumstances will arise, at contract inception it is not likely that those circumstances will arise, and whether such circumstances occur is highly susceptible to factors outside of Airport Operator's influence.

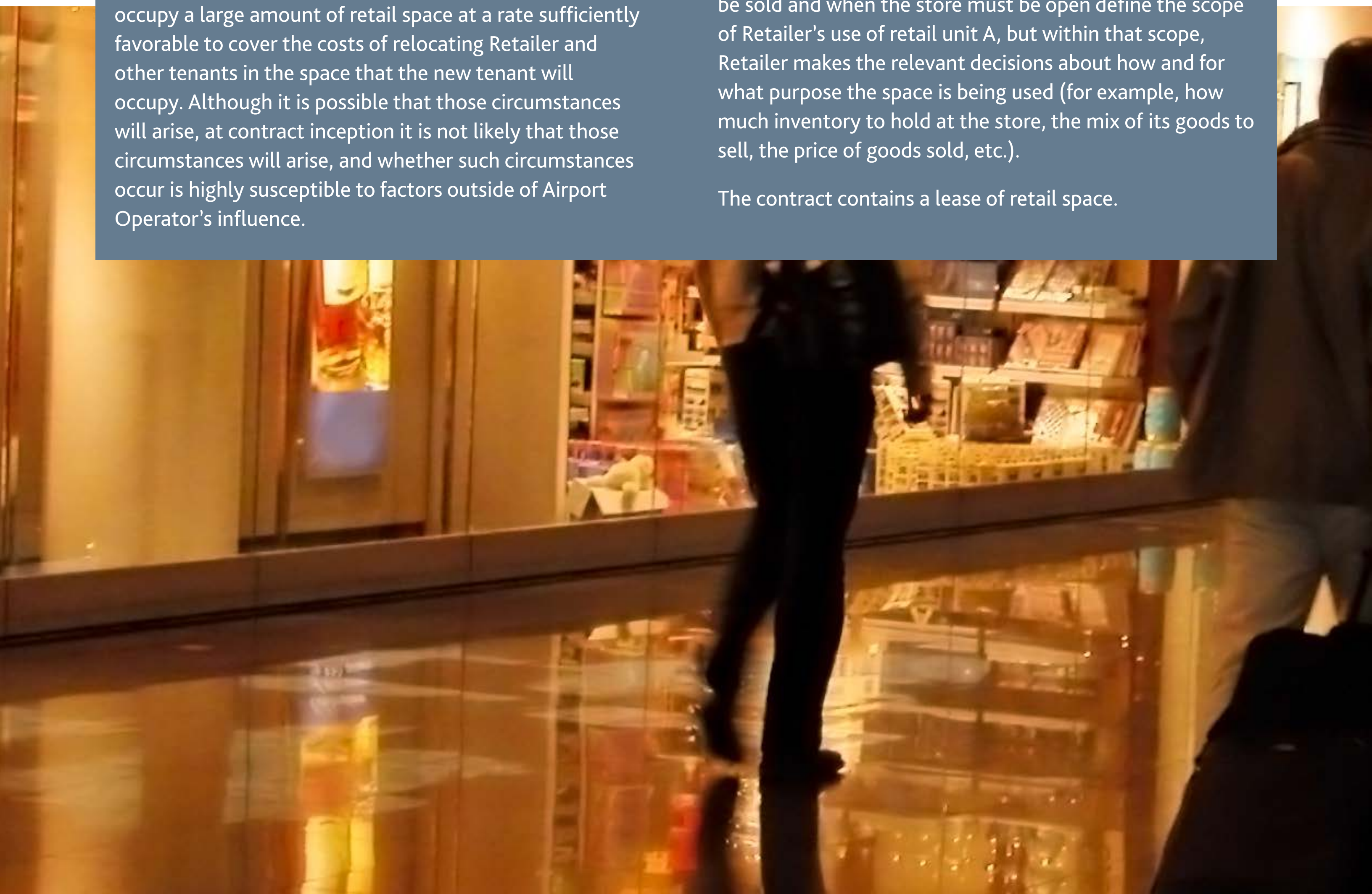
ANALYSIS

Is there an identified asset? Yes
Retail unit A is an identified asset which is explicitly specified in the contract. Airport Operator's substitution right is not substantive because Airport Operator would benefit economically from substitution only in specific circumstances that at inception of the contract are not likely to occur.

Is the economic criterion met? Yes
Retailer has exclusive use of retail unit A and therefore obtains substantially all of the economic benefits from use. Although Retailer will pay Airport Operator a portion of the cash flows derived from sales in retail unit A (i.e., 6% of monthly net sales), this represents consideration that Retailer pays to Airport Operator for the use of retail unit A and it does not affect the evaluation of the economic criterion in accordance with paragraph 842-10-15-19.

Is the power criterion met? Yes
The contractual restrictions on the types of goods that can be sold and when the store must be open define the scope of Retailer's use of retail unit A, but within that scope, Retailer makes the relevant decisions about how and for what purpose the space is being used (for example, how much inventory to hold at the store, the mix of its goods to sell, the price of goods sold, etc.).

The contract contains a lease of retail space.



EXAMPLE 2 (ADAPTED FROM PARAGRAPH 842-10-55-52 THROUGH 55-54)

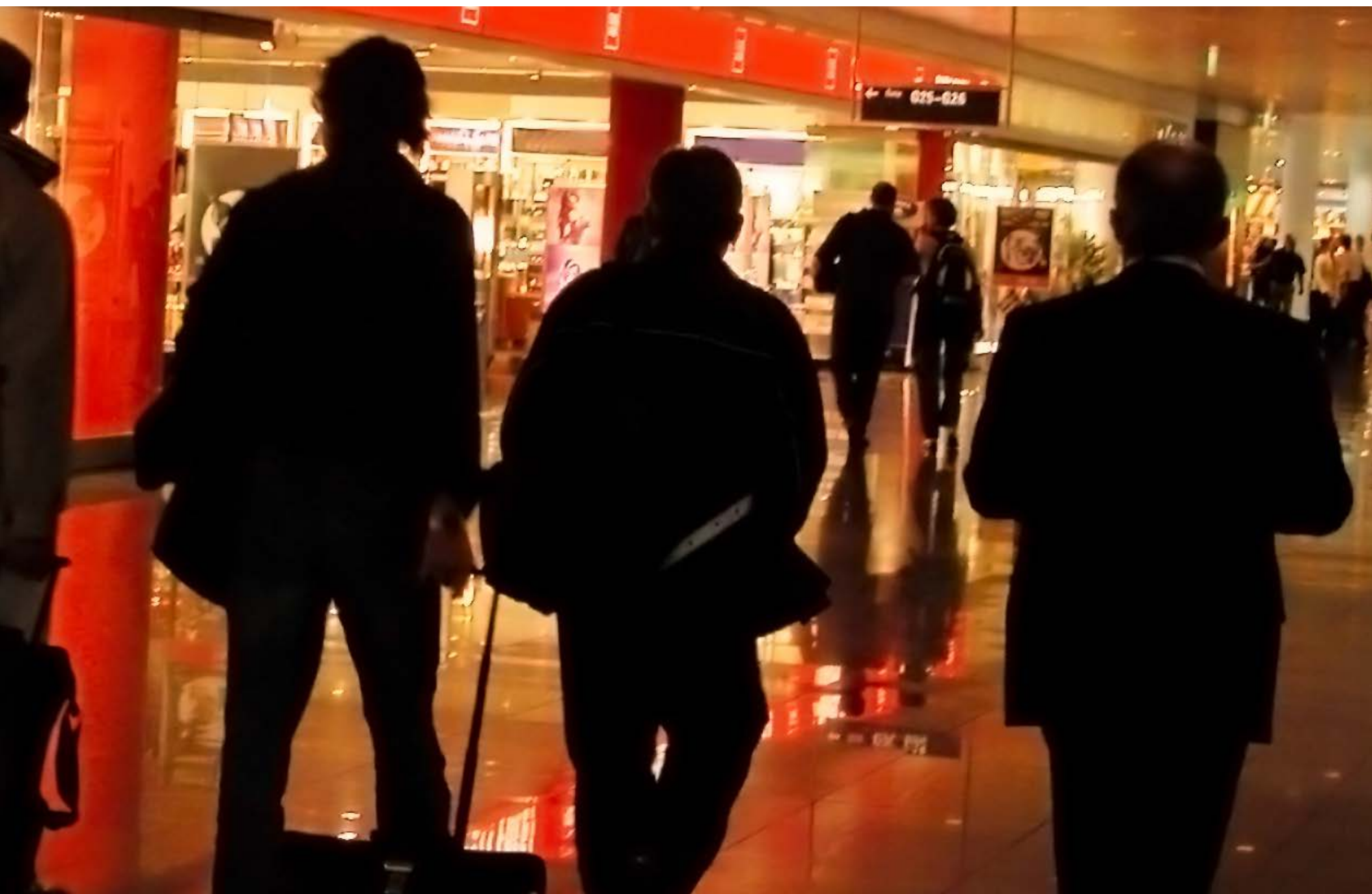
FACTS

Assume a similar situation as Example 1, except that the contract allows for the Retailer to use a designated area within the airport terminal. Retailer owns and utilizes a booth that is easily transferable to different areas in the airport terminal. Airport Operator has the ability to relocate the Retailer to different areas that would meet Retailer's specifications throughout the terminal at its discretion during the period of use. Airport Operator also would incur minimal costs associated with changing the space that Retailer uses based on activity in the airport terminal.

ANALYSIS

Is there an identified asset? No
Although the contract specifies that the Retailer will utilize a specific space in the airport to operate its booth, there are several other similar areas that the Retailer may be assigned to, which Airport Operator has the right to change, without Retailer's approval, throughout the period of use. Airport Operator would benefit economically from substituting/ relocating Retailer because the costs to move the booth are minimal, and substitution allows Airport Operator to use its airport space in the most effective way, for example relocating Retailer in other boarding areas in the airport to meet changing circumstances. Those conditions are likely to occur at contract inception considering Airport Operator's historical experience, business and operations. Accordingly, Airport Operator's substitution right is substantive.

The contract does not contain a lease.



EXAMPLE 3

FACTS

EZ Co owns and operates a group of convenience stores. EZ Co enters into an agreement with State Bank in which State Bank will provide armored car services to EZ Co for three years. During the term of the contract, State Bank will collect cash and checks from each store location three times per week, and those dates and times are predetermined in the contract and cannot be changed absent emergency situations. The armored car services do not include a lease and are not the subject of this example.

State Bank also provides one smart safe for each store location. The smart safe is connected electronically to State Bank's system and will transmit the value of cash and checks deposited into the safe to State Bank such that EZ Co receives credit in its bank account with State Bank within 24 hours of that deposit. Only State Bank has the right and ability to access the smart safes. Once an EZ Co employee deposits cash or checks into the safe, EZ Co cannot retrieve those items prior to State Bank's armored car service collecting them. However, EZ Co decides when to make deposits, as well as how much cash to deposit versus how much to retain for operating purposes.

ANALYSIS

Is there an identified asset? Yes
Each smart safe is implicitly specified once it is installed at the convenience store location, and State Bank does not have any substitution rights.

Is the economic criterion met? Yes
EZ Co obtains substantially all of the economic benefits from use of the safes throughout the three-year term of the contract because it has exclusive use of those safes. No other customer of State Bank can use the safes.

Is the power criterion met? Yes
Although State Bank has the right to access the safes to collect the funds deposited in them, that access is predetermined in the contract (the dates and times are predetermined in the contract and cannot be changed absent emergency situations). The ability to access the safes also would not grant State Bank the right to determine how and for what purpose the safe is used given the fact that State Bank gives EZ Co access to funds deposited in the safe in EZ Co's bank account prior to the funds actually being collected by State Bank. On the other hand, EZ Co determines whether to use the safe, and if so, when to use it and how much cash and checks to deposit into the safe throughout the period of use. Those are the most relevant decision-making rights that affect the economic benefits from use of the safes, and EZ Co (the customer) controls them.

The agreement contains a lease (each smart safe is a lease).

BDO Observation: Identification of contracts that are or contain leases is key. Most companies have historically tracked and accounted for traditional real estate and equipment leases. But retailers and restaurants should also consider other contracts for potential embedded leases, such as contracts for security services whereby the retailer / restaurant receives security equipment along with additional monitoring services from the supplier, or vending machines such as soda or gaming machines. Topic 842 does not provide a scope exception for small value leases, similar to the exception provided in IFRS 16, the leasing standard issued by the IASB. Nonetheless, the FASB does note in paragraph 122 in the Basis for Conclusions of ASU 2016-02 that entities may adopt reasonable capitalization thresholds below which lease assets and lease liabilities are not recognized, consistent with other applications of accounting policies, such as capitalization of property, plant and equipment. We believe that any application of a lease capitalization threshold should result in materially the same result when considering all leases, not solely the impact from applying the policy to a single lease, and must consider the impact of not recognizing both the right-of-use asset and the lease liability. Careful consideration should be given to the resulting non-recognition of lease liabilities which may result in the use of lower capitalization thresholds for leases as compared to property, plant, and equipment.

Lease and Nonlease Components

Once a contract is determined to be or include a lease based on the aforementioned criteria, the unit of account (called lease component in the standard) is typically the individual asset. Therefore, if a contract includes the lease of multiple assets, it should be separated into the individual assets if the lessee can benefit from the right to use each asset on its own or in conjunction with other readily available resources, and the right of use is neither highly dependent on nor highly interrelated with the other rights to use assets in the contract.

In addition, lessees must separate lease components from nonlease components. For purposes of this analysis, administrative tasks to initiate a lease and reimbursement of the lessor's costs (such as property taxes and insurance) are not considered components, and any consideration for those items therefore should be allocated to the components of the contract. Lessees must allocate the consideration to the separate lease and nonlease components on a relative standalone price basis. If observable standalone prices are not readily available, lessees must estimate standalone prices maximizing the use of observable information to the extent possible. The residual approach may be acceptable if the standalone price for a component is highly variable or uncertain.

However, the new standard does allow lessees a practical expedient under which entities can elect not to separate nonlease components under the contract, but instead account for them as part of the associated lease component. That results in a larger ROU asset and lease liability, and it may result in a change in lease classification, so companies will need to consider whether they will avail themselves of the practical expedient. The election is by asset class.

BDO Observation: The new standard also contains guidance requiring separate accounting for the land and building components, unless the effect of separating the land component would be insignificant. Accordingly, companies should at a minimum evaluate and document how they considered leases of land and property improvements.

Master Lease Arrangements

Often, one legal document may involve leases of multiple assets that are determined to be separate lease components. These documents are typically called master lease arrangements. The preceding analysis on determining the lease and nonlease components is applicable to these arrangements as well. Further, when assessing each lease component, the commencement date of the lease for each lease component may be different, which affects the timing and calculation of the lease liability and ROU asset and the lease classification test.

BDO Observation: For master leases, determine the ROU asset and lease liability upon commencement for each underlying asset and record each lease component separately in the system of record. This will make subsequent measurement events such as modifications easier to account for going forward. Additionally, this will ease any subsequent impairment analysis required under ASC 360 for the ROU asset.

Short-term Leases

The new standard provides lessees with a practical expedient related to short-term leases. Lessees can elect an accounting policy under which the recognition provisions of the standard are not applied to leases with lease terms of 12 months or less and that do not include an option to purchase the underlying asset that is reasonably certain to be exercised. This election must be made by asset class. If elected, leases that qualify for the exemption are not recognized on the balance sheet and lease payments related to these short term leases are recognized generally on a straight-line basis over the lease term, consistent with current accounting standards.

This recognition exemption however does not mean that short-term leases are scoped out of the new requirements. To qualify as short-term leases, lessees will need to assess the lease term like any other leases (e.g., determine whether it is reasonably certain the lessee will exercise a renewal option). Short-term leases are also subject to the reassessment requirements of the new standard and other requirements in the new standard, including disclosures.

EXAMPLE 4

FACTS

Calendar Co. sells calendars and holiday merchandise. In order to sell its products, it enters into an agreement to lease a storefront in a mall for the months of November and December each year for five years. The agreement specifies the storefront, and the mall owner cannot substitute another storefront. Does this arrangement qualify for the short-term lease practical expedient?

ANSWER

The agreement contains a lease. In order to determine whether the term is more than twelve months, Calendar Co. considers the "period of use" as defined in ASC 842-10-20 as "[t]he 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)." Because the periods of use are not consecutive, Calendar Co. must consider the aggregate term in order to determine whether it can apply the practical expedient for short term leases. The total aggregate term of the lease is ten months (two months per year for five years), and therefore Calendar Co. can elect to apply the practical expedient for short-term leases for this asset class.

KEY TERMS

Broadly speaking, the terms and concepts in Topic 842 are very consistent with similar terms and concepts in previous GAAP with focused attention on aligning certain of these terms with those in the recently effective guidance in Topic 606, Revenue from Contracts with Customers.

Commencement Date

The glossary defines the commencement date as "the date on which the lessor makes an underlying asset available for use by the lessee." This definition is consistent with previous GAAP. Upon this date, a lessee classifies the lease and recognizes an ROU asset and a lease liability.

BDO Observation: The commencement date may not be explicitly listed in contracts. Often, a lessee and lessor will negotiate expected commencement dates based on the availability of the asset. Developing a process to determine and accurately recognize the actual commencement date is crucial considering it is the date on which the lease is classified and recognized on balance sheet. Example documents to consider include letters acknowledging the transfer of possession and construction start dates, particularly with real estate transactions.

Lease Term

The lease term includes the noncancelable period for which the lessee has the right to use the underlying asset plus any period covered by an option to extend the lease if the lessee is reasonably certain to exercise the option or if the exercise of the option is controlled by the lessor. In addition, if the lease contains an early termination provision, the period covered by the termination option should be included unless the lessee is reasonably certain to exercise the termination option. Although the phrasing for the definition of lease term is slightly different from the "reasonably assured" concept under previous GAAP, the concept of "reasonably certain" is a relatively high threshold and is intended to be interpreted consistently with the "reasonably assured" concept in previous guidance.

In determining whether it is reasonably certain that an option will be exercised, an entity should consider all relevant economic and contractual factors consistent with paragraph 842-10-55-26, and include:

- Contractual terms and conditions,
- Significant leasehold improvements that are expected to have significant economic value after the initial lease term,
- Costs related to exiting the lease including negotiating a new lease and relocation costs,
- Costs associated with returning the leased asset to its contractually specified condition and/or location, and
- The importance of the underlying asset to the entity's operations.

Judgement should be consistently applied to determine what constitutes "significant" leasehold improvements that would require a lessee to include renewal options in the initial lease term.

EXAMPLE 5

FACTS

Retailer enters into a real estate lease agreement with Mall Operator that includes a base term of five years and three 5-year renewal options. Rent payments will begin once Retailer opens the store which is anticipated to be on June 1, 20x9. The expected delivery date for the store to the Retailer is April 1, 20x9. The Retailer will incur approximately $100,000 to install leasehold improvements to customize this space to its brand requirements. Typically, the Retailer's leasehold improvements have a useful life of eight years and are not transferable to another location.

The Mall Operator provides access to the store to the Retailer earlier than expected on March 1, 20x9, to install its leasehold improvements. Retailer's first monthly rental payment is due May 30, 20x9, which is the date the store opens.

When does the lease commence and what is the lease term?

ANSWER

The lease commences on March 1, 20x9 when the Mall Operator (lessor) makes the space available. Based on the existence of the significant leasehold improvements with a useful life longer than the base term, the Retailer would incur a significant economic loss by not exercising the first renewal option. Therefore, the lease term is ten years, base term plus one renewal period.

Lease Payments

Lease payments include the following:

- Fixed payments, including in substance fixed payments, less incentives paid or payable
- Variable lease payments based on an index or a rate, using the index or rate at the commencement date
- Exercise price of purchase option if reasonably certain
- Penalty payments if reflected in the lease term
- Fees paid by the lessee to owners of a special-purpose entity
- Amounts probable of being owed under a residual value guarantee

While fixed payments, purchase options and termination penalties are typically specified in the lease agreement, it may require judgment to determine whether variable payments are, in fact, unavoidable, and at what amount. Likewise, estimating the amount expected to be owed under a residual value guarantee will also require judgment.

BDO Observation: Leases may include in substance fixed payments that must be included in the measurement of the ROU asset and lease liability. In-substance fixed payments include payments that do not create genuine variability (such as those that result from clauses that do not have economic substance) and those that require the lower of two payments to be made when a lessee has a choice about a set of payments it makes. Lessees should focus on identifying payments that are unavoidable. One common example is when lease payments increase by the greater of the change in the consumer price index or a fixed percentage, for example 2%. Because the payments will increase based on the greater of those two amounts, they will always increase by at least 2%, making an increase of 2% an unavoidable lease payment. When assessing whether variable payments are unavoidable and therefore should be included in the measurement of the lease, companies should determine whether there is a minimum or floor amount for the variable lease payment that would be incurred. If so, the payments are in effect unavoidable and therefore these are included in the calculation of the ROU asset and lease liability by the lessee. Common phrases to look for in rent terms that may signal those payments include: "...the greater of...", "...not to be less than ...", and "...minimum amount of ...".

EXAMPLE 6

FACTS

Similar to the previous example: Retailer enters into a real estate lease agreement with Mall Operator that includes a base term of five years and three 5-year renewal options. The lease term is estimated to be ten years based on significant leasehold improvements. Rent payments are 6% of sales, not to be less than $45,000 annually and increasing thereafter each renewal period by at least $5,000.

What are the total lease payments for the lease term?

ANSWER

There is a minimum amount of rent of at least $45,000 during the base term, which then increases to at least $50,000 in the first option period. Those amounts are unavoidable, and therefore represent payments to include in the measurement of the lease. Accordingly, lease payments are calculated as:

- Base term has the following payments: $45,000 X 5 years = $225,000 plus
- Renewal option has the following payments: $50,000 X 5 years = $250,000 equals

Total lease payments are $475,000 for the initial calculation of the lease liability and right of use assets. Differences in the actual amount of rent owed versus the fixed payments above are considered variable rent expense, and should be expensed as incurred.

Initial Direct Costs

Initial direct costs are defined as incremental costs that would not have been incurred if the lease had not been executed, such as commissions and payments made to an existing tenant to incentivize that tenant to terminate its lease. This guidance represents a significant change from previous GAAP, and the intent is to align this guidance with the definition of costs to acquire a contract in the new revenue standard, ASC 606.

Costs to negotiate or arrange the lease that would have been incurred regardless of whether the lease was obtained are not considered initial direct costs and should be expensed as incurred. Examples of costs that are not considered initial direct costs include:

- Employee salaries – even those performing due diligence activities associated with the potential transaction,
- General overheads,
- Legal costs to negotiate a lease,
- Advertising costs, and
- Other costs related to activities that occur before a lease is obtained.

EXAMPLE 7

FACTS

Continuation of the scenario in Example 5: In conjunction with entering the lease, Retailer incurs the following costs:

- Broker fees - $10,000
- External legal fees for contract review - $5,000
- Salaries paid for internal lease administration employees - $3,000

What costs should be capitalized as initial direct costs?

ANSWER

The broker fees of $10,000 meet the definition of an initial direct cost. All other costs are incurred regardless of whether the lease is executed or not and should be expensed as incurred.

BDO Observation: For lessors and lessees with active leasing programs, review internal accounting policies to ensure that only qualified, initial direct costs are capitalized. This may represent a significant change from past applications.

Discount Rate

The discount rate should be the rate implicit in the lease if that rate is readily determinable. The rate implicit in the lease is the rate that causes the aggregate present value of the lease payments and the residual value of the underlying asset to equal the sum of the fair value of the underlying asset and any deferred initial direct costs of the lessor, minus any related investment tax credit expected to be retained and realized by the lessor. If not readily determinable, the lessee should use its incremental borrowing rate, which is now defined as the rate that the lessee would have incurred to borrow on a collateralized basis over a similar term an amount equal to the lease payments in a similar economic environment. This is a change in the definition from previous GAAP which typically allowed for companies to apply a weighted average approach including unsecured rates.

BDO Observation: Generally, we think it will be rare for a lessee to know the rate implicit in the lease since this requires knowing lessor-specific details, and the lessee will need to use its incremental borrowing rate. To that effect, the lessee will need to derive the incremental borrowing rate that reflects a collateralized basis for each lease's term and economic environment. Data points to consider include market data such as credit ratings, interest rates and available mortgage or lending rates. Companies should establish processes for obtaining current rates to ensure that new leases are appropriately valued.

The standard includes an optional practical expedient whereby non-public entities may use a risk-free rate, determined using a period comparable to that of the lease term, as an accounting policy applied to all leases. Risk-free rates are typically lower than collaterized rates and as such, will result in higher ROU assets and lease liabilities. Additionally, should a non-public entity elect this option and later engages in an initial public offering, the entity would be required to recast the financial statements in its filing for its ROU assets and liabilities to reflect the present value using a discount rate based on a collateralized basis.

RECOGNITION AND MEASUREMENT

Classification for Test Leases

Topic 842 requires lease classification to be determined upon lease commencement. Under previous GAAP, lease classification was determined at lease inception (the date the contract was signed). This means that leases are to be evaluated for classification, using the relevant discount rate, at the commencement date, which is not necessarily when the contract is signed. For those entities that execute leases months or years in advance of the asset being made available to the lessee, this will be a significant change in practice.

The new lease standard carried forward lease classifications that are generally consistent with previous GAAP. Leases must be classified as finance leases, (the term "capital lease" is no longer applied in the new standard), by a lessee and sales-type leases by a lessor if any one of the following five criteria are met:

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

The first four criteria are consistent with the criteria under previous GAAP, albeit without the bright line thresholds in the third and fourth criteria. However, the FASB indicated in the implementation guidance that one reasonable approach to determining whether either of these criteria have been met would be to conclude that 75% or more of the remaining economic life represents a major part, while 90% or more of the fair value of the underlying asset amounts to substantially all. In addition, an entity might conclude that a commencement date that falls within the last 25% of the economic life of the underlying asset results in a commencement date at or near the end of the asset's economic life. The new standard added a fifth criterion in determining whether a lease is a finance lease or sales-type lease, specifically whether the underlying asset is of such a specialized nature that it is expected to have no alternative use to the lessor at the end of the lease term.

BDO Observation: Because the new standard does not define "major part" and "substantially all," companies will need to establish policies defining those terms, even if they elect the thresholds provided in the implementation guidance. Both concepts are also used in other areas of GAAP, and should be applied consistently.

If none of the five criteria are met, the lease is classified as an operating lease by the lessee.

Recognition, Initial Measurement and Subsequent Measurement (other than Reassessments and Modifications)

The below table summarizes the accounting treatment by the lessee.

Financial Statement	Finance Lease	Operating Lease
Balance Sheet	Recognize ROU asset and lease liability at the commencement date of the lease.	Recognize ROU asset and lease liability at the commencement date of the lease.
	The lease liability, initially and subsequently, is measured at the present value of the remaining lease payments. The ROU asset initially is measured at the amount of the lease liability recognized, plus initial direct costs and prepaid lease payments, less lease incentives received.	The initial and subsequent measurement of the lease liability, and the initial measurement of the ROU asset, are the same as for finance leases.
	The ROU asset is subsequently amortized generally on a straight-line basis.	The ROU asset is subsequently amortized in such a way that the lease cost is recognized generally on a straight-line basis over the lease term in the income statement.
	*Note – finance and operating leases must be separately presented from each other either on the face of the financial statements or in the notes.	
Income Statement	Recognize interest on the lease liability separately from amortization of the ROU asset.	Recognize a single lease cost, calculated so that the cost of the lease is allocated over the lease term, generally on a straight-line basis.
Cash Flows	Classify repayments of the principal portion of the lease liability within financing activities and payments of interest on the lease liability and variable lease payments within operating activities.	Classify all cash payments for leases within operating activities.

Sublessors are required to apply the same accounting treatment as lessors. As sublease arrangements are common in the restaurant and retail sector, the accounting treatment for sublessors is further discussed **here**.

REASSESSMENTS AND MODIFICATIONS

The table on the previous page illustrates the accounting for a lease initially and subsequently assuming no changes occur. However, Topic 842 requires lessees to remeasure leases to provide more up-to-date and useful information to the financial statement users. Those remeasurements include reassessment of the lease term and lessee purchase options, and modifications.

Recognition of a Reassessment Event

Under previous GAAP, an entity typically did not have to reevaluate the accounting for its leases except when there was an execution of a modification to a legal document, such as an amendment to a lease or a letter of intent to exercise an option. However, Topic 842 now provides guidance that requires a lessee to reassess key estimates in the measurement of its lease liability and those are not solely based on the execution of a legal document.

One of the key inputs and assumptions used in the initial accounting for a lease is the assessment of options (extension, termination and purchase options) as those impact the determination of the lease term and of the lease payments. The FASB decided that lessees should update their assessment about those options, and therefore remeasure leases on balance sheet, to provide users with more relevant information. However, the FASB decided to limit such remeasurements to significant events or changes in circumstances that are within the lessee's control to reduce the burden on preparers.

Accordingly, the new standard requires lessees to reassess the lease term and purchase options when there is a significant event or change in circumstances that is within the lessee's control and that directly affects whether the lessee is reasonably certain to exercise a renewal or termination option, or to purchase the underlying asset. Examples of this type of reassessment event include, but are not limited to:

- Constructing leasehold improvements that are expected to have significant value beyond the existing lease term,
- Significantly modifying or making customizations to the underlying asset,
- Entering into a new lease arrangement for a new asset that will replace an existing leased 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
- Entering into a sublease arrangement as the sublessor for a period beyond the exercise date of the renewal option.

BDO Observation: Business decisions now affect key estimates such as lease term and the assessment of lease purchase options. 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. As discussed above, these decisions may not have a formal paper trail and will need to be documented to arrive at key decisions regarding these estimates. It is also critical to understand the timing of such decisions. For example, a decision to update all locations with a new brand image over a two-year period may result in a reassessment at that time of all impacted leases, or only as each location is actually updated, depending on corporate policies and processes.

The new standard also requires lessees to reassess the lease term and purchase options when:

- There is an event written in the contract that obliges the lessee to exercise (or not to exercise) an option to extend or terminate the lease,
- The lessee exercises an option even though the entity had previously determined that the lessee was not reasonably certain to do so,
- The lessee does not exercise an option even though the entity had previously determined that the lessee was reasonably certain to do so.

BDO Observation: As discussed above, "reasonably certain" is a high threshold. As a result, it will be common for companies in the retail and restaurant industries to exercise renewal options that weren't previously considered reasonably certain of being exercised. Companies will need to determine when those renewal periods are effective, thus triggering the reassessment requirement, paying particular attention to notice periods which may result in reassessment prior to the renewal period taking effect. Conversely, the issuance of a letter of intent may not be legally binding, and thus may not trigger the reassessment requirement.

Please note that if there is a change in the estimate for the lease term or the likelihood of a purchase option exercise, the lessee is also required to remeasure the lease payments (and may have to reallocate the consideration in the contract if there is more than one lease component or a lease component and at least one nonlease component), update the discount rate and reassess classification as of the date of the reassessment event. Any variable payments that depend on a rate or index should also be remeasured using the rate or index at the remeasurement date.

EXAMPLE 8

FACTS

Continuation of the scenario in Example 5: Retailer enters into a real estate lease agreement with Mall Operator that includes a base term of five years and three 5-year renewal options. The lease term is originally estimated to be ten years based on significant leasehold improvements.

After six years, Retailer adopts a new brand strategy which requires reimaging costs of $300,000. These new leasehold improvements have a useful life of ten years.

Should Retailer reassess the lease term?

ANSWER

Yes. Construction of the reimaged leasehold improvements is within the Retailer's control, and these leasehold improvements are expected to have significant value at the end of the first renewal period. Retailer must reassess the lease term. Note – no legal document was executed triggering this reassessment event.

Retailer concludes that it is now reasonably certain to exercise the second renewal period and must remeasure the lease liability using the remaining lease payments from the last four years of the initial lease term plus lease payments for the second renewal period, discounted at Retailer's incremental borrowing rate at time of reassessment. The difference between the remeasured lease liability and current carrying amount is recorded as an adjustment to the related ROU asset to reflect cost of additional rights. Retailer should also reassess lease classification and update its discount rate to determine the accounting treatment at the remeasurement date. If there were nonlease components, the lessee should remeasure and reallocate the consideration in the contract unless it elected the practical expedient not to separate for this asset class.

As discussed previously, a lessee must consider what constitutes a significant event such that it would be reasonably certain to exercise the renewal option. Common repair and maintenance activities would typically not be considered "significant" to trigger a reassessment event, as illustrated in the example below.

EXAMPLE 9

FACTS

Continuation of the scenario in Example 5: Retailer enters into a real estate lease agreement with Mall Operator that includes a base term of five years and three 5-year renewal options. The lease term is estimated to be ten years based on significant leasehold improvements.

After six years, Retailer needs to refresh 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.

Should Retailer reassess the lease term?

ANSWER

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

Recognition of a Modification Event

Modifications to legal terms in the lease contract are first assessed to determine if the modification qualifies for treatment as a separate contract (i.e., new stand-alone lease). If the modification grants the lessee an additional right of use not included in the original lease and the incremental increase in the lease payments is commensurate with the standalone price of the additional right of use, the modification is treated as a separate lease by the lessee. In other words, the original lease is unaffected and therefore not remeasured.

In contrast, if the modification event does not meet the criteria for treatment as a separate contract, the lessee will remeasure and classify the lease using the new terms and discount rate on the effective date of the modification. The process is the same as for reassessments of lease term and purchase options: the consideration in the contract is remeasured and reallocated to the components, lease classification is reassessed using an updated discount rate, fair value of the underlying asset and remaining economic life of the asset, and the lease is remeasured. The remeasurement adjustment to the lease liability will be offset by a corresponding change in the ROU asset unless the modification is a partial or full termination of the lease. For a partial or full termination of a lease, the lessee will decrease the carrying amount of the ROU asset on a proportionate basis to the partial or full termination of the lease, and any difference between the reduction in the lease liability and the proportionate reduction in the ROU asset is recognized as a gain or loss on the effective date of the modification. Topic 842 provides two examples of how to determine the reduction in ROU asset in those situations: based on the change in lease liability and based on the remaining right of use.[3]

BDO Observation: As ASC 842 is effective for public entities, there is increased focus on post-adoption accounting such as the treatment for modifications and reassessment events. If utilizing an IT system to calculate the ROU asset and lease liability, ensure that modification and reassessment events are properly recorded and captured on an ongoing basis. Further, we recommend developing an accounting policy that identifies common triggers that require analysis as modification or reassessment events.

Other Remeasurement Events

We explored above reassessments of the lease term and purchase options and lease modifications resulting in remeasurement of the lease. There are also two other situations requiring lease remeasurements:

- A contingency upon which some or all of the variable lease payments are based is resolved such that those payments now meet the definition of lease payments. For example, a lease of retail space where payments for the first two years are 5% of sales, and at the end of the second year the lease payments become fixed at the average of the payments made in the first two years.
- There is a change in the amount probable of being owed by the lessee under a residual value guarantee.

These two above situations require remeasurement of the lease in the same manner as reassessments and modifications previously discussed with two exceptions: the lessee does not reassess the discount rate nor lease classification in the above two situations. This is because those two reassessment requirements affect the cost of the right-of-use rather than increase or decrease the right-of-use of the asset.

3 See ASC 842-10-55 - Example 18 – Modification that Decreases the Scope of a Lease

IMPAIRMENT

Under previous GAAP, when performing the impairment test of an asset group in accordance with ASC 360-10-35, lessees did not include assets under operating leases in the carrying value of the asset group (since those were not recognized on balance sheet) but lessees included the operating lease cash outflows. For commonly leased assets such as stores or restaurants, companies typically applied the recoverability model against its investment in the leased asset, such as its leasehold improvements. With the adoption of Topic 842, ROU assets, including those related to operating leases, must be included in this recoverability test for each long-lived asset group.

Impairments of both operating lease ROU assets and finance lease ROU assets are accounted for in accordance with section 360-10-35. Under section 360-10-35, an asset group is tested for impairment when events or changes in circumstances indicate that the asset group may not be recoverable. For those in the retail and restaurant sector, the asset group will typically be at the individual store or restaurant level. The impairment test is a two-step process which includes the following:

Step 1: Determine if the asset group is recoverable by comparing the carrying value of the asset group with the undiscounted expected cash flows. If the asset group has a higher carrying value than its undiscounted expected cash flows, proceed to step two below.

Step 2 (if applicable): Determine the impairment loss if the asset group is not recoverable.

Finance Leases

Consistent with capital leases under previous GAAP, lease liabilities associated with finance leases are excluded when determining the carrying value of the asset group and the finance lease payments are excluded from the estimated undiscounted cash flows.

Operating Leases

Topics 842 and 360 do not specify whether the related lease liability for an operating lease should be included in an asset group for impairment testing purposes. We believe the following treatments are all acceptable approaches:

	Approach A	**Approach B**	**Approach C**
Step 1: Determine the carrying value of the asset group.	Exclude operating lease liability from the carrying value of the asset group.	Include operating lease liability in the carrying value of the asset group.	Include operating lease liability in the carrying value of the asset group.
Step 1: Determine the undiscounted expected cash flows.	Exclude lease payments.	Include lease payments but exclude interest accretion portion.	Include total lease payments (i.e., include interest accretion).
Step 2: Determine the impairment loss (when using a discounted cash flow approach)[4,5].	Similar approach as Step 1 above.	Similar approach as Step 1 but include total lease payments.	Similar approach as Step 1 above.

An entity should elect one of the approaches above to test the recoverability of its asset groups, including leased stores or restaurants, and apply it consistently thereafter.

BDO Observation: Because the different approaches generally treat operating leases consistently (i.e. either include the lease liability and the related payments or exclude both), the selection of one model or another will not typically result in different outcomes nor outcomes that are different than historically seen prior to the adoption of Topic 842. However, this may not always be the case, for example when the carrying value of the ROU asset is significantly different than the carrying value of the lease liability, which may occur when there are significant leasehold incentives or when lease payments accelerate substantially in the latter part of the lease term. Companies should elect one of the above approaches, and apply it consistently to all impairment assessments.

4 When applying step 2, ensure that market participant assumptions are used rather than entity specific assumptions, including the highest and best use of the asset group. Note, the highest and best use may be different than the company-specific use. For example, in some instances an entity might be able to generate more cash flows from subleasing a location than from operating it.

5 In allocating the impairment loss to long-lived assets, consider the ROU asset without the lease liability.

EXAMPLE 10

FACTS

Restaurant C&E enters into a 10-year real estate lease with payments of $100,000 per year, paid in arrears. The lease does not transfer ownership of the underlying asset nor is there an option for Restaurant C&E to purchase the asset. At the commencement date, Restaurant C&E determined that the effect of separating the land component from the building component was insignificant and that the lease for the combined components qualified for treatment as an operating lease. Restaurant C&E incurred no initial direct costs and was not offered lease incentives. Therefore, using its incremental borrowing rate of 7.0%, Restaurant C&E determined that the right of use asset and lease liability were $702,358 on the commencement date. Annual rent expense is recognized on a straight-line basis of $100,000 per year ($1,000,000/10).

At the end of year 3, Restaurant C&E is testing the asset group for impairment due to significant adverse changes in the business climate and lower financial performance than initially anticipated. The asset group is comprised of the ROU asset with an ending balance of $538,929 and unamortized leasehold improvements of $100,000. Likewise, the lease liability also has an ending balance of $538,929. As an accounting policy election, Restaurant C&E had elected to screen for impairment applying Approach C (from above). The undiscounted cashflows associated with the asset group are determined to be $84,000.

How does Restaurant C&E perform the Topic 360 impairment analysis and account for any resulting impairment?

ANSWER

Restaurant C&E performs the step 1 and step 2 assessment using Approach C below:

Approach C	
Step 1: Determine the carrying value of the asset group by including the operating lease liability in the carrying value of the asset group.	$100,000 (ROU asset of $538,939 netted against the lease liability of $538,939 plus the remaining balance of the leasehold improvements of $100,000).[6]
Step 1: Determine the undiscounted expected cash flows which include the entire amount of the lease payments.	The asset group is considered not recoverable as the carrying value of the asset group of $100,000 is more than the undiscounted cashflows of $84,000. Restaurant C&E proceeds to Step 2.
Step 2: Determine the impairment loss using a fair value approach such as the discounted cash flow analysis.	Assume Restaurant C&E determines that the discounted cash flow analysis equates to a fair value for the asset group of $62,000. Recognize an impairment loss of $38,000 (Asset grouping carrying value of $100,000 less fair value of $62,000).

6 Assume that other assets and liabilities that are part of the asset group, such as inventory, trade receivables and payables, are immaterial in this example and therefore ignored.

EXAMPLE 10 (CONTINUED)

The impairment loss is applied on a pro rata basis amongst only the long-lived assets in the asset group, which in this example are the operating lease ROU asset and the leasehold improvements. The journal entry is:[7]

Dr Impairment loss	$38,000		
		Cr ROU Asset	$32,053
		Cr Leasehold improvements	$ 5,947

Note, after impairment, Restaurant C&E no longer recognizes total expense on a straight-line basis. While the lessee still recognizes a single lease cost, the ROU asset is amortized generally on a straight-line basis over its remaining useful life while interest expense on the lease liability is recognized using the effective interest method, resulting in a front loaded pattern of expense recognition similar to that of a finance lease.

BDO Observation: If applying ASC 360-10-35 at the individual store or restaurant level, all relevant store-level assets and liabilities, such as leasehold improvements, inventory and operating payables, should also be considered part of the carrying value of the asset group in the step 1 recoverability assessment.

Cease-use Liabilities

Under previous GAAP, lessees were required to recognize a liability in the financial statements if certain criteria were met when the lessee ceased using the property under an operating lease in accordance with Topic 420, Exit or Disposal Cost Obligations. The intent with this guidance was for the lessee to recognize unavoidable costs associated with exiting or ceasing to use a previously off-balance sheet operating lease in its financial statements. As Topic 842 now requires all leases to be on the balance sheet, this guidance has been amended to exclude costs to terminate a contract that is a lease. Said briefly, if a lessee exits an operating lease, charges that are considered lease payments (whether fixed or variable) no longer require recognition on the balance sheet as of the cease-use date under Topic 420. This is because these payments are considered fixed or variable lease payments and therefore are outside the scope of Topic 420. This is true even though variable lease payments are not reflected in the lease liability.

BDO Observation: The key to determining whether a cost is within the scope of Topic 420 depends on an entity's election regarding separation of lease and nonlease components. If the lessee has elected the non-separation practical expedient for an asset class, all payments in the lease contract (whether initially related to the lease or nonlease components, and whether fixed or variable) are considered lease payments. Therefore, the entire contract is within the scope of Topic 842 and no cease-use liability is recognized for that lease contract. If the lessee has elected to separate the lease and nonlease components, the amounts allocated to the nonlease components are within the scope of Topic 420, and the lessee should accrue the portion of fixed payments and estimated variable payments allocated to the nonlease components on the cease-use date.

7 ASC 360-10-35-28 requires an impairment loss to be allocated to the long-lived assets within that group on a relative carrying value basis, except that the allocated loss cannot reduce the carrying value of an individual asset below its fair value, if that fair value can be determined without undue cost or effort. Assume that for this example, allocation on a relative carrying value basis is deemed appropriate.

ADDITIONAL TRANSACTIONS

Sale-leaseback Transactions

Previous GAAP provided a myriad of rules concerning sale-leaseback transactions, particularly those involving real estate assets. The guidance in Topic 842, which is applicable to sale-leasebacks of both real estate and other assets such as equipment, is more principle-based in nature and focuses on the substance of the transaction. For example, the first step in assessing a sale-leaseback transaction under Topic 842 is to determine if the transaction qualifies as a sale under the newly effective revenue standard (that is, whether a contract exists and whether control of the asset has transferred to the buyer-lessor). There are then two additional requirements within the sale-leaseback guidance that will typically preclude recognition of a sale and, thereby, preclude sale-leaseback accounting under Topic 842:

1. The option for the seller-lessee to repurchase the underlying asset (discussed below) or
2. The lease qualifies as a finance lease for the seller-lessee or a sales-type lease for the buyer-lessor.

Paragraph 842-40-25-3 further states that "[a]n option for the seller-lessee to repurchase the asset would preclude accounting for the transfer of the asset as a sale of the asset unless both of the following criteria are met:

a. The exercise price of the option is the fair value of the asset at the time the option is exercised [and]

b. There are alternative assets, substantially the same as the transferred asset, readily available in the marketplace."

The FASB has observed that real estate assets are, by nature, unique and as such the alternative assets exception in paragraph 842-40-25-3(b) is not met. Said another way, if a sale-leaseback transaction involving real estate includes the option for the seller-lessee to repurchase the underlying asset, this agreement does not qualify for sale-leaseback accounting under Topic 842 and instead should be treated as a financing arrangement.

BDO Observation: Repurchase options can take many different forms in legal agreements. Discuss with legal representatives to understand if there are any clauses that will allow the seller-lessee to obtain control of the underlying asset and preclude sale accounting.

Two terms that are often found in sale-leaseback agreements are rights of first refusal ("ROFR") and rights of first offer ("ROFO"). Under a right of first refusal, the seller-lessee typically has the right to match a bona fide offer obtained by the buyer-lessor from a third party buyer. Generally, a ROFR will not preclude sales accounting, as the decision to sell the asset or not, and thus control of the asset, transfers to the buyer-lessor. Under a ROFR, the seller-lessee can only repurchase the asset if the buyer-lessor chooses to sell it, and has no discretion on pricing.

In contrast, a ROFO may preclude sales accounting, as it provides the seller-lessee the right to make an offer to the buyer-lessor to repurchase the asset. If the buyer-lessor truly has the discretion to accept or reject the offer, then the buyer-lessor is deemed to control the asset (assuming no other provisions would indicate otherwise), and sales accounting is not precluded. However, if the buyer-lessor would be compelled, either economically or contractually, to accept the offer, then the ROFO would be considered the equivalent of a repurchase right, which would preclude sales accounting if the asset is real estate. In addition, if the seller-lessee is economically or contractually compelled to make an offer, a ROFO is equivalent to an obligation to repurchase the asset (i.e., a forward) which will result in a failed sale/purchase regardless of whether the asset is real estate or not. All relevant factors should be considered when determining whether the buyer-lessor or seller-lessee would be compelled to accept or make an offer. The factors outlined in ASC 842-40-55-26 typically will be useful in evaluating the existence of economic compulsion.

EXAMPLE 11

FACTS

Bob's Burgers buys a piece of land and constructs a restaurant on the premises. Once the premises had been open and operating for several months, Bob's Burgers enters into an arrangement with an unrelated buyer-lessor to contemporaneously sell and lease back the entire premises. Facts include:

- Sales Price = $2,000,000
- Bob's Burgers has an incremental borrowing rate of 4% on the transaction date
- Carrying value of land and building = $1,800,000 million immediately prior to the transaction
- Useful life of asset = 30 years
- Rental term is 20 years with annual payments fixed at $100,000 in arrears
- Contract includes the ability for Bob's Burgers to buy back the premises at any time based on market prices

What is the accounting treatment?

ANSWER

The buyback option precludes sale-leaseback accounting for both Bob's Burgers and the buyer-lessor even if the buyback price is fair value because the underlying asset is real estate and therefore considered unique. This arrangement is treated by Bob's Burgers and the buyer-lessor as a financing arrangement.

For transactions that qualify for sale-leaseback treatment and are determined to be at fair value, the lessee recognizes the sale and resulting gain/ loss on the date control transfers to the buyer-lessor.

EXAMPLE 12

FACTS

Consider similar facts as in Example 11, but this time, Bob's Burgers does not have the option to repurchase the property. Facts include:

- Sales Price = $2,000,000. The sales price has been determined to be equivalent to fair value.
- Bob's Burgers has an incremental borrowing rate of 4% on the transaction date
- Carrying value of land and building = $1,800,000 million immediately prior to the transaction
- Useful life of asset = 30 years
- Rental term is 20 years with annual payments fixed at $100,000 in arrears, which is considered fair market rent.
- Bob's Burgers determines that there is no effect on lease classification if separately accounting for the land component and the building component.
- The lease for the combined land and building components qualifies for treatment as an operating lease.

What is the accounting treatment?

ANSWER

Based on the facts provided, this arrangement qualifies for treatment as a sale-leaseback under Topic 842. Bob's Burgers will record the following journal entries on the date that control passes to the buyer-lessor:

1) Recognition of the sale and resulting gain

Dr Cash	$2,000,000		
		Cr Asset (land and building)	$1,800,000
		Cr Gain on Sale	$ 200,000

2) Record the lease liability and ROU asset

Dr ROU Asset	$ 1,359,033		
		Cr Lease Liability	$ 1,359,033

Asset Ownership During Construction

Previous GAAP provided detailed and prescriptive rules concerning build-to-suit transactions aimed at determining whether the lessee was deemed the accounting owner of the underlying asset being constructed. Topic 842 retains the general concept of a lessee controlling the asset being constructed but revisited the conditions leading to the lessee being considered the accounting owner. Paragraph 842-40-55-5 lists five scenarios (not all-inclusive) that result in the lessee being considered the asset owner during the construction period (and the transaction therefore being in the scope of the sale-leaseback guidance):

- Lessee has the right to obtain the partially constructed underlying asset at any point during the construction period including by making a payment to the lessor.
- Lessor has an enforceable right to payment for its performance to date, and the asset does not have an alternative use to the owner-lessor.
- Lessee legally owns either (1) the land and the property improvements that are under construction or (2) the non-real-estate asset that is under construction.
- Lessee controls the land that property improvements will be constructed upon and does not enter into a lease of the land before the beginning of construction that, together with renewal options, permits the lessor or another unrelated third party to lease the land for substantially all of the economic life of the property improvements.
- Lessee is leasing the land upon which the property improvements will be built, the term of which, together with renewal options, is for substantially all of the economic life of the property improvements, and does not enter into a sublease of the land that allows the lessor or another unrelated third party to sublease the land for substantially all of the economic life of the property improvements (when considering renewal options) before beginning construction.

If the lessee is deemed to control the underlying asset during construction, and is thus the accounting owner, then the lessee must recognize the costs associated with constructing or designing the asset in accordance with Topic 360. Similar to financed construction costs for other owned assets, any costs paid by the lessor should be accounted for as financing liabilities by the lessee. However, once the construction period is complete a lessee should re-evaluate the lease transaction using the applicable sale-leaseback guidance in Topic 842.

EXAMPLE 13

FACTS

Restaurant C&E purchased a raw piece of land and decided to work with developers in the area to build a new building. Developer Inc. enters into an arrangement with Restaurant C&E to construct the new building on the land based on Restaurant C&E's specifications. Once construction is complete, Restaurant C&E will lease the building for a non-cancellable 20-year term from Developer Inc. The lease also includes four five-year renewal periods in which rent resets to market rates at the beginning of each renewal period. Restaurant C&E is also responsible for any cost overruns beyond the initial estimate from Developer Inc. Prior to construction commencing, Restaurant C&E leases the undeveloped land to Developer Inc. for an initial term of twenty-five years with six 5-year renewal periods thereafter.

Additional facts include:

- Annual rent payments of $100,000, increasing 5% annually plus a percentage of any construction cost overruns.
- Economic life of building is 50 years.
- No transfer of title or purchase option in the lease.
- Restaurant C&E does not legally own the property improvements under construction.
- Restaurant C&E's specifications do not result in an asset with no alternative use.

What is the accounting treatment?

ANSWER

Based on the factors identified above, Restaurant C&E is not the asset owner during construction under Topic 842. Normal lease accounting applies when the lease commences.

Subleases

A lessee that enters into a sublease agreement should first consider whether it is relieved of the primary obligation under the original lease or not. If the lessee is relieved of the primary obligation under the original lease, then the sublease transaction is considered a termination of the original lease, and the ROU asset and lease liability are written off with a gain or loss recognized for any difference. Any termination penalty paid that was not already included in the lease payments used to determine the ROU asset and lease liability would be included in the determination of profit or loss on termination of the lease. If the lessee remains secondarily liable, any guarantee obligation should be accounted for in accordance with paragraph 405-20-40-2.

If the lessee remains primarily liable under the original lease, then the lessee should account for the sublease in a manner similar to that of a lessor. If the sublease is classified as an operating lease, the lessee continues to account for the original lease as it did prior to the sublease (that is, continue to recognize and amortize the ROU asset). Any sublease income is recognized on a straight-line basis in earnings, unless another systematic and rational method is more representative of the pattern of benefits to be obtained from use of the asset. If the sublease is classified as a sales-type or direct financing lease, the lessee should derecognize the ROU asset associated with the original lease (whether it was an operating or finance lease ROU asset), recognize a net investment in the sublease, and continue to account for the original lease liability as it did prior to the sublease.

The sublessor must use the rate implicit in the lease to determine the sublease classification, unless it is not readily available, in which case the discount rate established for the original lease may be used.

BDO Observation: If a sublessor enters into a sublease arrangement that is determined to be an operating lease and is still primarily liable under the original lease, consider the following:

1. Determine whether the original ROU asset should be separated into two or more units of account, such as the subleased portion versus the held and used portion. This could occur for example when the head lessee initially leases a five-story office building that it accounts for as one lease component. After lease commencement and before the end of the lease term, the head lessee (as sublessor) subleases one or more floors of that same building to a third-party.
2. Determine whether the sublease results in a change in asset grouping for impairment testing purposes under section 360-10-35.
3. Analyze whether the sublease transaction results in a need to test the asset group for impairment in accordance with section 360-10-35. Topic 842 notes that if the anticipated sublease income is less than the lease cost under the head lease for the same period, this is an indicator that the head lease ROU asset may not be recoverable.

EXAMPLE 14

FACTS

Continue the facts in Example 10 except this time, after 3 years, an adjacent shopping center lost its primary anchor tenant, resulting in declining traffic in the restaurant. As a result, Restaurant C&E decides to relocate to another area with stronger trade patterns and sublease the space for the remainder of the lease term to a third party. Given the declining traffic, market rates are now lower than Restaurant C&E's current rent obligations. At the time that the sublease agreement is executed, Restaurant C&E is not relieved of its primary obligation for the restaurant space and has the following ending balances prior to the sublease:

ROU Asset = $538,929

Lease Liability = $538,929

Restaurant C&E reviewed the terms of the sublease and noted that as the sublessor, this arrangement qualifies for treatment as an operating lease. The sublessee will be remitting $36,000 per year with no rent escalations for remaining years in the initial head lease term. As part of its analysis, Restaurant C&E determined the sublease arrangement represents an impairment trigger for the subleased ROU asset because the lease cost under the head lease exceeds the anticipated sublease income.

How does Restaurant C&E account for this sublease?

ANSWER

Restaurant C&E has two units of account – the head lease for the restaurant space, for which it is the lessee, and the sublease, for which it is the sublessor. Since Restaurant C&E is not relieved of its primary obligation to pay rent to the lessor, Restaurant C&E is considered the sublessor. Sublessors generally follow the same guidance as lessors. Therefore, Restaurant C&E will not derecognize the balances for the historical ROU asset and lease liability. However, it will perform an impairment test for the ROU asset given the triggering event, i.e. the fact that the sublease is at rates lower than the head lease. Restaurant C&E will also reassess whether to shorten the useful life of its long-lived assets, such as leasehold improvements, considering the sublease of the space, as well as assessing them for impairment.

Restaurant C&E will account for the sublease as an operating lease. As such, Retailer will recognize income from the sublease arrangement on a straight-line basis over the sublease lease term.

Dr Cash/Accounts Receivable	$36,000		
		Cr Sublease income	$36,000

DISCLOSURES

The objective of the disclosure requirements is to enable users of the financial statements to assess the amount, timing, and uncertainty of cash flows arising from leases. The following information is required to be disclosed:[8]

Disclosure Requirement	
Disclosure objective: Enable users of the financial statements to assess the amount, timing, and uncertainty of cash flows arising from leases. To achieve that objective, provide qualitative and quantitative information about the company's leases, significant judgments made in accounting for leases, and about amounts recognized.	
Level of detail, disaggregation: Consider level of detail and disaggregation necessary to satisfy the disclosure objective described above. Information should not be obscured by including a large amount of insignificant detail or by aggregating items that have different characteristics.	
Qualitative information	**Quantitative information**
Information about the nature of leases including: [9] ▶ General description ▶ Basis and terms and conditions related to variable lease payments ▶ Terms and conditions of any options to extend or terminate the lease, including narrative disclosure about those that are included in the measurement of ROU assets and lease liabilities and those that are not ▶ Terms and conditions of any purchase options ▶ Terms and conditions of any residual value guarantees ▶ Restrictions or covenants imposed by leases, such as relating to dividends or incurring additional financial obligations.	Related to the statement of operations: ▶ Finance lease costs segregated by interest on the lease liabilities and amortization of the ROU assets ▶ Operating lease cost ▶ Short-term lease cost, excluding expenses relating to leases with a lease term of less than one month ▶ Variable lease cost ▶ Sublease income disclosed on a gross basis separate from finance lease and operating lease expense ▶ Net gain or loss from sale and leaseback transactions
Information about significant assumptions, including: ▶ The determination of whether a contract contains a lease ▶ Allocation of consideration between lease and nonlease components ▶ Determination of the amount of any residual value ▶ Determination of the discount rate for the lease.	Related to the statement of financial position: ▶ A maturity analysis of finance lease liabilities separately from operating lease liabilities on an undiscounted basis for each of the first five years and in total for the periods thereafter, including reconciliation of the undiscounted amount to the amount recognized in the balance sheet.
The fact that the lessee has elected the practical expedients related to short-term leases and separating lease and nonlease components, if applicable, and related information.	Related to other information, including the statement of cash flows: Separately for finance and operating leases, the following information: ▶ Cash paid, segregated between operating and financing cash flows ▶ Supplemental noncash information on lease liabilities arising from obtaining ROU assets ▶ Weighted-average remaining lease term ▶ Weighted-average discount rate.
Information about leases that have not yet commenced but that create significant rights, obligations.	
Lease transactions between related parties in accordance with ASC 850-10-50-1 through 50-6.	

See **Appendix A** for an example of disclosures for a lessee.

8 Refer to BDO Newsletter for disclosures for lessors **here**.

9 Lessees must disclose this information related to subleases, if applicable and material.

CONCLUSION

The new leases standard will result in a significant change in the accounting for operating leases. Lessees are now required to recognize ROU assets and lease liabilities on the balance sheet for those leases, except short-term leases, and have processes in place to timely identify events requiring remeasurement of their leases. Likewise, a lessee's ROU assets are now subject to the recoverability test under Topic 360 similar to other long-lived assets. Further, lessees need to assess the impact of initial adoption and continuing to apply the new standard on their accounting and reporting, including assessing how to obtain the additional information needed to comply with the new disclosure requirements.

APPENDIX A – DISCLOSURE EXAMPLE - LESSEE

Background

For purposes of this example, we have assumed that Susie's Stitch-n-Sew ("Susie's") is a national retailer of fabrics and other craft materials which primarily leases its retail locations. We have not presented a statement of financial position, but have assumed that Susie's has presented the following captions:

- Operating lease ROU assets
- Fixed assets, net
- Current portion of operating lease liabilities
- Long-term operating lease liabilities
- Current portion of long-term debt
- Long-term debt

We have also not presented a statement of comprehensive income, but have assumed that Susie's has presented Cost of sales, SG&A expense, Depreciation and amortization expense, and Interest expense.

This example assumes that the guidance in Topic 842 has been in effect for all periods presented, and that all amounts are in millions.

Note X. Leases

Susie's has historically entered into a number of lease arrangements under which we are the lessee. Specifically, of our 250 retail locations, 240 are subject to operating leases and 5 are subject to finance leases. In addition, we lease our corporate headquarters facility, as well as various warehouses and regional offices. We are also a party to an additional 12 leases in which we previously operated a retail location, but which are now subleased to third parties. In addition, we have elected the short-term lease practical expedient related to leases of various equipment used in our retail locations.

As of December 31, 20X9, we have entered into eight leases for additional retail locations and one lease for an additional warehouse which have not yet commenced. Although certain of the retail locations are currently under construction, we do not control the building during construction, and are thus not deemed to be the owner during construction.

All of our retail leases include multiple optional renewal periods. Upon opening a new retail location, we typically install brand-specific leasehold improvements with a useful life of eight years. To the extent that the initial lease term of the related lease is less than the useful life of the leasehold improvements, we conclude that it is reasonably certain that a renewal option will be exercised, and thus that renewal period is included in the lease term, and the related payments are reflected in the ROU asset and lease liability. Generally, we do not consider any additional renewal periods to be reasonably certain of being exercised, as comparable locations could generally be identified within the same trade areas for comparable lease rates.

All of our leases include fixed rental payments, but many of our leases also include variable rental payments. Specifically, a number of our leases in certain markets require rent payments that are calculated as a percentage of sales in that location. In addition, we also commonly enter into leases under which the lease payments increase at pre-determined dates based on the change in the consumer price index. While the majority of our leases are gross leases, we also have a number of leases in which we make separate payments to the lessor based on the lessor's property and casualty insurance costs and the property taxes assessed on the property, as well as a portion of the common area maintenance associated with the property. We have elected the practical expedient not to separate lease and nonlease components for all of our building leases.

During 20x9, 20x8 and 20x7, we recognized rent expense associated with our leases as follows:

	20x9	**20x8**	**20x7**
Operating lease cost:			
Fixed rent expense	$23.7	$22.6	$20.5
Variable rent expense	3.8	3.6	3.4
Finance lease cost:			
Amortization of ROU assets	2.5	2.4	2.2
Interest expense	2.0	2.1	2.0
Short-term lease cost	0.2	0.2	0.3
Sublease income	(1.3)	(1.1)	(1.2)
Net lease cost	$30.9	$29.8	$27.2
Lease cost - Cost of sales	$4.2	$4.0	$4.1
Lease cost - SG&A[10]	22.2	21.3	18.9
Lease cost - Depreciation and amortization	2.5	2.4	2.2
Lease cost - Interest expense	2.0	2.1	2.0
Net lease cost	$30.9	$29.8	$27.2

Amounts recognized as right-of-use assets related to finance leases are included in Fixed assets, net in the accompanying statement of financial position, while related lease liabilities are included in Current portion of long-term debt and Long-term debt. As of December 31, 20x9 and 20x8, right-of-use assets and lease liabilities related to finance leases were as follows:

	20x9	**20x8**
Finance lease ROU assets	$17.6	$17.0
Finance lease liabilities:		
Current portion of long-term debt	2.2	2.2
Long-term debt	15.3	15.1

10 Sublease income is presented net in SG&A in this example. Generally, we believe it is acceptable to present sublease income net against expenses if subleasing is not a significant component of the entity's business, but is instead used primarily to limit losses from leases that are no longer deemed necessary. Otherwise, sublease income should be presented gross in revenues.

During the years ended December 31, 20x9, 20x8 and 20x7, we had the following cash and non-cash activities associated with our leases:

	20x9	**20x8**	**20x7**
Cash paid for amounts included in the measurement of lease liabilities:			
Operating cash flows from operating leases	$26.0	$25.7	$24.8
Operating cash flows from finance leases	2.0	2.1	2.0
Financing cash flows from finance leases	2.0	1.9	1.9
Non-cash investing and financing activities:			
Additions to ROU assets obtained from:			
New operating lease liabilities	$18.7	$20.3	$16.2
New finance lease liabilities	-	3.4	-

The future payments due under operating and finance leases as of December 31, 20x9 is as follows:

	Operating	**Finance**
Due in 20y0	$22.6	$2.2
20y1	23.9	3.8
20y2	24.7	3.6
20y3	22.4	3.2
20y4 and thereafter	35.2	8.3
	128.8	21.1
Less effects of discounting	(35.9)	(3.6)
Lease liabilities recognized	$92.9	$17.5

As of December 31, 20x9 and 20x8, the weighted-average remaining lease term for all operating leases is 3.4 years and 3.5 years, respectively, while the weighted-average remaining lease term for all finance leases is 4.9 years and 5.6 years, respectively.

Because we generally do not have access to the rate implicit in the lease, we utilize our incremental borrowing rate as the discount rate. The weighted average discount rate associated with operating leases as of December 31, 20x9 and 20x8 is 4.2% and 4.0%, respectively, while the weighted-average discount rate associated with finance leases is 3.9% and 3.8%, respectively.

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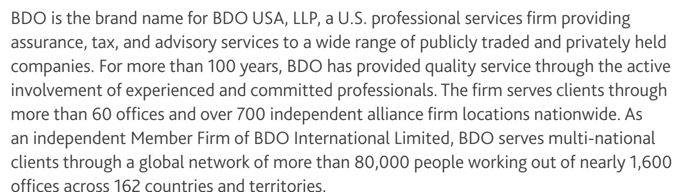

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