What you need to know

- Identifying a complete population of leases to be accounted for during transition and after the effective date has been one of the more challenging aspects of implementing the new standard.

- After adoption, lessees need to focus more on monitoring contracts to identify new leases. Existing leases also need to be monitored for modifications and reassessment events that could change the accounting.

- Significant judgment may be required to account for lease and non-lease components of an arrangement (e.g., an aircraft and ground handling services in a capacity purchase arrangement) and to determine the term of a lease (e.g., when a lessee has a legal right to renew an airport terminal lease).

- This publication has been updated to reflect the FASB’s deferral of the effective date for entities that weren’t required to adopt the standard at the same time as PBEs and certain not-for-profit entities and employee benefit plans.

Overview

While many companies have already adopted the new leases standard1 issued by the Financial Accounting Standards Board (FASB or Board), other entities are still working on implementation.

In fact, the FASB has deferred the effective date of Accounting Standards Codification (ASC) 842 for entities that are not public business entities (PBEs)2 and were not required to adopt the standard at the same time as PBEs (i.e., certain not-for-profit entities and employee benefit plans) to give them more time to implement the standard. The standard is now effective for
these entities for annual periods beginning after 15 December 2020 (i.e., 1 January 2021 for a calendar-year entity), and interim periods beginning after 15 December 2021 (i.e., 1 January 2022 for a calendar-year entity). Early adoption is permitted.

While lessees with significant operating leases are most affected by the requirement to record assets and liabilities for most of these leases, both lessees and lessors generally have made or will need to make changes to their accounting policies, processes, systems and internal controls to implement the standard.

This publication summarizes the standard and describes key industry considerations for airlines. Entities should consider these industry-specific issues when implementing and applying the standard. Like all entities, airlines need to apply the standard to leases of office space, office equipment and all other leased assets.

This publication complements our Financial reporting developments (FRD) publication, Lease accounting: Accounting Standards Codification 842, Leases (SCORE No. 00195-171US), which provides an in-depth discussion of ASC 842. We refer to that publication as our ASC 842 FRD.

Key considerations
Scope and scope exceptions
The scope of ASC 842 is limited to leases of property, plant and equipment (i.e., land and depreciable assets), including subleases of those assets. ASC 842 does not apply to any of the following:

- Leases of intangible assets
- Leases to explore for or use minerals, oil, natural gas and similar non-regenerative resources, including the intangible right to explore for those natural resources and rights to use the land in which those natural resources are contained (unless those rights to use include more than the right to explore for natural resources), but not equipment used to explore for the natural resources
- Leases of biological assets, including timber
- Leases of inventory (i.e., assets held for sale in the ordinary course of business, assets in the process of production for sale, and assets to be currently consumed in the production of goods or services to be available for sale)
- Leases of assets under construction

Definition of a lease
A lease is a contract (i.e., an agreement between two or more parties that creates enforceable rights and obligations), or part of a contract, that conveys the right to control the use of identified property, plant or equipment (i.e., an identified asset) for a period of time in exchange for consideration. See Appendix A for a flowchart from ASC 842 of how to determine whether an arrangement is or contains a lease.

Identified asset
The requirement that there be an identified asset is fundamental to the definition of a lease. Under ASC 842, an identified asset could be either implicitly or explicitly specified in a contract such as an aircraft used in a capacity purchase arrangement. In such an arrangement, a regional airline (lessor) flies a major airline’s passengers by operating its own aircraft at the direction of a major airline (lessee).
An identified asset also can be a physically distinct portion of a larger asset (e.g., gates and other terminal space in an airport). An airline may have access to gates during only certain times of the day (e.g., in the morning at an international terminal). An important factor in assessing whether there is an identified asset is understanding whether the contract requires a specific gate to be made available to the airline. If so, there likely is an identified asset.

Even if an asset is specified, a customer does not have the right to use an identified asset if, at inception of the contract, a supplier has the substantive right to substitute the asset throughout the period of use (i.e., 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). A substitution right is substantive when both of the following conditions are met:

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

Airlines will need to evaluate whether substitution rights in contracts (e.g., contracts to use gates or other airport terminal space) are substantive. If the supplier’s substitution right is substantive, the arrangement would not include a lease. The assessment of whether a supplier’s substitution right is substantive will depend on the facts and circumstances of each contract and require the use of judgment.

When an airline is evaluating whether an airport’s right to substitute the use of a specified gate for an alternative gate is substantive, the airline needs to evaluate whether the airport has the practical ability to move the airline to another gate throughout the period of use and whether the airport would benefit economically from doing so. For example, if the airline leases a substantial number of gates at the airport and the remaining gates are leased to other airlines, the airline may conclude the airport does not have the practical ability to substitute the airline’s gates throughout the period of use. Even if the airline concluded that the airport has the practical ability to move it to another gate, it may conclude the airport would not benefit economically from doing so.

**Right to control the use of the identified asset**

A contract conveys the right to control the use of an identified asset for a period of time if, throughout the period of use, the customer has both of the following:

- The right to obtain substantially all of the economic benefits from the use of the identified asset
- The right to direct the use of the identified asset

If the customer has the right to control the use of an identified asset for only a portion of the term of the contract, the contract contains a lease for that portion of the term.

A customer can obtain economic benefits either directly or indirectly (e.g., by using, holding or subleasing the asset). Economic benefits include the asset’s primary outputs (i.e., goods or services) and any by-products (e.g., renewable energy credits that are generated through use of the asset), including potential cash flows derived from these items. Economic benefits also include benefits from using the asset that could be realized from a commercial transaction with a third party. However, economic benefits arising from ownership of the identified asset (e.g., tax benefits related to excess tax depreciation and investment tax credits) are not considered economic benefits derived from the use of the asset and therefore are not considered when assessing whether a customer has the right to obtain substantially all of the economic benefits.
A customer has the right to direct the use of an identified asset throughout the period of use when either:

› The customer has the right to direct how and for what purpose the asset is used throughout the period of use.

› The relevant decisions about how and for what purpose the asset is used are predetermined and the customer either (1) has the right to operate the asset, or direct others to operate the asset in a manner it determines, throughout the period of use without the supplier having the right to change the operating instructions or (2) designed the asset, or specific aspects of the asset, in a way that predetermines how and for what purpose the asset will be used throughout the period of use.

When evaluating whether a customer has the right to direct how and for what purpose the asset is used throughout the period of use, the focus should be on whether the customer has the decision-making rights that will most affect the economic benefits that will be derived from the use of the asset. The decision-making rights that are most relevant are likely to depend on the nature of the asset and the terms and conditions of the contract.

Under ASC 842, determining whether certain contracts, particularly those involving a significant service component (e.g., contract manufacturing, supply agreements, transportation arrangements), contain a lease is more important for lessees than it is under ASC 840, Leases, because lessees are now required to account for most leases on their balance sheet.

While evaluating whether the customer directs the use of an identified asset will be straightforward in many arrangements, evaluating other arrangements – particularly those with a significant service component – may require more consideration.

Example 7 in ASC 842, which appears in the box below, illustrates how an airline may evaluate the definition of a lease.

**Illustration 1 – Identifying a lease**

Customer enters into a contract with an aircraft owner (Supplier) for the use of an explicitly specified aircraft for a two-year period. The contract details the interior and exterior specifications for the aircraft.

There are contractual and legal restrictions in the contract on where the aircraft can fly. Subject to those restrictions, Customer determines where and when the aircraft will fly and which passengers and cargo will be transported on the aircraft.

Supplier is responsible for operating the aircraft, using its own crew. Customer is prohibited from hiring another operator for the aircraft or operating the aircraft itself during the term of the contract.

Supplier is permitted to substitute the aircraft at any time during the two-year period and must substitute the aircraft if it is not working. Any substitute aircraft must meet the interior and exterior specifications in the contract. There are significant costs involved in outfitting an aircraft in Supplier’s fleet to meet Customer’s specifications.

The contract contains a lease. Customer has the right to use the aircraft for two years.

There is an identified asset. The aircraft is explicitly specified in the contract, and although Supplier can substitute the aircraft, its substitution right is not substantive. Supplier’s substitution right is not substantive because of the significant costs involved in outfitting another aircraft to meet the specifications required by the contract such that Supplier is not expected to benefit economically from substituting the aircraft.
Customer has the right to control the use of the aircraft throughout the two-year period of use because:

a) Customer has the right to obtain substantially all of the economic benefits from use of the aircraft over the two-year period of use. Customer has exclusive use of the aircraft throughout the period of use.

b) Customer has the right to direct the use of the aircraft. The restrictions on where the aircraft can fly define the scope of Customer's right to use the aircraft. Within the scope of its right of use, Customer makes the relevant decisions about how and for what purpose the aircraft is used throughout the two-year period of use because it decides whether, where, and when the aircraft travels as well as the passengers and cargo it will transport. Customer has the right to change these decisions throughout the two-year period of use.

Although the operation of the aircraft is essential to its efficient use, Supplier's decisions in this regard do not give it the right to direct how and for what purpose the aircraft is used. Consequently, Supplier does not control the use of the aircraft during the period of use, and Supplier's decisions do not affect Customer's control of the use of the aircraft.

The supplier may retain certain rights, such as the rights to make certain decisions to protect its investment in the asset (e.g., determining whether conditions are safe for operation), known as protective rights. However, a supplier's protective rights, in isolation, do not prevent the customer from having the right to direct the use of the underlying asset.

How we see it

Because the accounting for operating leases under ASC 840 is similar to the accounting for service contracts, entities may not have always focused on determining whether an arrangement is a lease or a service contract. For entities that have not yet adopted, they may need to revisit assessments of existing leases and service arrangements because, under ASC 842, most operating leases are recognized on lessees' balance sheets, and the effects of incorrectly accounting for a lease as a service may be material.

The FASB noted in the Background Information and Basis for Conclusions of Accounting Standards Update (ASU) 2016-02 (BC393(a)) that the practical expedient that permits entities not to reassess whether any expired or existing contracts contain leases does not grandfather incorrect assessments made under ASC 840 (i.e., the practical expedient applies only to arrangements that were appropriately assessed under ASC 840).

Identifying and separating components of a contract and allocating contract consideration

For contracts that contain the rights to use multiple assets but not land (e.g., the airframe of an aircraft and the engines), the right to use each asset is considered a separate lease component if both of these conditions are met:

- The lessee can benefit from the right of use either on its own or together with other resources that are readily available to the lessee.
- The right of use is neither highly dependent on, nor highly interrelated with, the other right(s) to use underlying assets in the contract.
If one or both of these criteria are not met, the right to use multiple assets is considered a single lease component.

The right to use the assets that comprise an aircraft (e.g., the airframe, the engines) typically are considered highly dependent on and interrelated with each other. As a result, airlines likely will conclude that there is a single lease component (i.e., the aircraft).

For contracts that involve the right to use land and other assets (e.g., land and a building), ASC 842 requires an entity to classify and account for the right to use land as a separate lease component, unless the accounting effect of not separately accounting for land is insignificant.

Many contracts contain a lease coupled with an agreement to purchase or sell other goods or services (non-lease components). For example, an airline may lease gates in an airport terminal where the landlord provides common area maintenance (CAM) services (e.g., cleaning services). CAM is considered a non-lease component. The non-lease components are identified and accounted for separately from the lease component in accordance with other US GAAP (except when a lessee or lessor applies the practical expedients to not separate lease and non-lease components). For example, the non-lease components may be accounted for as executory arrangements by lessees (customers) or as contracts subject to ASC 606, Revenue from Contracts with Customers, by lessors (suppliers).

In certain leases, a lessee may reimburse the lessor, or make certain payments on behalf of the lessor to a third party, that relate to the leased asset such as payments for insuring the lessor’s asset and real estate taxes associated with the asset. Payments for insurance and real estate taxes are not separate components of the contract because they do not represent payments for goods or services. Lessees allocate these payments between the lease and non-lease component based on the components’ relative standalone prices.

### Illustration 2 – Allocating contract consideration if a lessee does not elect the practical expedient to combine the lease and non-lease components

On 1 January 20X0, Major Airline (lessee) enters into a three-year capacity purchase arrangement with Regional Airline (lessor). Under the terms of the arrangement, Major Airline agrees to pay the following for the right to use one of Regional Airline’s aircraft and for Regional Airline’s services to operate the aircraft:

- A fixed payment per year of $500,000 payable on 31 December of each year
- A variable payment per year that is based on flight hours (there are no minimum flight hour requirements). Amounts incurred are payable on 31 December of each year.

In this example, the right to use the aircraft for three years is a lease component, with a standalone price of $700,000. The lease is classified as an operating lease. The operating services Regional Airline provides for three years are a non-lease component, with a standalone price of $1,050,000. In practice, capacity purchase arrangements likely will include more than one non-lease component, but for simplicity we have assumed that the operating services represent a single non-lease component. Assume Major Airline incurs no initial indirect costs, and its incremental borrowing rate at lease commencement is 5%.

Major Airline does not elect the practical expedient to combine the lease and non-lease components.
In this example, Major Airline allocates the fixed consideration in the contract as follows:

<table>
<thead>
<tr>
<th>Component</th>
<th>Relative %</th>
<th>Allocation of fixed consideration</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td>Year 1</td>
</tr>
<tr>
<td>Lease</td>
<td>40% (a)</td>
<td>$200,000</td>
</tr>
<tr>
<td>Operating services</td>
<td>60% (b)</td>
<td>$300,000</td>
</tr>
<tr>
<td>100%</td>
<td></td>
<td>$500,000</td>
</tr>
</tbody>
</table>

(a) $700,000 / ($700,000 + $1,050,000) = 40%
(b) $1,050,000 / ($700,000 + $1,050,000) = 60%

The initial measurement of the right-of-use (ROU) asset and lease liability is $544,650 using the allocated consideration in the contract of $600,000 discounted using Major Airline’s incremental borrowing rate at lease commencement of 5%.

At the end of year one, Major Airline pays the annual payment of $500,000, of which $200,000 is allocated to the lease component and $300,000 is allocated to operating services.

Lessee prepares financial statements on an annual basis at the end of the year. At the end of year one, Major Airline records the following for the fixed consideration:

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Lease liability</td>
<td>$ 172,768</td>
</tr>
<tr>
<td>Lease expense</td>
<td>$ 200,000</td>
</tr>
<tr>
<td>Service expense</td>
<td>$ 300,000</td>
</tr>
<tr>
<td>ROU asset</td>
<td>$ 172,768</td>
</tr>
<tr>
<td>Cash</td>
<td>$ 500,000</td>
</tr>
</tbody>
</table>

(a) Difference between the initial measurement of the lease liability (and right-of-use asset) at lease commencement ($544,650) and the present value of remaining lease payments at the end of year one ($371,882)
(b) Payments allocated to the lease component recognized on a straight-line basis (total consideration in the contract of $600,000 over three years)
(c) Expense attributable to the non-lease component
(d) Cash payment

Major Airline makes a variable payment of $250,000 at the end of year one based on flight hours incurred. Major Airline allocates the variable payments not based on an index or rate to the lease and non-lease component on the same basis as the initial allocation of the consideration in the contract.

In this example, Major Airline allocates the variable payment in the contract as follows:

<table>
<thead>
<tr>
<th>Component</th>
<th>Relative %</th>
<th>Allocation of variable payment</th>
</tr>
</thead>
<tbody>
<tr>
<td>Lease</td>
<td>40%</td>
<td>$ 100,000</td>
</tr>
<tr>
<td>Operating services</td>
<td>60%</td>
<td>$ 150,000</td>
</tr>
<tr>
<td>100%</td>
<td></td>
<td>$ 250,000</td>
</tr>
</tbody>
</table>

At the end of year one, Major Airline records the following for the variable payment:

<table>
<thead>
<tr>
<th>Component</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Lease expense</td>
<td>$ 100,000</td>
</tr>
<tr>
<td>Service expense</td>
<td>$ 150,000</td>
</tr>
<tr>
<td>Cash</td>
<td>$ 250,000</td>
</tr>
</tbody>
</table>
**Practical expedient to not separate non-lease and associated lease components – lessees**

ASC 842 provides a practical expedient that permits lessees to make an accounting policy election (by class of underlying asset) to account for each separate lease component of a contract and its associated non-lease components as a single lease component.

Lessees that do not make an accounting policy election to use this practical expedient are required to allocate the consideration in the contract to the lease and non-lease components on a relative standalone price basis. Lessees are required to use observable standalone prices (i.e., prices at which a customer would purchase a component of a contract separately) when readily available. If observable standalone prices are not readily available, lessees estimate standalone prices, maximizing the use of observable information. A residual estimation approach may be appropriate when the standalone price for a component is highly variable or uncertain.

<table>
<thead>
<tr>
<th>Illustration 3 – Allocating contract consideration if a lessee elects the practical expedient to combine lease and non-lease components</th>
</tr>
</thead>
<tbody>
<tr>
<td>Assume the same facts as in Illustration 2 except Major Airline elects the practical expedient to combine lease and non-lease components. Major Airline has concluded the lease is an operating lease.</td>
</tr>
<tr>
<td>In this example, Major Airline allocates all of the consideration to the lease component. Therefore, it recognizes consideration in the contract of $1,500,000 as part of lease payments.</td>
</tr>
<tr>
<td>The initial measurement of the right-of-use (ROU) asset and lease liability is $1,361,624 using Major Airline’s incremental borrowing rate at lease commencement of 5%.</td>
</tr>
<tr>
<td>At the end of year one, Major Airline pays the annual rental payment of $500,000 and makes a variable payment of $250,000 based on flight hours incurred.</td>
</tr>
<tr>
<td>Lessee prepares financial statements on an annual basis at the end of the year. At the end of year one, Major Airline records the following for the fixed and variable consideration:</td>
</tr>
<tr>
<td>Lease liability $431,919 (a)</td>
</tr>
<tr>
<td>Lease expense $750,000 (b)</td>
</tr>
<tr>
<td>ROU asset $431,919 (a)</td>
</tr>
<tr>
<td>Cash $750,000 (c)</td>
</tr>
<tr>
<td>(a) Difference between the initial measurement of the lease liability (and the right-of-use asset) at lease commencement ($1,361,624) and the present value of remaining lease payments at the end of year one ($929,705)</td>
</tr>
<tr>
<td>(b) Fixed and variable payments allocated to the lease component; fixed payments recognized on a straight-line basis (total consideration in the contract of $1,500,000 over three years) plus the variable payment of $250,000 in year one</td>
</tr>
<tr>
<td>(c) Cash payment</td>
</tr>
</tbody>
</table>

Lessees can make a policy election to not separate a lease component from its associated non-lease components.

**How we see it**

Airlines should carefully evaluate their arrangements to determine whether to elect this practical expedient for a class of underlying assets. For example, an airline may want to elect the practical expedient for a class of underlying assets when observable standalone prices of certain non-lease components (e.g., CAM) are not readily available or are difficult to estimate. Alternatively, an airline may not want to elect the practical expedient for a class of underlying assets when combining significant non-lease components with the lease components would result in a significantly higher lease liability. Capacity purchase arrangements often include significant non-lease components such as flight operation services.
For many lessees in the airline industry, identifying non-lease components of contracts has been a change in practice. As discussed earlier, entities may not have focused on identifying lease and non-lease components because their accounting treatment (e.g., the accounting for an operating lease and a service contract) was often the same. However, because most leases are recognized on lessees' balance sheets under ASC 842, lessees have had to put more robust processes in place to identify the lease and non-lease components of contracts.

Practical expedient to not separate non-lease and associated lease components – lessors

ASC 842 provides a practical expedient that allows lessors to elect, by class of underlying asset, to not separate non-lease components from the associated lease components if the non-lease components otherwise would be accounted for in accordance with the new revenue standard and both of the following criteria are met:

1. The lease component and the associated non-lease components have the same timing and pattern of transfer.
2. The lease component, if accounted for separately, would be classified as an operating lease.

A lessor that concludes the above criteria are met then evaluates whether the lease or non-lease component(s) are the predominant component. A lessor that determines that the non-lease component(s) associated with the lease component are the predominant components in the contract is required to account for the combined component in accordance with ASC 606, including its disclosure requirements.

If the non-lease components aren’t the predominant components, the lessor accounts for the combined components as an operating lease in accordance with ASC 842. An entity that elects the lessor practical expedient to not separately account for qualifying lease and non-lease components must apply the expedient to all qualifying leases in that class and provide certain disclosures.

In determining whether a non-lease component or components are the predominant component(s) in a combined component, a lessor must consider whether the lessee would be reasonably expected to ascribe more value to the non-lease component(s) than to the lease component. The Board said in BC35 of the Background Information and Basis for Conclusions of ASU 2018-11 that a lessor should be able to reasonably determine which guidance to apply (based on predominance) without having to perform a detailed quantitative analysis or a theoretical allocation to each component.
How we see it

ASC 842 does not provide detailed guidance on how to evaluate whether the predominant component is the lease or non-lease component. Likewise, the Background Information and Basis for Conclusions of ASU 2018-11 says in BC 35 that “(t)he Board concluded that an entity should be able to reasonably determine which Topic to apply (based on predominance) without having to perform a detailed quantitative analysis or theoretical allocation to each component.”

We agree that, in some cases, a reasonable qualitative analysis may provide an adequate basis for conclusions. However, if it is not clear which component (the lease component or related non-lease component(s)) is predominant, we believe some quantitative analysis may be necessary. The extent of the quantitative evaluation would depend on facts and circumstances of each contract.

An airline should carefully consider whether it should elect this practical expedient for arrangements where it is a lessor (e.g., a regional airline in a capacity purchase arrangement). The practical expedient provides relief by permitting lessors to combine non-lease and associated lease components, if certain criteria are met. But determining whether the lease component would be classified as an operating lease and identifying the predominant component (i.e., the component the lessee is reasonably expected to ascribe significantly more value to) will require judgment.

Airines that are lessors and do not elect to apply the practical expedient (or elect to apply it but have some non-lease components that don’t qualify) will need to apply judgment to allocate consideration to the lease and non-lease components based on the guidance in ASC 606.

The practical expedient is elected by class of underlying asset and is applied to all arrangements in that class of underlying asset that qualify for the expedient (i.e., a lessor cannot pick and choose which arrangements to account for using the expedient).

If a contract includes a lease and multiple associated non-lease components, a lessor that applies the practical expedient must combine all components that qualify for the expedient while separately accounting for the components that do not qualify (i.e., those for which the timing and pattern of transfer of the lease and associated non-lease components are not the same).

A lessor that elects the optional practical expedient, including a lessor that accounts for the combined component entirely in accordance with ASC 606, is required to disclose, by class of underlying asset:

- Its accounting policy election and the class or classes of underlying assets for which the practical expedient was elected
- The nature of the following items:
  - The lease components and non-lease components combined as a result of applying the practical expedient
  - The non-lease components, if any, that are accounted for separately from the combined component because they do not qualify for the practical expedient
  - Whether the combined component is accounted for under ASC 842 or ASC 606
**Lease term**
The lease term begins at the lease commencement date and is determined on that date based on the noncancelable term of the lease, together with all of the following:

- Periods covered by an option to extend the lease if the lessee is reasonably certain to exercise that option
- Periods covered by an option to terminate the lease if the lessee is reasonably certain not to exercise that option
- Periods covered by an option to extend (or not terminate) the lease in which the exercise of the option is controlled by the lessor

Some airlines have terminal leases with US airport authorities that cover periods as short as 30 days and do not have contractual renewal options, but the airline’s right to renew the agreement for the same or substantially similar space is guaranteed under US law. In those cases, an airline’s legal right to renew should be considered when determining the lease term. An airline will need to assess, for each lease, whether it is reasonably certain to exercise its right to renew and, if so, for what period.

Determining whether the reasonably certain threshold has been met requires significant judgment. An airline might consider the following factors in its assessment: how significant the airport is to the airline’s operations (e.g., a hub airport), whether the airline has made significant leasehold improvements at the airport, if the airline has guaranteed the airport’s debt, or if the airline has other significant long-term assets (e.g., intangible assets related to rights to fly between two countries or to take off or land at an airport).

**Lease payments**
Lease payments are payments made by a lessee to a lessor, relating to the right to use an underlying asset during the lease term, and are used to measure a lessee’s lease assets and liabilities.

Some lease agreements include payments that are described as variable or may appear to contain variability but are in-substance fixed payments because the contract terms require the payment of a fixed amount that is unavoidable. Such payments are included in the lease payments at lease commencement and, thus, are used in the classification test and to measure entities’ lease assets and lease liabilities.

For lessees, variable lease payments that are not based on an index or rate are not included in lease payments and are recognized when the achievement of the specified target that triggers the variable payments is considered probable. For lessors, variable lease payments that are not based on an index or rate are recognized as income in profit or loss in the period in which the changes in facts and circumstances on which the variable lease payments are based occur.

Airlines need to analyze their contracts carefully to determine whether the payments must be included in lease payments (e.g., fixed or variable payments based on an index or rate) or whether the payment is excluded from lease payments (variable payments not based on an index or rate). Significant judgment may be required.

When determining lease payments, airlines need to consider all payments associated with a lessee exercising an option to purchase the underlying asset, an option to renew and an option to terminate the lease, consistent with the determination of lease term. That’s because the exercise price in a purchase option is included as a lease payment if the lessee is reasonably certain to exercise the option. Similarly, a termination penalty is included as a lease payment if it is not reasonably certain that the lessee will not terminate the lease. Significant judgment may be required when evaluating purchase, renewal and termination options.
The following payments may represent fixed payments for airlines:

- Stated minimum payments
- Payments based on a stated rate per square footage
- Payments in the amount of the principal and interest on special facility bonds (i.e., debt-service payments)

The following may represent variable payments for airlines that are not based on an index or rate:

- Payments based on usage measures (e.g., landing fees, passengers enplaned, bags processed)
- Payments based on an allocation of an airport’s actual net operating costs (i.e., payments intended to cover expenses that an airport does not recover through airport revenues, which may include passenger facility charges, concessions or retail revenues and parking revenues). This may include payments of a portion of the airport’s actual net operating costs that are allocated to an airline based on the square footage that the airline occupies.

**How we see it**

To appropriately classify and account for leases, airlines will need to carefully evaluate the terms of each contract to determine whether payments are lease payments or variable lease payments not based on an index or rate.

**Lease classification**

At lease commencement, a lessee classifies a lease as a finance lease and a lessor classifies a lease as a sales-type lease if the lease meets **any one** of the following criteria:

- 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 a major part of the remaining economic life of the underlying asset. This criterion is not applicable for leases that commence at or near the end of the underlying 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 included 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.

A lessee classifies a lease as an operating lease when it does not meet any of the criteria above.

A lessor classifies a lease as a direct financing lease when none of the criteria above are met but the lease meets **both** of the following criteria:

- The present value of the sum of lease payments and any residual value guaranteed by the lessee and **any other third party unrelated to the lessor** equals or exceeds substantially all of the fair value of the underlying asset.
- It is probable that the lessor will collect the lease payments plus any amount necessary to satisfy a residual value guarantee.
A key difference between the sales-type lease and direct financing lease classification tests is the treatment of residual value guarantees provided by unrelated third parties other than the lessee. Those third-party guarantees are excluded from the evaluation of the “substantially all” criterion in the sales-type lease test. However, they are included in the evaluation in the direct financing lease test. In addition, the evaluation of the collectibility of lease payments and residual value guarantees affects direct financing lease classification, whereas it does not affect sales-type lease classification. However, the evaluation of collectibility does affect sales-type lease recognition and measurement.

For lessors, all leases not classified as sales-type leases or direct financing leases are classified as operating leases.

Lessees and lessors reassess lease classification as of the effective date of a modification (i.e., a change to the terms and conditions of a contract that results in a change in the scope of or consideration for the lease) that is not accounted for as a separate contract. Lessees also are required to reassess lease classification when there is a change in their assessment of either the lease term or whether they are reasonably certain to exercise an option to purchase the underlying asset.

**How we see it**

Under the new leases standard, reassessing whether a modified contract is or contains a new lease has resulted in changes to financial reporting from ASC 840. In addition to analyzing their facts and circumstances, entities need to update their accounting policies, processes, internal controls and other documentation to reflect the analysis required by the new standard.

ASC 842 does not change today’s guidance for classifying leases of terminal space and other airport facilities owned by a governmental unit or authority. If such an arrangement contains a lease and meets the criteria in ASC 842-10-55-13, it will be classified as an operating lease. For additional discussion refer to section 3.4.9, *Leases of government-owned facilities*, of our ASC 842 FRD.

**Lessee accounting**

At the commencement date of a lease, a lessee recognizes an asset representing the right to use the underlying asset during the lease term and a liability to make lease payments.

The initial recognition of the right-of-use asset and the lease liability is the same for operating leases and finance leases, as is the subsequent measurement of the lease liability. However, the subsequent measurement of the right-of-use asset for operating leases and finance leases differs under ASC 842.

For finance leases, lessees are required to separately recognize the interest expense on the lease liability and the amortization expense on the right-of-use asset. This generally results in a front-loaded expense recognition pattern. The periodic lease expense for operating leases is generally recognized on a straight-line basis.

**Short-term leases recognition and measurement exemption**

Lessees can make an accounting policy election (by class of underlying asset to which the right of use relates) to apply accounting similar to ASC 840’s operating lease accounting to leases that meet ASC 842’s definition of a short-term lease (i.e., the short-term lease exemption). A short-term lease is defined 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. The short-term lease election can only be made at the commencement date.
A lessee that makes this accounting policy election does not recognize a lease liability or right-of-use asset on its balance sheet. Instead, the lessee recognizes lease payments as an expense on a straight-line basis over the lease term and variable lease payments that do not depend on an index or rate as expense in the period in which the achievement of the specified target that triggers the variable lease payments becomes probable. Any recognized variable lease expense is reversed if it is probable that the specified target will no longer be met.

A lease that gives an airline the right to use a gate at an airport for longer than a year but only at specified times of the day may qualify for this exemption because the lease term is determined based on the nonconsecutive periods of use. For example, assume an airline leases a terminal gate for two years but can only use the gate between 6 p.m. and midnight (i.e., for six hours, or 25%, each day). During the remaining hours of each day, another party (e.g., the airport) controls the right to use the terminal gate. In this example, the lease term is approximately 183 days (i.e., 25% per day x 365 days per year x 2 years). Because the lease term is 12 months or less, the lease could qualify for the short-term lease exemption.

How we see it
The ASC 842 lessee disclosure requirements apply to all leases, including leases for which the entity has elected the short-term lease exception. The disclosure requirements have impacted whether some entities elected to apply the short-term lease exception. For example, a lessee that makes this election needs to have systems, processes and controls that can track total lease costs, including amounts that relate to short-term leases.

Refer to Appendix B for examples of lessee accounting for a finance lease and an operating lease.

Lessor accounting
Sales-type lease accounting under ASC 842 generally requires lessors to derecognize the carrying amount of the underlying asset, recognize the net investment in the lease and recognize, in net income, any selling profit or selling loss. However, if collection of lease payments and any residual value guarantee provided by the lessee is not probable at lease commencement, a lessor does not derecognize the underlying asset and does not recognize its net investment in the lease. Instead, a lessor continues to account for the underlying asset using other US GAAP (e.g., depreciates, evaluates the asset for impairment in accordance with ASC 360, Property, Plant, and Equipment) and recognizes lease payments received, including variable lease payments that do not depend on an index or rate, as a deposit liability until the earlier of either of the following:

- Collection of lease payments, plus any amounts necessary to satisfy a residual value guarantee provided by the lessee, becomes probable.
- Either of the following events occurs:
  - The contract is terminated, and the lease payments received from the lessor are nonrefundable.
  - The lessor repossesses the underlying asset and has no further obligation to the lessee under the contract, and the lease payments received from the lessee are nonrefundable.

Lessors account for direct financing leases using an approach that is similar to the accounting for sales-type leases for which collectibility is probable. However, for a direct financing lease, any selling profit is deferred at lease commencement and included in the initial measurement of the net investment in the lease (i.e., selling profit reduces the net investment in the lease). Any selling loss is recognized at lease commencement. The lessor recognizes interest income over the lease term in an amount that produces a constant periodic discount on the remaining balance of the net investment in the lease.
For operating leases, lessors continue to recognize the underlying asset and do not recognize a net investment in the lease on the balance sheet or initial profit (if any). If collectibility of lease payments and residual value guarantees is probable at lease commencement, a lessor subsequently recognizes lease income over the lease term on a straight-line basis unless another systematic and rational basis better represents the pattern in which benefit is expected to be derived from the use of the underlying asset. However, when collectibility of lease payments and any residual value guarantees is not probable at lease commencement or after the commencement date for an operating lease (including a lease that would otherwise have qualified as a direct financing lease if it had met the related collectibility requirements), lease income is limited to the lesser of (1) the straight-line amount and (2) the lease payments, including any variable lease payments, that have been collected from the lessee.

At a July 2019 FASB meeting, the FASB staff described another acceptable approach to account for uncollectible operating lease receivables. After completing the ASC 842 assessment, a lessor would apply an ASC 450-20 reserve to the remaining operating lease receivables that, based on historical data, it doesn’t expect to collect (i.e., leases that were not impaired under ASC 842). The FASB staff said the accounting for the ASC 450-20 reserve would be consistent with the accounting applied for trade receivables prior to the adoption of ASC 326, Financial Instruments – Credit Losses.

For airlines, lessor accounting will apply to regional airlines that enter into capacity purchase arrangements that qualify as leases. In these arrangements, a regional airline provides the use of its aircraft to a major airline. For additional discussion of lessor accounting, refer to our ASC 842 FRD.

Other considerations

Maintenance deposits

ASC 842 doesn’t change the existing guidance on accounting for maintenance deposits and determination of whether those amounts should be treated as deposits or as variable lease payments. For additional discussion refer to section 4.8.7, Lessee accounting for maintenance deposits, of our ASC 842 FRD.

Lease return conditions

Aircraft lease agreements often contain provisions that require an airline to return an aircraft’s airframe and engines to the lessor in a certain condition or pay an amount to the lessor based on the airframe and engine’s actual condition when returned. Typically, an aircraft is expected to be returned at “half time,” which means that at least 50% of the eligible flight time since the last overhaul remains when the aircraft is returned to the lessor. Airlines need to carefully consider whether these lease return conditions are accounted for under ASC 410-20, Asset Retirement and Environmental Obligations – Asset Retirement Obligations, or under ASC 842.

Lease return conditions resulting from a lessee modification of the leased asset (e.g., requirement to remove leasehold improvements) generally would not meet the definition of lease payments or variable lease payments and would be accounted for under ASC 410-20. In contrast, costs to dismantle and remove an underlying asset at the end of the lease term that are imposed by the lease agreement (e.g., costs to return an aircraft to a certain location at the end of the lease, costs to return the aircraft at “half-time”) generally would be considered lease payments or variable lease payments (not based on an index or rate) and accounted for under ASC 842.
Sale and leaseback transactions
Because lessees are required to recognize most leases on the balance sheet (i.e., all leases except for short-term leases if the lessee makes an accounting policy election to use this exemption), sale and leaseback transactions do not provide lessees with a source of off-balance sheet financing.

Both the seller-lessee and buyer-lessor are required to apply ASC 842 and certain provisions of ASC 606 to determine whether to account for a sale and leaseback transaction as a sale (seller-lessee) and purchase (buyer-lessor) of an asset. If control of an underlying asset passes to the buyer-lessor, the transaction is accounted for as a sale (seller-lessee) or purchase (buyer-lessor) and a lease by both parties. If not, the transaction is accounted for as a financing by both parties. Also, note that sale and leaseback transactions among entities under common control are subject to ASC 842-40’s sale and leaseback guidance.

Lessee involvement in asset construction
ASC 842 makes significant changes to how lessees and lessors evaluate their involvement in asset construction. ASC 842 focuses on whether the lessee controls the asset being constructed to determine whether it is the accounting owner of an asset under construction, while ASC 840 focuses on whether the lessee has substantially all of the construction-period risk.

If the lessee controls the asset during the construction period, lessees and lessors will apply the sale and leaseback guidance when the construction of the asset is complete and the lease commences. If the lessee does not control the underlying asset being constructed, any payments made for the right to use the underlying asset are lease payments, regardless of the timing or form of those payments. Lease payments made prior to lease commencement are recognized as a prepaid asset and evaluated in the lease classification test. Costs incurred by the lessee (when the lessee does not control the asset during construction) that relate specifically to the construction or design of an asset that are not payments for the use of an asset to be leased are recognized in accordance with other US GAAP (e.g., ASC 330, Inventory; ASC 360).

For guidance on accounting for lessee involvement in construction and related transition guidance refer to our ASC 842 FRD.

Lease modifications
ASC 842 defines a lease modification as a change to the terms and conditions of a contract that results in a change in the scope of or the consideration for a lease. For example, a modification may occur when an airline agrees to shorten or extend the term of a lease of older aircraft or when the airline and lessor agree to adjust the pricing in a capacity purchase arrangement.

Lessees and lessors account for a lease modification as a separate contract (i.e., separate from the original lease) when certain conditions are met. How an entity accounts for modifications that do not result in a separate contract depends on whether the entity is a lessee or lessor, the nature of the modification, and the classification of the lease before and after the modification.

Refer to our ASC 842 FRD for details on accounting for lease modifications.

Transition
Refer to our ASC 842 FRD for transition guidance.
Next steps

Entities that have not yet adopted the standard should consider the following:

- They will have to develop new processes, controls and/or systems to identify a complete population of leases and gather information necessary to perform the accounting and make the disclosures required by the standard.

- Off-calendar Securities and Exchange Commission (SEC) registrants should provide disclosures about the effects of the new leases standard on the financial statements as required by Staff Accounting Bulletin Topic 11.M. The SEC staff expects a registrant’s disclosures to evolve and become more specific as the effective date of a standard approaches and the registrant makes progress in its implementation plan.

Endnotes:

1 ASC 842, Leases.
2 See the ASC Master Glossary for the definition of a public business entity.
3 The FASB issued ASU 2019-10, Financial Instruments — Credit Losses (Topic 326), Derivatives and Hedging (Topic 815), and Leases (Topic 842): Effective Dates, to defer certain effective dates for these standards. For the leases standard, the ASU deferred the effective date for entities that were not required to adopt the standard at the same time as PBES. The standard was effective for PBES, not-for-profit entities that have issued or are conduit bond obligors for securities that are traded, listed or quoted on an exchange or over-the-counter market and employee benefit plans that file or furnish financial statements with or to the Securities and Exchange Commission for annual periods beginning after 15 December 2018, and interim periods within those years.
4 See ASC 842-10-30-5 for a definition of lease payments that describes differences in lease payments for lessees and lessors.
5 ASC 450-20, Contingencies — Loss Contingencies.
Appendix A: How to determine whether an arrangement is or contains a lease

The following flowchart is included in ASC 842’s implementation guidance and depicts the decision-making process for determining whether an arrangement is or contains a lease. Refer to our ASC 842 FRD for further guidance on these topics.

Start

- Is there an identified asset? 
  - Consider paragraphs 842-10-15-9 through 15-16.

  - Yes
  - Does the customer have the right to obtain substantially all of the economic benefits from use of the asset throughout the period of use? 

  - No
  - Does the customer or the supplier have the right to direct how and for what purpose the identified asset is used throughout the period of use? 

  - Yes
  - Does the customer have the right to operate the asset throughout the period of use without the supplier having the right to change those operating instructions? 

  - No
  - Did the customer design the asset (or specific aspects of the asset) in a way that predetermines how and for what purpose the asset will be used throughout the period of use? 

  - No
  - The contract does not contain a lease.

  - Yes
  - The contract contains a lease.

- Customer
- Supplier

Neither; how and for what purpose the asset will be used is predetermined
Appendix B: Lessee accounting examples

Illustration 1 – Lessee accounting for an operating lease

Fly High Air, Inc. (Lessee) enters into a three-year lease of terminal space and concludes that the agreement is an operating lease. The lease term commences at the beginning of year one and Fly High Air, Inc. agrees to pay the following annual payments at the end of each year: $10,000 in year one, $12,000 in year two and $14,000 in year three. For simplicity, there are no purchase options, payments to the lessor before the lease commencement date, lease incentives from the lessor or initial direct costs. The initial measurement of the right-of-use asset and lease liability is $33,000 using a discount rate of approximately 4.235%. Fly High Air, Inc. uses its incremental borrowing rate because the rate implicit in the lease cannot be readily determined. Fly High Air, Inc. calculates that the annual straight-line lease expense is $12,000 per year [($10,000 + $12,000 + $14,000) ÷ 3].

Analysis: At lease commencement, Fly High Air, Inc. would recognize the following right-of-use asset and lease liability:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Right-of-use asset</td>
<td>$33,000</td>
</tr>
<tr>
<td>Lease liability</td>
<td>$33,000</td>
</tr>
</tbody>
</table>

To initially recognize the lease-related asset and liability

The following journal entries would be recorded in the first year:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Lease expense</td>
<td>$12,000</td>
</tr>
<tr>
<td>Right-of-use asset</td>
<td>$2,000</td>
</tr>
<tr>
<td>Cash</td>
<td>$10,000</td>
</tr>
<tr>
<td>Lease liability</td>
<td>$8,602</td>
</tr>
<tr>
<td>Right-of-use asset</td>
<td>$8,602</td>
</tr>
</tbody>
</table>

To record lease expense and adjust the right-of-use asset for the difference between cash paid and straight-line lease expense (i.e., accrued rent). To adjust the lease liability to the present value of the remaining lease payments with an offset to the right-of-use asset. The adjustment of $8,602 is calculated as the initially recognized lease liability ($33,000) less the present value of remaining lease payments ($24,398) at the end of Year 1.

A summary of the lease contract’s accounting (assuming no changes due to reassessment) is as follows:

<table>
<thead>
<tr>
<th>Description</th>
<th>Initial</th>
<th>Year 1</th>
<th>Year 2</th>
<th>Year 3</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash lease payments:</td>
<td>$10,000</td>
<td>$12,000</td>
<td>$14,000</td>
<td></td>
</tr>
<tr>
<td>Income statement:</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Periodic lease expense (straight-line)</td>
<td>12,000</td>
<td>12,000</td>
<td>12,000</td>
<td></td>
</tr>
<tr>
<td>Prepaid (accrued) rent for period</td>
<td>$2,000</td>
<td>$-</td>
<td>$2,000</td>
<td></td>
</tr>
<tr>
<td>Balance sheet:</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Lease liability</td>
<td>$33,000</td>
<td>$24,398</td>
<td>$13,431</td>
<td>$-</td>
</tr>
<tr>
<td>Adjust: prepaid/(accrued) rent</td>
<td>$-</td>
<td>$(2,000)</td>
<td>$(2,000)</td>
<td>$-</td>
</tr>
<tr>
<td>(cumulative)</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Right-of-use asset</td>
<td>$33,000</td>
<td>$22,398</td>
<td>$11,431</td>
<td>$-</td>
</tr>
</tbody>
</table>

Immaterial differences may arise in the recomputation of amounts in the example above due to rounding.
Illustration 2 – Lessee accounting for a finance lease

Fly High Air, Inc. (Lessee) enters into a three-year lease of equipment and concludes that the agreement is a finance lease because the lease term is for a major part of the remaining economic life of the underlying asset (also three years). The lease term commences at the beginning of year one and Fly High Air, Inc. agrees to make the following annual payments at the end of each year: $10,000 in year one, $12,000 in year two and $14,000 in year three. For simplicity, there are no purchase options, payments to the lessor before the lease commencement date, lease incentives from the lessor or initial direct costs. The initial measurement of the right-of-use asset and lease liability is $33,000 (present value of lease payments using a discount rate of 4.235%). Fly High Air, Inc. uses its incremental borrowing rate because the rate implicit in the lease cannot be readily determined. Fly High Air, Inc. amortizes the right-of-use asset on a straight-line basis over the lease term.

Analysis: At lease commencement, Fly High Air, Inc. would recognize the right-of-use asset and lease liability:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Right-of-use asset</td>
<td>$33,000</td>
</tr>
<tr>
<td>Lease liability</td>
<td>$33,000</td>
</tr>
</tbody>
</table>

To initially recognize the lease-related asset and liability

- The following journal entries would be recorded in the first year:

  - Interest expense $1,398
    - Lease liability $1,398

To record interest expense and accrete the lease liability using the interest method (4.235% x $33,000)

  - Amortization expense $11,000
    - Right-of-use asset $11,000

To record amortization expense on the right-of-use asset ($33,000 ÷ 3 years)

  - Lease liability $10,000
    - Cash $10,000

To record lease payment

A summary of the lease contract’s accounting (assuming no changes due to reassessment) is as follows:

<table>
<thead>
<tr>
<th>Description</th>
<th>Initial</th>
<th>Year 1</th>
<th>Year 2</th>
<th>Year 3</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash lease payments</td>
<td>$10,000</td>
<td>$12,000</td>
<td>$14,000</td>
<td></td>
</tr>
<tr>
<td>Lease expense recognized</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Interest expense</td>
<td>$1,398</td>
<td>$1,033</td>
<td>$569</td>
<td></td>
</tr>
<tr>
<td>Amortization expense</td>
<td>$11,000</td>
<td>$11,000</td>
<td>$11,000</td>
<td></td>
</tr>
<tr>
<td>Total periodic expense</td>
<td>$12,398</td>
<td>$12,033</td>
<td>$11,569</td>
<td></td>
</tr>
<tr>
<td>Balance sheet</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Right-of-use asset</td>
<td>$33,000</td>
<td>$22,000</td>
<td>$11,000</td>
<td>$–</td>
</tr>
<tr>
<td>Lease liability</td>
<td>$(33,000)</td>
<td>$(24,398)</td>
<td>$(13,431)</td>
<td>$–</td>
</tr>
</tbody>
</table>

Immaterial differences may arise in the recomputation of amounts in the example above due to rounding.
Illustration 3 — Comparing the two types of leases for lessees

This table illustrates the similarities and differences in accounting for the finance lease (see illustration 2) and the operating lease (see illustration 1):

Finance lease:

<table>
<thead>
<tr>
<th>Time</th>
<th>Lease liability</th>
<th>Right-of-use (ROU) asset</th>
<th>Interest expense</th>
<th>Amortization expense</th>
<th>Total expense</th>
</tr>
</thead>
<tbody>
<tr>
<td>Initial</td>
<td>$ 33,000</td>
<td>$ 33,000</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Year 1</td>
<td>$ 24,398</td>
<td>$ 22,000</td>
<td>$ 1,398</td>
<td>$ 11,000</td>
<td>$ 12,398</td>
</tr>
<tr>
<td>Year 2</td>
<td>$ 13,431</td>
<td>$ 11,000</td>
<td>1,033</td>
<td>11,000</td>
<td>12,033</td>
</tr>
<tr>
<td>Year 3</td>
<td>$ —</td>
<td>$ —</td>
<td>569</td>
<td>11,000</td>
<td>11,569</td>
</tr>
</tbody>
</table>

$ 3,000 $ 33,000 $ 36,000

Operating lease:

<table>
<thead>
<tr>
<th>Time</th>
<th>Lease liability</th>
<th>Cumulative prepaid (accrued) rent¹</th>
<th>ROU asset</th>
<th>Lease expense</th>
</tr>
</thead>
<tbody>
<tr>
<td>Initial</td>
<td>$ 33,000</td>
<td>$ —</td>
<td>$ 33,000</td>
<td></td>
</tr>
<tr>
<td>Year 1</td>
<td>$ 24,398</td>
<td>$ (2,000)</td>
<td>$ 22,398</td>
<td>$ 12,000</td>
</tr>
<tr>
<td>Year 2</td>
<td>$ 13,431</td>
<td>$ (2,000)</td>
<td>$ 11,431</td>
<td>12,000</td>
</tr>
<tr>
<td>Year 3</td>
<td>$ —</td>
<td>$ —</td>
<td>$ —</td>
<td>12,000</td>
</tr>
</tbody>
</table>

$ 36,000

¹ Prepaid and accrued rent amounts would not be presented separately on the balance sheet. Instead, the ROU asset would be presented on the balance sheet net of cumulative prepaid or accrued amounts (if any).

The initial measurement of the right-of-use asset and the lease liability is the same for finance and operating leases. Also, the same total lease expense is recognized over the life of the arrangement but with different income statement classification and timing of recognition. However, a lessee generally recognizes higher periodic lease expense in the earlier periods of a finance lease than it does for an operating lease.