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.

- Entities have made or will need to make changes to their accounting policies, processes, systems and internal controls, even if applying the standard doesn’t have a significant effect on their financial statements.

- 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 standard\(^1\) 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 entities in the automotive subsectors. Entities should consider these industry-specific issues when implementing and applying the standard. Like all entities, automotive entities 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 the appendix 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. An identified asset also can be a physically distinct portion of a larger asset. Examples of identified assets include a floor of a building, a dedicated production facility or a dedicated production line within a contract manufacturing facility. 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.

If a supplier’s substitution right is substantive, the arrangement would not include a lease. Automotive entities need to evaluate whether substitution rights in contracts are substantive (e.g., supplier arrangements); that assessment will depend on the facts and circumstances of each contract and require the use of judgment.

For example, when an auto manufacturer is evaluating whether the right of an automotive parts supplier (APS) to substitute the use of a dedicated production line for an alternative production line is substantive, the auto manufacturer needs to evaluate whether the APS has the practical ability to substitute an alternative production line throughout the period of use and whether the APS would benefit economically from doing so. If the auto manufacturer concludes that the APS has the practical ability to use another production line to manufacture the parts, it may also conclude that the APS would not benefit economically from a substitution if the APS would incur significant costs to customize another production line within the facility to meet the specific requirements of the auto manufacturer’s vehicle. In this fact pattern, the auto manufacturer would conclude the substitution rights are not substantive.

### 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.

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.

Automotive entities need to carefully consider whether a contract is a lease or contains a lease. For example, the customer in a long-term supply arrangement may have the right to direct the use of the identified asset (e.g., a production facility, a dedicated production line) because it (1) decides what type of output will be produced (e.g., different colors or styles of seats) and the timing and quantity of production or (2) has the right to make changes to these decisions throughout the period of use. However, the customer will still need to determine whether it has a right to substantially all of the economic benefit from the use of the asset. Evaluating whether these arrangements contain a lease may require judgment.

**Illustration 1 — Long-term supply arrangements**

An auto manufacturer enters into a three-year contract with an APS for a dedicated production line to manufacture certain engine components. The contract states that the auto manufacturer has the exclusive use of the production line (that is, APS cannot use the production line for any other customer).

The manufacturing qualifications of the engine components are specified in the contract. The auto manufacturer issues production releases to the APS outlining the quantity and timing of engine components to be delivered. If the production line is not producing engine components for the auto manufacturer, it does not operate.

The APS operates and maintains the production line on a daily basis.

**Analysis**

This contract contains a lease. The auto manufacturer has the right to use the dedicated production line for three years.

There is an identified asset. The dedicated production line is an implicitly identified asset because the APS has only one line that can fulfill the contract, and the APS does not have the right to substitute the specified production line.
The auto manufacturer has the right to control the use of the dedicated production line (i.e., the identified asset) throughout the three-year period of use because:

- The auto manufacturer has the right to substantially all of the economic benefits from use of the dedicated production line over the three-year period of use. The auto manufacturer has exclusive use of the dedicated production line; it has rights to all of the engine components produced throughout the three-year period of use.

- The auto manufacturer has the right to direct the use of the dedicated production line. The auto manufacturer makes the relevant decisions about how and for what purpose the production line is used because it has the right to determine whether, when and how much the production line will produce (that is, the timing and quantity, if any, of engine components produced) throughout the period of use. Because the APS is prevented from using the production line for another purpose, the auto manufacturer’s decision-making rights about the timing and quantity of engine components produced, in effect, determine when and whether the production line produces engine components.

Although the operation and maintenance of the production line are essential to its efficient use, the APS’s decisions in this regard do not give it the right to direct how and for what purpose the production line is used. Consequently, the APS does not control the use of the production line during the period of use. Instead, the APS’s decisions are dependent on the auto manufacturer’s decisions about how and for what purpose the production line is used.

Determining whether a customer has the right to direct the use of an asset throughout the period of use may require significant judgment. Changes in facts and circumstances may result in a different conclusion.

Examples 8 and 9 in the standard provide contract manufacturing illustrations of the evaluation of whether a customer controls the use of an asset throughout the period of use.

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., a building and equipment, multiple pieces of equipment), 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.

For contracts that involve the right to use land and other assets (e.g., land and a manufacturing facility), 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 APS may lease tooling or machinery from a vendor that also provides routine maintenance on the tooling or machinery. The maintenance 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).

**Entities that separate lease and non-lease components allocate fixed and variable payments to these components throughout the lease term.**

**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, an APS (lessee) enters into a lease with a vendor (Lessor) for a single piece of machinery for three years. Under the terms of the agreement, the APS agrees to pay the following for the right to use Lessor’s machinery:

- A fixed payment payable on 31 December of each year starting at $300,000 and increasing 10% each year
- A variable payment per year based on the actual costs Lessor incurs for maintenance related to the leased machinery. Amounts incurred are payable on 31 December of each year.

In this example, the right to use the equipment for three years is a lease component, with a standalone price of $800,000. The lease is classified as an operating lease. The maintenance is a non-lease component, with a standalone price of $123,000.

Assume that the APS incurs no initial direct costs, and its incremental borrowing rate at lease commencement is 4%.

Also, the APS does not elect the practical expedient to combine the lease and non-lease components.
In this example, the APS 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>Lease</td>
<td>86.7% (a)</td>
<td>$ 260,000 $ 286,000 $ 315,000 $ 861,000</td>
</tr>
<tr>
<td>Maintenance</td>
<td>13.3 (b)</td>
<td>40,000 44,000 48,000 132,000</td>
</tr>
<tr>
<td>Total</td>
<td>100%</td>
<td>$ 300,000 $ 330,000 $ 363,000 $ 993,000</td>
</tr>
</tbody>
</table>

(a) $800,000 / (800,000 + 123,000) = 86.7%
(b) $123,000 / (800,000 + 123,000) = 13.3%

The initial measurement of the right-of-use (ROU) asset and lease liability is $794,000 using the allocated consideration in the contract of $861,000 discounted using the APS’s incremental borrowing rate at lease commencement of 4%.

At the end of year one, the APS pays the annual rental payment of $300,000, of which $260,000 is allocated to the lease component and $40,000 is allocated to maintenance services.

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

- Lease liability $ 228,000 (a)
- Lease expense $ 287,000 (b)
- Maintenance expense $ 44,000 (c)
- ROU asset $ 255,000 (d)
- Cash $ 300,000 (e)
- Maintenance accrual $ 4,000 (f)

(a) Difference between the initial measurement of the lease liability (and right-of-use asset) at lease commencement ($794,000) and the present value of remaining lease payments at the end of year one ($566,000).
(b) Payments allocated to the lease component recognized on a straight-line basis (total consideration in the contract of $861,000 over three years).
(c) Expense attributable to the non-lease component (total maintenance expense of $132,000 over three years).
(d) Adjustment in (a) of $228,000 plus accrued lease expense of $27,000, which is the difference between the cash paid for the lease component of $260,000 and straight-line lease expense of $287,000.
(e) Cash payment.
(f) Maintenance accrual for the difference between the straight-line expense allocated to the maintenance component ($44,000) and the maintenance payment ($40,000).

The APS makes a variable payment of $50,000 at the end of year one based on Lessor’s actual costs incurred for maintenance services. The APS allocates variable payments to the lease and non-lease component (i.e., maintenance) on the same basis as the initial allocation of the consideration in the contract.

In this example, the APS 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>86.7%</td>
<td>$ 43,350</td>
</tr>
<tr>
<td>Maintenance</td>
<td>13.3</td>
<td>6,650</td>
</tr>
<tr>
<td>Total</td>
<td>100%</td>
<td>$ 50,000</td>
</tr>
</tbody>
</table>

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

- Lease expense $ 43,350
- Maintenance expense $ 6,650
- Cash $ 50,000

Immaterial differences may arise in the recomputation of amounts in the example above due to rounding.
**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 the APS elects the practical expedient to combine lease and non-lease components. The APS has concluded the lease is an operating lease.</td>
</tr>
<tr>
<td>In this example, the APS allocates all of the consideration to the lease component. Therefore, it recognizes all of the fixed consideration in the contract ($993,000) as lease payments.</td>
</tr>
<tr>
<td>The initial measurement of the right-of-use (ROU) asset and lease liability is $916,000 using the APS’s incremental borrowing rate at lease commencement of 4%.</td>
</tr>
<tr>
<td>At the end of year one, the APS pays the annual payment of $300,000 and makes a variable payment of $50,000 based on Lessor’s actual costs incurred for maintenance.</td>
</tr>
<tr>
<td>Lessee prepares financial statements on an annual basis at the end of the year. At the end of year one, the APS records the following for the fixed and variable consideration:</td>
</tr>
<tr>
<td>Lease liability</td>
</tr>
<tr>
<td>Lease expense</td>
</tr>
<tr>
<td>ROU asset</td>
</tr>
<tr>
<td>Cash</td>
</tr>
<tr>
<td>(a) Difference between the initial measurement of the lease liability (and the right-of-use asset) at lease commencement ($916,000) and the measurement at the end of year one ($653,000).</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 $993,000 over three years) plus the variable payment of $50,000 in year one.</td>
</tr>
<tr>
<td>(c) Adjustment in (a) of $263,000 plus accrued lease expense of $31,000, which is the difference between the cash paid of $350,000 and straight-line lease expense of $381,000.</td>
</tr>
<tr>
<td>(d) Cash payment.</td>
</tr>
<tr>
<td>Immaterial differences may arise in the recomputation of amounts in the example above due to rounding.</td>
</tr>
</tbody>
</table>

When a lease includes a non-lease component related to the purchase of inventory, we believe an entity should separate the purchase of inventory from other lease and non-lease components, even if it has elected to apply the practical expedient to the class of underlying asset to which the lease relates. For example, if a contract contains a lease as well as non-lease components related to a service and the purchase of sheet metal to be used in the construction of inventory, we believe the purchase of the sheet metal should be accounted for as a component of inventory rather than together with the lease component because the purchase of a physical good is not a “non-lease component associated with that lease component.”
How we see it

For many lessees in the automotive 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.

Lessees that make the policy election to account for a lease component of a contract and its associated non-lease components as a single lease component allocate all of the contract consideration to the lease component. Therefore, the initial and subsequent measurement of the lease liability and right-of-use asset is greater than if the policy election was not applied, which could have an effect on a lessee’s impairment analysis.

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

A lessor that applies the practical expedient combines all components that qualify for the expedient and separately accounts for the non-lease component(s) that do not qualify.

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.

Determining whether a lease or non-lease component is the predominant component may be challenging for certain automotive arrangements.

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

Determining whether the reasonably certain threshold has been met requires significant judgment.
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 not included in lease payments and 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 occur.

Entities 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, automotive entities 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. Judgment may be required when evaluating purchase, renewal and termination options.

If lessees conclude that a supply arrangement is a lease, they need to analyze the consideration in the contract to determine the fixed payments that must be included within the lease payments and the variable lease payments (not based on an index or rate) that must be recognized when the achievement of the specified target that triggers the variable lease payment is considered probable. For example, a supply arrangement may have variable lease payments based upon levels of output over a given period of time.

Among other disclosures in each period presented in the financial statements, lessees need to disclose the variable lease cost, which includes both the variable lease cost amounts recognized in profit or loss during the period and any amounts capitalized as part of the cost of another asset in accordance with other standards (e.g., ASC 330, Inventory) during the period. Among other disclosures, lessors need to disclose (in a tabular format) in each annual and interim reporting period lease income relating to variable lease payments (not included in the measurement of the lease receivable, as applicable).

Lessees and lessors need to disclose variable lease cost in their financial statements.

How we see it

Lessees must evaluate whether their current processes and internal controls are sufficient to allocate and track variable lease cost appropriately.
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.

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 (i.e., the right-of-use asset) and a liability to make lease payments (i.e., the lease liability).

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.

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.

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. If a lease would otherwise qualify as a direct financing lease but the collection of the lease payment and any residual value guarantee (i.e., those guaranteed from the lessee or any other third party unrelated to the lessor) are not probable at the commencement date, the lease is classified as an operating 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.

**Other considerations**

**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.

**Repurchase agreements**

Auto manufacturers typically provide repurchase options on the sales of certain vehicles (e.g., repurchase options on sales of fleet vehicles). Before adopting ASC 606, auto manufacturers typically accounted for these transactions as leases. After adopting ASC 606, entities first look to that guidance to evaluate the accounting for these arrangements.

For example, when the auto manufacturer has the obligation to repurchase the vehicle at the end customer’s request (i.e., a put option), but the auto manufacturer determines under ASC 606 that the customer does not have a significant incentive to exercise that right, the auto manufacturer would likely account for the transaction as a sale with a right of return. If an auto manufacturer determines that the customer has a significant economic incentive to exercise the put option, the auto manufacturer would account for the transaction as a lease or a financing arrangement.

Refer to section 7.3, *Repurchase agreements*, of our FRD publication, *Revenue from contracts with customers (ASC 606)*, for further discussion of repurchase options that may result in an arrangement being accounted for as a lease rather than a sale to a customer.

**Discount rate**

Discount rates are used to determine the present value of the lease payments, determine lease classification and to measure a lessor’s net investment in the lease for sales-type and direct financing leases and a lessee’s liability.

For a lessee, the discount rate for the lease is the “rate implicit in the lease” and, if that rate cannot be readily determined, its incremental borrowing rate. For a lessor, the discount rate for the lease is the rate implicit in the lease. The rate implicit in the lease is similar to the current definition in US GAAP and reflects the nature and specific terms of the lease. The discount rate should not be less than zero.

For more information about discount rates, 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 entities agree to extend the lease term for equipment used in manufacturing an engine.

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.

ASC 842 eliminates the requirement for related parties to evaluate the economic substance of a lease to determine the appropriate accounting.
Related-party lease transactions
ASC 842 requires lessees and lessors to account for related-party leases (e.g., leases of assets such as machinery between an APS and a related-party auto manufacturer) on the basis of the legally enforceable terms and conditions of the lease. This eliminates the requirement in ASC 840 for lessees and lessors to evaluate the economic substance of a lease to determine the appropriate accounting.

Lessees and lessors are required to apply the disclosure requirements for related party transactions in accordance with ASC 850, Related Party Disclosures.

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 ASC 842-10-55-100 through 55-123.
5 See ASC 842-10-30-5 for a definition of lease payments that describes differences in lease payments for lessees and lessors.
6 ASC 450-20, Contingencies - Loss Contingencies.
Appendix: 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?
Consider paragraphs 842-10-15-17 through 15-19.

Yes

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?

Customer

Supplier

Yes

Neither; how and for what purpose the asset will be used is predetermined

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?

Yes

The contract contains a lease.

No

The contract does not contain a lease.