INSIGHTS

New Lease Accounting Standard

ASU 2016-02

Impacts and Implementation

September 2016

CohnReznick

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On February 25, 2016, the Financial Accounting Standards Board (the "FASB" or the "Board") issued new guidance on lease accounting, *Accounting Standards Update No. 2016-02, Leases (Topic 842)* (the "ASU"). The new guidance under the ASU replaces the current guidance under ASC 840 Leases, and it is applicable to all entities that enter into leases. The purpose of this publication of **INSIGHTS** is to assist entities with understanding the ASU, how it will affect them and what they need to do to implement it.

Depending on the nature and significance of an entity's leasing activities, the impact of the ASU could vary significantly. The impact could range from situations where it may not have any significant impact to situations where an entity needs to modify the processes it uses to account for leases, including what kinds of data it uses, what kinds of judgments it makes, and what kinds of measurements it prepares. All of these areas need to be understood in order to properly prepare for and successfully adopt the ASU. In order to achieve this, entities will need to address the following questions:

What changed under the ASU?

The ASU changed the accounting for leases in a number of ways. It changed the definition of what constitutes a lease, and it changed the classification criteria. Lease classification went from a bright line set of criteria to a more principles-based set. It also changed how some types of leases are recognized.

> ***CR Comment – The most significant change under the ASU is the new requirement for lessees to recognize lease assets and lease liabilities related to operating leases.***

How do the changes impact your financial statements and financial performance?

The ASU changed the financial presentation for leases, especially for operating leases of lessees. The accounting for operating leases by lessees went from not recording any lease assets or lease liabilities on their balance sheets to recognizing both a right-of-use asset and a lease liability for substantially all operating leases[1]. Lessors went from utilizing leasing criteria to determine sales-type leases to utilizing the revenue standard. Both lessees and lessors went from providing basic lease disclosures to providing more qualitative information regarding their leasing activities.

> ***CR Comment – One of the more significant impacts for lessees can be the effects on other agreements, especially those where existing covenants (such as loan covenants) or other financial performance criteria exist which could be adversely affected by the requirement to recognize a lease liability.***

How will it change the processes and procedures used to account for leases?

The ASU changes the data needed and the initial judgments that must be made. It also changes the complexity of the measurements that are required to be made on an ongoing basis.

[1] The only exception to the lessee recognition requirements is the short-term lease election, which is only available to lessees who have adopted the short-term lease election as an accounting policy applicable to their qualifying short-term leases.

> ***CR Comment – More complex measurements will be required, such as the lessee's determination of amortization expense related to operating leases or the lessor's determination of the interest rate needed in connection with recognition of the deferred gain related to direct financing leases.***

What key decisions and judgments do you need to make?

Entities will need to understand the various decisions and judgments they need to make and then assess the impacts those decisions and judgments may have. They will include matters such as determining the probability a lessee will or will not exercise a specific option under the lease, as well as the types of accounting policies that should be adopted.

> ***CR Comment – Decisions, such as determining whether to adopt certain accounting policies, will be required. Judgments, such as determining whether the likelihood a lessee will exercise an option to purchase the leased asset or exercise an option to extend the lease, will also be required. The process of thinking through these decisions and judgments will require entities to understand the key financial statement impacts they will have including any potential impacts on other existing agreements.***

How do you get started?

Getting started will require entities to get organized and to establish a plan and priorities. Such a plan will require entities to assess the significance of their lease portfolios and leasing activities. Entities with significant leasing activities will need to identify any complex areas where more information and evaluation will be required. Entities with existing agreements (other than leases) which require specific financial performance or other benchmarks to be met for qualification or compliance purposes will need to identify those agreements and the specific requirements involved. Once a plan has been established, then an entity will need to establish a time frame for completing the plan, including the evaluation of the impacts, and implementation of any procedural changes considered necessary.

> ***CR Comment – Part of the plan will need to identify and address any other areas that may be impacted, such as identifying the need for any new accounting processes or modifications to internal controls.***

To assist with the challenges posed by the above questions, we have organized this publication of **INSIGHTS** into individual topical areas which are listed below. Each topic is designed to address specific aspects of the ASU essential to understanding its impact and what needs to be considered in connection with its implementation.

We have also provided exhibits to illustrate specific information, including example financial statement impacts based on selected lease classifications. A listing of the exhibits is provided below:

Summary of the ASU

As mentioned above, the most significant change under the ASU is the new requirement for lessees to recognize lease assets and lease liabilities in connection with leases classified as operating leases. This is a new requirement under the ASU. The only exception to the recognition requirements for lessees relates to short-term operating leases where the lessee has elected, as an accounting policy, not to recognize lease assets and lease liabilities for leases that qualify as short-term leases (referred to herein as the "short-term lease election"). Under existing guidance neither lease assets nor lease liabilities are required to be recognized in connection with leases classified as operating leases. The new recognition requirements resulted from the FASB's belief that all leases create an asset and a liability for the lessee.

> ***CR Comment** – In the ASU certain terms are new and need to be understood. Accordingly, we have provided descriptions of the more significant terms used in the ASU in* Exhibit VIII - Key Terms.

Under the ASU, an entity will need to: (1) identify whether a contract is or contains a lease; (2) if a contract is a lease or contains a lease, identify and separate the lease and the non-lease components; (3) allocate contract consideration between lease and non-lease components (the allocation method is different for lessees and lessors); and (4) determine the appropriate classification of any identified leases.

Identifying a Lease

A contract will be considered a lease if it conveys the right to control the use of an identified asset for a period of time in exchange for consideration. In order to be considered a lease, the asset must be identifiable. If a portion of an asset is involved, it should be physically distinct.

Conveyance of the right to control the use of an identified asset includes both the right to obtain substantially all of the economic benefits from use of the asset as well as the right to direct the use of the asset. A customer has control and, therefore, has obtained the right to use the identified asset when they can make important decisions about the use of the asset similar to the decisions that they would make with respect to the use of assets they own. The principle of control is used when distinguishing between a lease and a service for purposes of determining whether or not a component of a contract should be considered part of the lease (i.e. lease versus non-lease components). The ASU aligns the principle of control in the context of lease transactions with other U. S. GAAP, such as Topic 606, *Revenue from Contracts with Customers* (Topic 606) and Topic 810, *Consolidation*. See Exhibit I - Evaluation of Whether a Contract is a Lease for an illustration of the steps involved in evaluating whether a contract is a lease.

> ***CR Comment** – Substantive substitution rights which allow the supplier of the asset to substitute another asset in place of the identified asset can impact the customer's right to use the identified asset throughout the period of use. The ability to substitute an asset only after occurrence of specified events would not be considered substantive. If the customer cannot reasonably determine whether a substitution right is substantive, then it is not considered substantive.*

Separating Components of a Contract

If a contract is or contains a lease, it will need to be evaluated to identify the separate lease and non-lease components. The right to control the use of an underlying asset will need to be considered a separate lease component if both of the following are true:

a. The lessee can benefit from the right to use the asset; and

b. The right to use the asset is neither highly dependent nor highly interrelated with another right in the contract to use such asset (i.e. each right does not significantly affect the other).

> ***CR Comment –** Lessees can adopt, as an accounting policy, an election applied by class of underlying asset not to separate non-lease components from lease components and to account for any separate lease components as a single lease component.*

The ASU provides additional guidance in connection with leases which include land as well as other assets. The right to use the land is considered a separate lease component unless the land element would not affect the lease classification or the amounts related to the land lease component would not be significant.

> ***CR Comment –** When the right to use the land is coterminous with the right to use the other assets, separation of the land component may not be required. However, in other situations, the right to use the land, including the period of time under the lease term related to the land component, may be different than the right to use the other assets. In such situations, separation of the land component may be necessary, except for lessees which have adopted an accounting policy not to separate lease components applicable to the class of asset which involves the land.*

Allocation of Consideration in the Contract to Separate Components

Once the separate lease and non-lease components of a contract have been identified, the consideration in the contract must be allocated to each such component. The method used to perform this allocation will depend on whether the entity is a lessee or a lessor.

Lessee Allocation - Consideration in the contract should be allocated based on relative standalone prices of the separate lease and non-lease components. Standalone prices are those a customer would pay to separately purchase each component.

> ***CR Comment –** Lessees may make an accounting policy election to combine related lease and non-lease components, and account for them as a single component. A lessee may elect to apply this practical expedient by class of underlying asset.*

Lessor Allocation - Allocation of the consideration in the contract to the separate lease and non-lease components should be based on the new revenue recognition guidance in Topic 606.

Determining Lease Classification

The process of determining the appropriate lease classification involves the application of five basic lease classification criteria (basic criteria). For lessees, application of the basic criteria is all that is involved. However, because lessors have more lease classifications to consider, they may be required to apply two additional lease classification criteria (additional criteria for lessors) before they can make that determination. Under the ASU, lessees will classify all leases either as finance leases (formerly capital leases) or as operating leases. Under the ASU, lessors will classify all leases using one of three classification types: a) sales-type leases; b) direct financing leases; or c) operating leases. Under the ASU, the leveraged lease classification is no longer available.

Lease Classification Criteria

Under the ASU there are now five basic lease classification criteria instead of four. The basic criteria are applicable to both lessees and lessors. However, lessors may be required to apply two additional criteria in certain situations in order to determine whether a lease that does not qualify as a sales-type lease should be classified as a direct financing lease or as an operating lease. A brief description of all of the criteria is provided below.

Basic Criteria

Under the ASU, the basic criteria continues to focus on the same four areas which exist under current guidance, however, a fifth criterion related to special use situations has been added. Application of the basic criteria is different under the ASU than it is under existing guidance. It is now more principles-based and, therefore, requires more judgment to be exercised. The basic criteria as set forth in the ASU[2] are listed below.

a. *Transfer of ownership*

The lease transfers ownership of the underlying asset to the lessee by the end of the lease term.

> ***CR Comment – This criterion is unchanged under the ASU.***

b. *Purchase Option*

The lease grants the lessee an option to purchase the underlying asset that the lessee is reasonably certain to exercise.

> ***CR Comment – Under current guidance the criterion focuses on the existence of a bargain purchase option. Under the ASU, a lessee's option to purchase the underlying asset is not required to be a bargain purchase option. However, the mere existence of an option does not satisfy the criterion. In order for the criterion to be met, exercise of the option of the lessee must be reasonably certain. Additional information related to the concept of "reasonably certain" is provided later in this publication of INSIGHTS.***

c. *Lease Term*

The lease term is for the major part of the remaining economic life of the underlying asset. However, if the commencement date falls at or near the end of the economic life of the underlying asset, this criterion shall not be used for purposes of classifying the lease.

> ***CR Comment – Under current guidance, the threshold of the criterion is that the lease term must be equal to 75% or more of the estimated economic life of the leased property (a bright line test). Under the ASU, implementation guidance indicates that if the lease term is for 75% or more of the remaining economic life of the underlying asset this criterion would be considered to have been met. That same implementation guidance indicates that a commencement date which falls within the last 25% of the total economic life of the underlying asset would indicate that the criterion should not be used. In other words, the criterion based on the lease term is not considered useful at the end of the useful life of the leased asset and could lead to inappropriate lease classifications.***

d. *Lease Payments*

The present value of the sum of the lease payments and any residual value guaranteed by the lessee that is not already reflected in the lease payments equals or exceeds substantially all of the fair value of the underlying asset.

> ***CR Comment – Under current guidance, a similar criterion exists and is met if the present value at the beginning of the lease term of the minimum lease payments, including any profit thereon, equals or exceeds 90% of the fair value of the leased property to the lessor at lease inception (a bright line test). Under the ASU, implementation guidance indicates that if the present value sum described in the new criterion is 90% or more of the fair value of the underlying asset, then this criterion would be considered to have been met.***
>
> ***The ASU also indicates that if it is not practicable for an entity to determine the fair value of an underlying asset, then the lease classification would be determined without consideration of the lease payments criterion. Practicable means that a reasonable estimate of fair value can be made without undue cost or effort.***

[2] The basic lease classification criteria are listed in the ASU at 842-10-25-2.

> ***Key Takeaway:*** ***The above present value criterion only includes any residual value guaranteed by the lessee. It does not include any residual value guaranteed by a third party. Any residual value not guaranteed by the lessee, but which is guaranteed by any third party not related to the lessor, is not included in the sales-type lease classification criteria. However, it would be considered under the additional criteria for lessors used by the lessor in determining whether or not a lease should be classified as a direct financing lease.***

e. Specialized Use

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 lease term.

> ***CR Comment –*** ***This criterion is new under the ASU. The concept of this criterion is that a lease of specialized assets would either contain terms which would transfer substantially all of the benefit of the asset to the lessee or, if not, that the lessee would have consumed all or substantially all of the remaining benefits from the underlying asset.***

Additional Criteria for Lessors

The additional criteria for lessors only apply in situations where none of the basic criteria are met. When that happens (none of the basic criteria are met) and the lease is not classified as a sales-type lease, the lessor must apply additional criteria in order to determine whether the lease should be classified as a direct financing lease or as an operating lease. If both of the additional criteria for lessors are met, then the lease is classified as a direct financing lease. If not, then the lease is classified as an operating lease. The additional criteria for lessors under the ASU[3] are listed below:

a. The present value of the sum of the lease payments and any residual value guaranteed by the lessee that is not already reflected in lease payments and/or any other third party unrelated to the lessor equals or exceeds substantially all of the fair value of the underlying asset.

> ***Key Takeaway:*** ***The above additional criterion is different than the five basic criteria because it adds any residual value guaranteed by a third-party to the present value amount. Lessors will need to be careful to determine the source of any residual value guarantees for purposes of determining lease classification.***

b. It is probable that the lessor will collect the lease payments plus any amount necessary to satisfy a residual value guarantee.

> ***CR Comment –*** ***As explained in the basis for conclusions section of the ASU, under a direct financing lease, the Board believes the lessor's risk of owning the underlying asset is effectively converted from an asset risk to a credit risk.***

Lease Recognition

Once an entity has determined that a contract contains a lease and has determined the appropriate lease classification, then it must recognize the lease. With two exceptions, recognition of a lease will involve some type of present value measurement of the lease payments over the term of the lease. The first exception, which only applies to lessees, involves the short-term lease election where the lessee has elected not to recognize either the right-of-use asset or the lease liability. The second exception, which only applies to lessors, involves operating leases where the lessor does not remove the underlying asset or record any net investment in the lease.

[3] The additional lease classification criteria applicable to lessors are listed in the ASU at 842-10-25-3.

Other

Understanding the financial statement impacts associated with lease classification will be discussed in a subsequent section of this publication of **INSIGHTS** (see the section on Financial Statement Impacts). In addition, certain other areas of the ASU will be addressed in the section entitled Other Areas of Impact. While the ASU has over 50 defined terms, certain ones, which are listed in Exhibit VIII - Key Terms, are especially important since they affect both the recognition and measurement requirements under the ASU.

Financial Statement Impacts

All leases of lessees are classified either as finance leases (formerly capital leases) or as operating leases. The balance sheet differences between financing leases and operating leases may not be significant, except in situations where the lessee has made a short-term lease election.

All leases of lessors are classified as sales-type leases, direct financing leases or operating leases. Lessor operating leases under the ASU are presented consistent with existing guidance. The primary difference between a sales-type lease and a direct financing lease relates to the treatment of selling profit and initial direct costs. While the underlying asset is derecognized for both a sales-type lease and a direct financing lease, the net investment in the lease is determined differently. In a sales-type lease the selling profit is recognized at the commencement date when the underlying asset is derecognized. However, any selling profit is required to be deferred in a direct financing lease, which effectively reduces the amount of the net investment in the lease. The ASU also impacts how lessors may be required to treat initial direct costs.

CR Comment – Initial direct costs of lessors are always deferred in connection with leases classified as either operating leases or direct financing leases. However, for leases classified as sales-type leases, initial direct costs are not allowed to be deferred unless the fair value of the underlying asset equals its carrying amount on the commencement date.

The financial statement impacts which will occur as a result of applying the ASU depend on lease classification. Certain impacts are minimal when compared to how leases are accounted for currently. However, other impacts, especially for lessees, can be significantly different. The financial statement impacts for lessees and lessors are summarized separately below in **Table 1 – Financial Statement Impacts for Lessees** and **Table 2 – Financial Statement Impacts for Lessors**, respectively. In addition to the information provided in the tables below, illustrative presentations of selected financial reporting impacts is provided in the exhibits. Operating and financing leases of lessees are presented in Exhibit II - Example Illustration of Operating Lease of Lessee and Exhibit III - Example Illustration of Financing Lease of Lessee. Sales-type and direct financing leases of lessors are presented in Exhibit IV - Example Illustration of Sales-type Lease of Lessor and Exhibit V – Example Illustration of Direct Financing Lease of Lessor.

Table 1 – Financial Statement Impacts for Lessees			
Lease Type	**Balance Sheet**	**Income Statement**	**Statement of Cash Flows**
Operating Lease (*other than short-term lease election*)			
Right-of-use asset	Recognized at the commencement date		All changes included in operating activities
Lease liability	Recognized at the commencement date		All payments included in operating activities
Lease Cost		Single lease cost	
CR Comment – Measurement of the right-of-use asset includes the amount of the lease liability plus any lease payments made to the lessor on or before commencement date minus any lease incentives received plus any initial direct costs incurred by the lessee. Initial recognition of any unpaid amounts related to the right-of-use asset and the lease liability would be considered noncash activities. Measurement of the lease liability is based on the present value of the remaining lease payments using the lessee's discount rate. Initial recognition of any unpaid amounts related to the right-of-use asset and the lease liability would be considered noncash activities. *Lease costs include the interest expense and amortization of the right-of-use asset.* Measurement of the interest expense is based on the lease liability and the lessee's discount rate. Measurement of the amortization expense of the right-of-use asset is based on the difference between the straight-line amount of lease cost and the interest expense.			
Short-term Operating Lease			
Right-of-use asset	Right-of-use asset and lease liability is not recognized		
Lease liability	Right-of-use asset and lease liability is not recognized		
Lease cost		Single lease cost recognized on a straight-line basis	All payments reflected in operating activities
CR Comment – The accounting for short-term operating leases is consistent with operating leases under current guidance.			
Financing Lease			
Right-of-use asset	Recognized at the commencement date		Initial recognition of any unpaid amounts related to the right-of-use asset and the lease liability would be considered noncash activities.
Lease liability	Recognized at the commencement date		Payment of the principal portion of the lease liability is included in financing activities.
Amortization expense		Amortization expense of the right-of-use asset is presented consistent with depreciation expense of similar assets when compared to the leased asset.	Amortization expense would be an adjustment to income in operating activities.
Interest on lease liability		Interest expense on the lease liability is recognized consistent with other interest costs.	
CR Comment – Initial recognition of any unpaid amounts related to the right-of-use asset would be considered a noncash activity. Initial recognition of any unpaid amounts related to the lease liability would be considered a noncash activity. *Measurement of amortization expense related to a financing lease is determined independently from interest expense. Recognition of the expenses related to a financing lease under the ASU is consistent with current guidance. Measurement of interest expense related to a financing lease is determined independently from amortization expense. Recognition of the expenses related to a financing lease under the ASU is consistent with current guidance.*			

Table 2 – Financial Statement Impacts for Lessors			
Lease Type	**Balance Sheet**	**Income Statement**	**Statement of Cash Flows**
Operating Lease			
Underlying asset	Underlying asset not derecognized		
Net investment in the lease	No net investment in the lease is recognized		
Lease income		Recognized on a straight-line basis	Changes resulting from the application of the straight-line method to rental revenue are included in operating activities
Depreciation expense		Depreciation expense on the underlying asset continues to be recorded	
CR Comment – *initial direct costs are deferred. Lessor operating leases under the ASU continue to be accounted for consistently with how lessor operating leases are accounted for under current guidance.*			
Sales-type Lease			
Underlying asset	Underlying asset is derecognized		Derecognition of the underlying asset and recognition of the net investment in the lease will be included in investing activities
Net investment in the lease	Net investment in the lease is recognized		Changes in the net investment in the lease are included in operating activities
Selling profit		Gain or loss is recognized as a result of derecognizing the underlying asset and recording the net investment in the lease	
Lease income		Interest is recognized on the net investment in the lease	
CR Comment – *Any unpaid amounts related to derecognition of the underlying asset and recognition of the net investment in the lease will be included in noncash activities. Initial direct costs can only be deferred in situations where the fair value and the carrying amount of the underlying asset are equal. The net investment in the lease equals the sum of the lease receivable and the unguaranteed residual asset. The unguaranteed residual asset is the amount that a lessor expects to derive from the underlying asset following the end of the lease term that is not guaranteed by the lessee or any other third-party and is measured on a discounted basis.*			
Direct Financing Lease			
Underlying asset	Underlying asset is derecognized		Paid amounts related to derecognition of the underlying asset and recognition of the net investment in the lease will be included in operating activities
Net investment in the lease	Net investment in the lease is recognized		Changes related to the net investment in the lease are included in operating activities
Selling profit		No gain is recognized as a result of derecognizing the underlying asset and recording the net investment in the lease	
Lease income		Interest income is recognized on the net investment in the lease	
CR Comment – *Any unpaid amounts related to derecognition of the underlying asset and recognition of the net investment in the lease will be included in noncash activities. Under a direct financing lease the lessor's risk of owning the underlying asset is effectively converted from an asset risk to a credit risk. The net investment in the lease in a direct financing lease is the sum of the lease receivable and the unguaranteed residual asset less any deferred selling profit. Any gain on derecognition is required to be deferred and will be recognized over the lease term as a component of lease income. Any loss would be recognized. Lease income includes recognition of deferred gain. The rate of interest used to determine the amount of any deferred gain to be recognized each period must be separately determined and most likely will be a different rate than the lessor's rate implicit in the lease.*			

Other Areas of Impact

In addition to the financial statement impacts described above, accounting for leases may also impact other agreements, especially those of lessees which may have to record significant lease liabilities for the first time. Recording significant lease liabilities in connection with operating leases may cause issues for lessees with financial covenants or other performance related requirements specified under existing agreements. In such situations, lessees will need to anticipate those impacts and, if possible, work with the party involved in an affected agreement in order to avoid potential problems.

Lease Modifications

Whenever a contract which contains a lease is modified, a determination is required to be made regarding whether or not the modification is considered a separate contract. When a modification qualifies as a separate contract, the modified portion of the contract is evaluated and accounted for separately based on its own merits. Whether or not a modification to a contract is required to be accounted for as a separate contract is based on the existence of two conditions which must both exist, as described below:

a. Lessee is granted an additional right of use not included in the original contract; and
b. Lease payments increase commensurate with the standalone price for the additional right of use.

Modifications which are not considered separate contracts still require reassessment of the classification of the existing lease. In addition, certain lease modifications can require reassessments of the lease term as well as the lease payments, which in turn can impact the present value measurements used to recognize lease assets and lease liabilities.

> ***CR Comment –** When lease modifications result in changes to either lease terms or lease payments, or both, the impact on the present value measurements can require use of a new discount rate. Additionally, any initial direct costs, lease incentives, and any other payments made or received in connection with a modification are required to be accounted for consistently with how they would be accounted for in connection with a new lease.*

Variable Lease Payments

Variable lease payments are payments made by the lessee to the lessor for the right to use an underlying asset that vary because of changes in facts and circumstances occurring after the commencement date, other than the passage of time. Variable lease payments that depend on an index or a rate such as the CPI or a market interest rate are already included in lease payments by both the lessee and the lessor using the index or rate at the commencement date. Subsequent changes in the index or rate do not require any adjustment to the present value measurements of either the lessee or the lessor unless lease payments are required to be remeasured for another reason. Changes in the index or rate would be recognized in earnings as those changes occurred. Other types of variable lease payments are not included by the lessee in the lease liability or by the lessor in the lease receivable. Any variable lease payments which are not included in the lease liability or the lease receivable are recognized in the period when the changes in facts and circumstances on which the variable lease payments are based occur, regardless of lease classification.

> ***CR Comment –** Some variable lease payments may contain provisions for payment which are based on contingencies. Changes in circumstances which cause a lease payment previously considered to be a variable lease payment to no longer be considered variable can require a reassessment of lease payments. This will be addressed in the section on* Data Needs and Measurements.

Build-to-suit Arrangements versus Use during Construction

Build-to-suit arrangements typically involve situations where the underlying asset is not available to and the lessee does not have the right to use the underlying asset prior to completion of construction. In such a situation, the commencement date of the lease would not occur until construction was completed and the lessee obtained the right to use the underlying asset. A build-to-suit arrangement would be different from a situation where the underlying asset is available to and the lessee does obtain the right to use the underlying asset and then constructs leasehold improvements of its own.

> ***CR Comment –*** ***There is no distinction between the right to use an underlying asset during a construction period and the right to use that asset after the construction period. This can be especially significant in situations which involve ground and building leases with lease costs incurred during construction periods. Such lease costs may be eligible for capitalization, as set forth in the guidance applicable to the real estate industry in ASC Topic 970, Real Estate.***

Sale-Leasebacks

Sale and leaseback transactions under the ASU separate the determination of whether or not a sale has occurred from the accounting for the leaseback. Further, the determination of whether or not a sale has occurred is now subject to the general revenue accounting guidance set forth in Topic 606. In order to qualify as a sale, a contract, as defined under Topic 606, must exist and the performance obligation must be met through the transfer of control of the asset to the buyer.

> ***Key Takeaway:*** ***Existence of a leaseback does not, in isolation, prevent the buyer-lessor from obtaining control of the asset. However, classification of the leaseback by the seller-lessee as a finance lease or by the buyer-lessor as a sales-type lease would prevent the buyer-lessor from obtaining control of the asset.***

Data Needs and Measurements

Data Needs

In order to determine the appropriate lease classification at the commencement date and perform the measurements needed, entities will need to obtain certain data. Some of that data is common to all leases and will be needed both by lessees and lessors. On the other hand, some data is needed only by the lessee or the lessor in connection with their lease classifications.

Common Data Needed by Both Lessees and Lessors

Economic life and any special use of the leased asset

Information related to the original economic life of the leased asset is needed by both lessees and lessors in connection with the application of the basic criteria for purposes of determining lease classification. In addition, both lessees and lessors will need to know the remaining economic life of the leased asset for the same purpose. Finally, if the leased asset involves any special use, that information will also be needed in connection with the determination of lease classification.

Fair value of the underlying asset

The fair value of the underlying asset is utilized in the application of the basic criteria for purposes of determining lease classification by both lessees and lessors. For lessors, fair value can affect how initial direct costs are treated in connection with a sales-type lease. In those types of leases, if the fair value of the underlying asset is equal to its carrying amount, then the initial direct costs are deferred. Otherwise, they are required to be expensed.

CR Comment – Fair value has no effect on the treatment of initial direct costs related to either direct financing leases or operating leases of lessors, where such costs are required to be deferred.

Key Takeaway: If it is not practicable for an entity to determine the fair value of an underlying asset, then the lease classification would be determined without consideration of the lease payments criterion. Practicable means that a reasonable estimate of fair value can be made without undue cost or effort.

Lease payments

Several different types of information may need to be obtained in connection with lease payments, including any amounts already paid, any fixed payments, any variable payments which are based on an index, any residual value payments guaranteed by the lessee which are considered probable of being made, any payments due in connection with penalties which are expected to be incurred, and any lease incentives paid or to be paid by the lessor.

Lease term

Information related to determining the lease term would include any noncancelable lease term, any options to extend the lease, any option to terminate the lease, and the commencement date of the lease. Such information would need to include sufficient detail to enable a judgment to be made regarding whether any options to extend or terminate the lease would be considered reasonably certain of exercise by the lessee.

Initial direct costs

Treatment of initial direct costs can be different for lessees and lessors depending on lease classification. However, information related to the types of costs included or includable as initial direct costs and the related amounts needs to be determined regardless of lease classification.

Additional Data Needed by Lessees

In addition to the common types of data described above, lessees also may need additional data in connection with determining the appropriate discount rate applicable to a specific lease or, in some situations, a portfolio of leases. Information related to the lessee's discount rate is described below.

Discount rate - the lessor's rate implicit in the lease

Determination of the discount rate to be used by the lessee can involve multiple options depending on the types of information available and on whether the lessee is a public business entity. The discount rate used by the lessee is important since it impacts the measurement of the right-of-use asset, the lease liability, and the amount of interest expense related to the lease liability other than nonrecognition situations involving the short-term lease exception. The lessee should use the rate implicit in the lease if it can be determined. However, as a practical matter, determination of the rate implicit in the lease may not be possible. If determination of the rate implicit in the lease is not possible, then the discount rate to be used by the lessee will depend on two other factors, each of which is described separately below.

Discount rate - the lessee's incremental borrowing rate

The first factor applies to lessees that are public entities. If the lessee is a public business entity and the lessor's rate implicit in the lease cannot be determined, then it will be required to use an appropriately determined incremental borrowing rate as the discount rate for each lease.

Discount rate – private business entity risk-free rate

The second factor applies to lessees that are not public entities. If the lessee is not a public business entity and the lessor's rate implicit in the lease cannot be determined, then determination of the appropriate discount rate will depend on whether or not the lessee has adopted an accounting policy to utilize a risk-free rate as its discount rate. Adoption of an accounting policy to utilize a risk-free rate must be applied to all leases based on asset class. If the lessee has not adopted an accounting policy to utilize a risk-free rate, then it is required to utilize an appropriately determined incremental borrowing rate as its discount rate for each lease.

Additional Data Needed by Lessors

In addition to the common types of data described above, lessors also will need the additional data described below.

Rate implicit in the lease

The rate implicit in the lease is not the same as the discount rate a lessor would use in connection with a direct financing lease. That discount rate would be separately determined.

> ***CR Comment – Even in connection with leases classified as direct financing leases, the lessor will need to determine a rate implicit in the lease. The determination of the rate implicit in the lease only includes the discounts included in the definition of that term under the ASU.***

Residual value

The estimated residual value of the leased asset at the end of the lease may or may not be guaranteed. Additionally, if the residual value is guaranteed, it may be guaranteed either by the lessee or by a third-party. This information will impact the determination of lease payments as well as assessing whether or not any of the basic criteria used to determine lease classification has been met.

Measurements

With the exception of qualifying leases under a short-term lease election, lessees will be required to perform present value measurements in connection with all of their leases. With the exception of leases classified as operating leases, lessors will also be required to perform present value measurements in connection with their leases. Those measurements become more complex for lessors with direct financing leases because of the additional measurements resulting from deferral of any selling profit.

Lessees will need to prepare present value measurements related to the lease liability in order to determine the amount of interest on the lease liability. Separate measurements will be required to determine the amount of amortization of the right-of-use asset. These measurements will differ depending on whether the lease is classified as an operating lease, other than the short-term lease election, or as a financing lease.

> ***CR Comment – The amortization expense in a lease classified as an operating lease other than the short-term lease election must be derived. It is the difference between the straight-line amount of the lease cost and the interest expense amount, which is measured utilizing the present value information applied to the lease liability using the lessee's discount rate. For lessees, measurements related to amortization expense in connection with a financing lease are made independently from the amount of lease cost.***

Lessors will need to prepare present value measurements in order to determine the amount of lease income to be recognized on the net investment in the lease, which is only recognized in connection with sales-type leases and direct financing leases. Accretion of lease income on the net investment in the lease may require utilization of different discount rates depending on whether the lease is classified as a sales-type lease or a direct financing lease. The accretion amount will include interest earnings on the lease receivable as well as recognition of any unguaranteed residual asset amount. In situations where the lease is classified as a direct financing lease, the accretion will also include the amount of any deferred selling profit to be recognized.

Measurement Updates (Reassessments)

The items subject to reassessment include the lease term, an option to purchase the underlying asset, and lease payments. A reassessment which requires the present value measurements to be updated can require changes to the discount rate used as well as changes to the index or rate used in connection with any variable lease payments based on such index or rate. The index or rate used at the commencement date would be updated to reflect the index or rate at the remeasurement date. The requirement to reassess these items is different for lessees than it is for lessors, as described below.

Lessor reassessments

Lessors are only required to reassess the above items when the lease contract has been modified.

Lessee reassessments

Lessees, on the other hand, can be required to reassess the above items as a result of factors other than a lease modification, as described further below.

Lease term and options to purchase the underlying asset

Lessees will need to reassess lease terms and/or options to purchase the underlying asset whenever significant events or changes in circumstances occur which are within the lessee's control and which affect the lessee's assessment of whether those items are reasonably certain to occur or not occur. Additionally, lessees must reassess the lease term and any options to purchase the underlying asset whenever the lessee either elects to exercise an option previously considered not reasonably certain or elects not to exercise an option previously considered reasonably certain to be exercised.

Lease payments

Lessees are required to reassess lease payments in connection with a lease modification. In addition, lessees are required to reassess lease payments in the following circumstances:

Variable lease payments: *When v*ariability is based on a contingency and the variable lease payment is no longer considered variable because the contingency is resolved.

Lease term: When changes in the lease term occur.

Option to purchase the underlying asset: When changes in the assessment of the likelihood of exercise by the lessee of an option to purchase the underlying asset occur and those changes affect the assessment of whether exercise of the option is considered reasonably certain.

Residual value guaranty payment probability: When changes related to a residual value guaranty by the lessee occur which cause the assessment of payment to be considered probable.

Transition and Implementation Considerations

Public business entities are required to adopt the ASU for fiscal years beginning after December 15, 2018 (including any interim periods within the fiscal year). Other entities (private business entities) are given more time and are not required to adopt the ASU until fiscal years beginning after December 15, 2019. Early adoption is permitted. Adoption of the ASU will include transition and implementation considerations. Entities will need to determine what they need to do procedurally and what the impacts will be before they can determine a date of adoption.

> **CR Comment –** ***Adoption requires the new lease accounting to be applied to the earliest period included in the financial statements. Any adjustments required to beginning equity are required to be made to beginning equity of the earliest period presented.***

Transition and implementation need to be considered separately. Transition considerations impact the manner in which existing leases are affected by adoption of the ASU. The decisions which must be made in connection with transition, while important, are more immediate and short-term in nature. Implementation considerations, on the other hand, impact the manner in which new leases are affected by adoption of the ASU. Those decisions will affect the entity on an ongoing basis and, therefore, are more long-term in nature.

Most of the procedures and measurements which are required in connection with new leases (implementation) are also applicable in transition to existing leases unless an entity adopts the practical expedients available in the ASU.

A brief description of the types of considerations related to practical expedients available under the ASU is provided below.

Transition Considerations

The ASU provides a number of practical expedients which are available in connection with transition. The purpose of the practical expedients available in transition is to lessen the effort and potential costs which might be incurred as a result of initially adopting the new lease accounting standards under the ASU. A comparison of the procedures a lessee would need to apply in transition depending on whether or not the practical expedients are adopted is provided in Exhibit VI - Why Lessee Transition Practical Expedients Matter and a comparison of the procedures a lessor would need to apply is provided in Exhibit VII - Why Lessor Transition Practical Expedients Matter.

> **Key Takeaway**: ***If an entity does not take advantage of the practical expedients available in transition then the process of adopting the new lease accounting under the ASU will be a far more detailed process requiring all of its existing leases to be reassessed as if they were new leases. In other words, if the practical expedients are not adopted, then the processes to be applied in transition will be essentially the same as the processes that will need to be followed in implementation.***

Transition Practical Expedients

Certain of the transition practical expedients are available to both lessees and lessors. They are required to be adopted as a package and include the following:

Election not to reassess expired or existing contracts

For entities with a significant number of lease contracts, this practical expedient will significantly reduce the amount of time required in transition. In combination with the lease classification practical expedient described below, this election will help minimize both the time required as well as any possible adjustments to beginning equity which might occur as a result of adopting the ASU.

Election not to reassess lease classifications

Similar to the above, this practical expedient will significantly reduce the amount of time required to be expended in transition. Reassessment of the lease classification would require application of the basic criteria to existing leases, which involves multiple determinations.

Election not to reassess initial direct costs
For entities with either a significant number of lease contracts or older existing leases, reassessment of the composition and nature of costs included as initial direct costs could take considerable effort.

Independent of the above transition practical expedients, entities (both lessees and lessors) can elect to use hindsight in determining the lease term during transition.

In addition to the above, lessees (only) are allowed to elect, as an accounting policy by class of underlying asset, not to separate non-lease components from lease components of a contract. Instead, a lessee can account for them all as a single lease component.

Implementation Considerations

In addition to the practical expedients available in transition, lessees also need to evaluate whether or not to adopt certain accounting policies which will affect their lease accounting on an ongoing basis. Three of the more significant accounting policies which should be considered by lessees are listed below:

Non-lease components
Lessees which intend to elect the transition practical expedient regarding choosing not to separate non-lease components of a contract from the lease components must elect an accounting policy to that effect.

Short-term leases
If the lessee wants to elect not to apply the recognition requirements to leases that qualify as short-term leases, they must make that election by adopting it as an accounting policy. Once the short-term lease election is adopted it must be applied based on class of asset.

Discount rate
A lessee which is a private business entity (not available to public business entities) is permitted to use an appropriate risk-free rate for purposes of making its present value measurements related to determining the amount of its lease liability as long as it elects to do so as an accounting policy. The appropriate risk-free rate will be the risk-free rate for a time period which is comparable to the lease term.

In addition to any practical expedients to be adopted in transition and any accounting policy decisions that need to be made, lessees and lessors will need to determine the changes to their existing processes and procedures that need to be adopted in connection with the ASU. This will involve determining the types of data that will be needed in order to determine whether a contract is a lease. Once a contract has been identified as a lease, then entities will need to determine whether any additional information will be needed and what procedures will need to be utilized to determine the appropriate lease classification. Once the lease classification has been determined the focus then shifts to utilizing the information to make the present value measurements required when the lease is initially recorded as well as the ongoing measurements required over the lease term.

Significant Judgments and Decisions

In order to avoid unintended consequences and other surprises when adopting the ASU, entities will need to evaluate a number of factors and make several judgments and decisions, as described below.

Judgments related to lease classification

Application of the basic lease criteria will involve a significant number of judgments related to the likelihood of occurrence of certain lessee actions, as listed below:

Purchase option judgment

Exercise of a purchase option by the lessee under the basic criteria needs to be reasonably certain in order for that criterion to be met. Entities will need to establish procedures related to information necessary to support how this judgment is determined, since it will affect the classification of the lease.

Lease term judgment

The lease term under the basic criteria needs to be for the major part of the remaining economic life of the underlying asset in order for that criterion to be met. The criterion related to the lease term under current guidance is a bright line test based strictly on 75% or more of the estimated economic life of the leased property. Implementation guidance under the ASU indicates that in situations where the lease term is 75% or more of the remaining economic life of the underlying property, then the lease term criterion would be considered to have been met. Entities should avoid establishing unrealistic quantitative thresholds merely to arrive at a specific lease classification. As a practical matter, other than when the short-term lease classification is in effect, whether or not the lease term criterion is met will have little impact on how recognition of a lease at the commencement date impacts the balance sheet of a lessee. However, lease classification could affect whether or not a sale can be recognized in connection with a sale and leaseback transaction.

Lease payments judgment

The lease payment criterion is based on whether the present value of the lease payments and any residual value guaranteed by the lessee that is not already reflected in the lease payments equals or exceeds substantially all of the fair value of the underlying asset (assuming that it is practicable to obtain the fair value information). Judgments related to determination of what constitutes "substantially all" of the underlying asset's fair value. Additionally, judgments will need to be made regarding whether or not fair value information is considered practicable to obtain. Similar to lease term judgments, the criterion related to lease payments under current guidance is a bright line test based strictly on the application of a 90% threshold. The ASU provides implementation guidance which indicates that in situations where the present value amount described in the lease payment criterion exceeds 90% or more of the fair value of the underlying asset, then the lease payments criterion would be considered to have been met.

Judgments related to determination of "reasonably certain"

The ASU makes numerous references to whether or not a lessee is reasonably certain to exercise an option. Examples include options to extend the lease as well as options to purchase the underlying asset. Assessment of whether a lessee is reasonably certain to exercise or not to exercise an option is required to be made based on consideration of all economic factors, which would include the following:

Contract terms

Comparison of the contract terms to current market rates.

Leasehold improvements

Whether leasehold improvements are expected to have a significant value on the date an option becomes exercisable.

Lease termination costs

Includes potential costs related to obtaining a new lease, relocation, identifying another underlying asset, or returning the underlying asset to a specified condition or location.

Importance of the underlying asset to lessee's operations

Whether the underlying asset is specialized in nature or its location is important to the lessee.

> ***CR Comment – Many of the above economic factors may be interrelated which means they would need to be considered in combination.***

Decisions related to adoption of transition practical expedients

The most significant decision all entities will make is whether or not to adopt the package of practical expedients available in transition. As stated above, the transition practical expedients would have to be adopted as a package. Entities should carefully consider the impact of not adopting the package of practical expedients available in transition would have on the procedures required in transition.

Decisions related to accounting policies

Lessees in particular will need to make significant decisions regarding which accounting policies they may wish to adopt under the ASU. Certain of these accounting policies could, if adopted, impact the effort they will be required to expend in connection with accounting for leases under the ASU. However, lessees should be aware that some of the accounting policies which they might adopt could affect their present value measurements and have a significant effect on the financial statement impacts of adopting the ASU.

Decisions by private business entity lessees regarding discount rates

Lessees which are private business entities can adopt an accounting policy and elect to use a risk-free interest rate as their discount rate. If the lessee does adopt such an accounting policy it will be required to use the appropriately determined risk-free rate in connection with all of its leases.

> ***CR Comment – While utilization of a risk-free rate will make the determination of the lessee's discount rate easier, lessees need to understand the impact of using a risk-free rate on their present value measurements. Usually, risk-free rates will be lower than a lessee's incremental borrowing rate or the lessor's rate implicit in the lease. Use of a lower discount rate would result in a larger present value for the lease liability amount. Subsequently, use of a lower risk-free rate would result in lower amounts of interest expense. For operating leases, other than those under the short-term lease election, the lower interest amount would not have any impact on the amount of total lease cost. Amortization expense of the right-of-use asset would be increased to offset the lower interest expense. However, the higher lease liability amount could adversely affect other agreements where the amount of liabilities recorded is a factor. For financing leases, the lower interest expense could impact the lessee's operating performance since the interest expense and the amortization expense are determined independently of total lease cost.***

Decisions related to measurements

Some of the present value measurements may require entities to develop procedures or to acquire software to enable them to prepare the measurements. Other than certain situations involving lease portfolios, many of the present value measurements will need to be prepared on a lease-by-lease basis. Developing the processes necessary to enable entities to prepare these measurements will be one of the key decisions entities will need to make and will impact their financial reporting capabilities.

Assessments and Getting Started

Entities should not underestimate the amount of effort that will be required to implement the new lease accounting standards under the ASU. The amount of effort required will depend on the volume of leasing activity an entity has as well as the complexity of its lease agreements. It will also depend on the decisions made along the way. We have identified some of the significant implementation related activities entities should consider below.

Evaluate Your Portfolio

The first step an entity should take is to evaluate its leasing activities. One approach to take in this evaluation is for the entity simply to look at its current lease accounting information based on lease classification, including the amount of remaining lease costs required in connection with operating leases of lessees. Another step that should be taken is to determine the number of leases an entity has as well as the frequency new lease agreements are entered into. Other factors which an entity should consider would include the existence of variable lease payments and whether or not leases involve single assets or portions of assets. Entities should also identify any large lease portfolios of similar assets.

Evaluate Potential Impact on Existing Agreements

Entities need to identify any existing agreements which contain specific requirements related to measurements of liabilities or expenses. Such requirements could impact whether or not the impacts of adopting the new lease accounting will adversely impact the entity's ability to comply with any performance based covenants or other requirements under those agreements.

> ***CR Comment – Other agreements may contain provisions which could impact the entity's ability to participate in certain activities governed by the agreement.***

Evaluate Adoption of Practical Expedients

Most entities will want to adopt the package of practical expedients available in transition. In some cases entities may wish to adopt other available practical expedients. Entities should evaluate the impact adoption of the available practical expedients might have on their transition to the new lease accounting standards.

Evaluate Accounting Policies

Using the information described above, entities need to evaluate which accounting policies they wish to adopt.

Determine Specific Data Needs

Based on the types of leasing activities an entity has as well as the make-up of its leasing portfolio, entities then will need to determine the various data they will need to obtain in order to allow them to determine lease classifications and to make all of the measurements necessary. Additional data requirements may be necessary in connection with variable lease payments or other complex situations. Entities will want to consider what type of approach to take when determining specific data needs. Some data may not be needed at all in connection with leases which are known to meet certain of the basic criteria. However, if data which is not initially obtained is subsequently determined to be needed, entities may find the delay adversely impacts their reporting capabilities and requirements.

Determine Calculation Approach

Once an entity has determined the number of leases in each lease classification, then it will need to determine which measurements need to be prepared. Those measurements will need to be appropriately designed to enable the entity to accommodate new leases as well as existing ones.

> ***CR Comment – In some cases, multiple calculations may be needed. Such would be the case for lessees with operating leases where one calculation is needed for purposes of determining the interest component and another calculation must be prepared in order to determine the amortization component. For lessors, multiple calculations may be needed in situations involving direct financing leases where a separate discount rate (different from the rate implicit in the lease) is required in connection with the deferral of selling profit.***

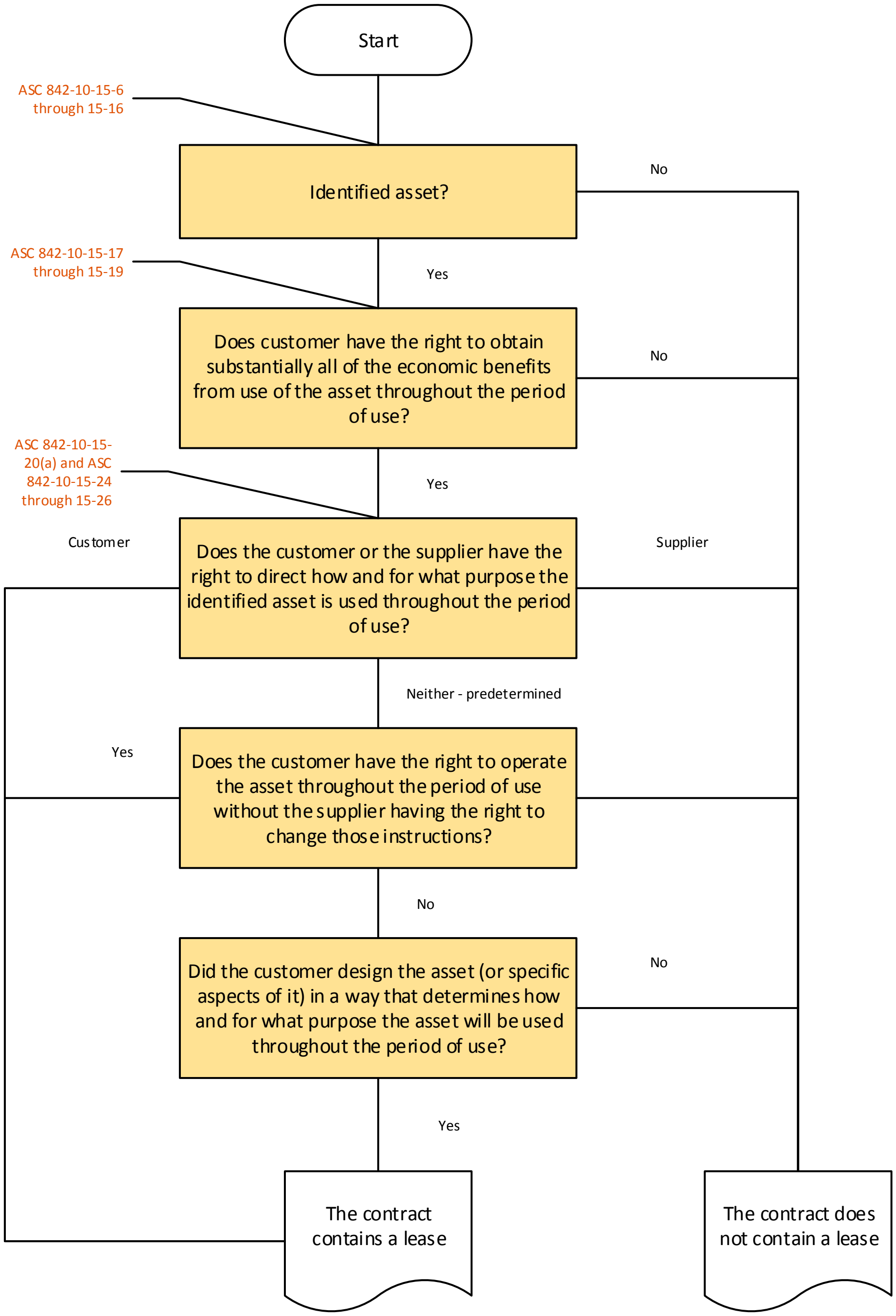
Assess Impact on Internal Controls and Procedures

Depending on the volume and complexity of an entity's leasing activities, implementing the new accounting standard may also have impacts on internal controls and other procedures the entity utilizes for purposes of financial reporting, including preparing the necessary disclosure information. In assessing which accounting policies and procedures to modify or adopt, entities should consider the impacts beyond those involved in connection with either transition or the initial adoption of the ASU. In connection with new leases, entities will need to consider the data needed and the procedures involved in connection with the initial determination of lease classification. Additional consideration will need to be given to what will be required in connection with financial reporting and disclosure requirements, including whether any additional information or procedures will be involved. Consideration also will need to be given to what will be required in connection with monitoring changes in agreements or other circumstances which might impact amounts already recorded as a result of any changes to either the lease classification or present value measurements. Finally, consideration should be given to what will be required in connection with the accounting required at the end of the lease (that is, the scheduled lease termination as opposed to a modification or reassessment event).

Questions and Assistance

Clients who have specific questions regarding the new guidance for leases can contact their CohnReznick partner for assistance. Other individuals that have specific questions on the topic can contact Michael Beck at Michael.Beck@CohnReznick.com.

Exhibit I – Evaluation of Whether a Contract is a Lease[4]



[4] This flowchart is consistent with the one included in the ASU.

Exhibit II –Example Illustration of Operating Lease of Lessee[5]

Lessee Operating Lease - Assumptions

Lease term - years		5
Discount rate for the lease		6.0%
Lease payments made before commencement	$	5,000
Lease incentives received	$	(2,500)
Initial direct costs paid	$	2,500
Lease payment schedule		
Year 1	$	-
Year 2		10,000
Year 3		15,000
Year 4		25,000
Year 5		25,000
Total remaining lease payments	$	75,000
Lease liability - present value	$	59,978
Lease cost (net cash outlay)	$	80,000
Annual straight-line amount	$	16,000

Lessee Operating Lease - Financial Statement Impacts

	Commencement	Year 1	Year 2	Year 3	Year 4	Year 5
Balance sheet						
Assets						
Right-of-use asset	$ 64,978	$ 52,577	$ 40,391	$ 27,835	$ 14,585	$ -
Liabilities & equity						
Lease liability	$ 59,978	$ 63,577	$ 57,391	$ 45,835	$ 23,585	$ -
Income statement						
Lease cost	$ -	$ 16,000	$ 16,000	$ 16,000	$ 16,000	$ 16,000
Statement of Cash Flows						
Operating - source (use)						
Increase in right-of-use asset	$ (5,000)	$ -	$ -	$ -	$ -	$ -
Increase (decrease) in lease liability	-	3,599	(6,186)	(11,556)	(22,250)	(23,585)
Amortization of right-of-use asset	-	12,401	12,186	12,556	13,250	14,585
Net operating cash flow impact	$ (5,000)	$ 16,000	$ 6,000	$ 1,000	$ (9,000)	$ (9,000)
Investing - source (use)	$ -	$ -	$ -	$ -	$ -	$ -
Financing - source (use)	$ -	$ -	$ -	$ -	$ -	$ -
Noncash - source (use)						
Right-of-use asset	$ (59,978)	$ -	$ -	$ -	$ -	$ -
Lease liability	59,978	-	-	-	-	-
Net noncash impact	$ -	$ -	$ -	$ -	$ -	$ -
Net cash impact	$ (5,000)	$ -	$ (10,000)	$ (15,000)	$ (25,000)	$ (25,000)

[5] This simplified example is designed to illustrate the accounting impacts and measurements involved in accounting for an operating lease by a lessee. Lease classification is assumed to be appropriate and is not illustrated. Net cash impact information in the Statement of Cash Flows section is for information only,

Exhibit III – Example Illustration of Financing Lease of Lessee[6]

Lessee Financing Lease - Assumptions

Lease term - years		5
Discount rate for the lease		6.0%
Lease payments made before commencement	$	5,000
Lease incentives received	$	(2,500)
Initial direct costs paid	$	2,500
Lease payment schedule		
Year 1	$	-
Year 2		10,000
Year 3		15,000
Year 4		25,000
Year 5		25,000
Total remaining lease payments	$	75,000
Lease liability - present value	$	59,978
Lease cost (net cash outlay)	$	80,000
Asset life - Years (Straight-line method)		5

Lessee Financing Lease - Financial Statement Impacts

	Commencement	Year 1	Year 2	Year 3	Year 4	Year 5
Balance sheet						
Assets						
Right-of-use asset	$ 64,978	$ 51,982	$ 38,987	$ 25,991	$ 12,996	$ -
Liabilities & equity						
Lease liability	$ 59,978	$ 63,577	$ 57,391	$ 45,835	$ 23,585	$ -
Income statement						
Interest expense	$ -	$ 3,599	$ 3,814	$ 3,444	$ 2,750	$ 1,415
Amortization expense	-	12,996	12,996	12,996	12,996	12,996
Total expense	$ -	$ 16,595	$ 16,810	$ 16,440	$ 15,746	$ 14,411
Statement of Cash Flows						
Operating - source (use)						
Increase (decrease) in accrued interest	$ -	$ 3,599	$ (3,599)	$ -	$ -	$ -
Amortization	-	12,996	12,996	12,996	12,996	12,996
	$ -	$ 16,595	$ 9,397	$ 12,996	$ 12,996	$ 12,996
Investing - source (use)						
Right-of-use asset	$ (5,000)	$ -	$ -	$ -	$ -	$ -
Financing - source (use)						
Lease liability	$ -	$ -	$ (2,587)	$ (11,556)	$ (22,250)	$ (23,585)
Noncash - source (use)						
Right-of-use asset	$ (59,978)	$ -	$ -	$ -	$ -	$ -
Lease liability	59,978	-	-	-	-	-
Net noncash impact	$ -	$ -	$ -	$ -	$ -	$ -
Net cash impact	$ (5,000)	$ -	$ (10,000)	$ (15,000)	$ (25,000)	$ (25,000)

[6] This simplified example is designed to illustrate the accounting impacts and measurements involved in accounting for a financing lease by a lessee. For comparison purposes the financing lease example utilizes the same general assumptions as the operating lease example. Lease classification is assumed to be appropriate and is not illustrated. Net cash impact information in the Statement of Cash Flows section is for information only.

Exhibit IV – Example Illustration of Sales-Type Lease of Lessor[7]

Lessor Sales-Type Lease - Assumptions

Fair value of underlying asset	$	74,000
Carrying value of underlying asset	$	69,000
Lease term - years		5
Rate implicit in the lease		4.128%
Lease payments		
Year 1	$	-
Year 2		10,000
Year 3		15,000
Year 4		25,000
Year 5		25,000
	$	75,000
Initial direct costs	$	2,500
Lessee guaranteed residual value	$	12,000
Net investment in the lease	$	74,000

Lessor Sales-Type Lease - Financial Statement Impacts

	Commencement	Year 1	Year 2	Year 3	Year 4	Year 5
Balance sheet						
Assets						
Net investment in the lease	$ 74,000	$ 77,054	$ 70,234	$ 58,133	$ 35,532	$ 12,000
Income statement						
Gain on sale of leased asset	$ 5,000	$ -	$ -	$ -	$ -	$ -
Lease income	-	3,054	3,180	2,899	2,399	1,468
Total revenue	5,000	3,054	3,180	2,899	2,399	1,468
Initial direct cost expensed	2,500	-	-	-	-	-
Net income (loss)	$ 2,500	$ 3,054	$ 3,180	$ 2,899	$ 2,399	$ 1,468
Statement of Cash Flows						
Operating - source (use)						
(Increase) decrease in net investment in the lease	$ -	$ (3,054)	$ 6,820	$ 12,101	$ 22,601	$ 23,532
Gain on sale of leased asset	(5,000)	-	-	-	-	-
	$ (5,000)	$ (3,054)	$ 6,820	$ 12,101	$ 22,601	$ 23,532
Investing - source (use)	$ -	$ -	$ -	$ -	$ -	$ -
Financing - source (use)	$ -	$ -	$ -	$ -	$ -	$ -
Noncash - source (use)						
Underlying asset	$ 69,000	$ -	$ -	$ -	$ -	$ -
Net investment in the lease	(69,000)	-	-	-	-	-
Net noncash impact	$ -	$ -	$ -	$ -	$ -	$ -
Net cash impact	$ (2,500)	$ -	$ 10,000	$ 15,000	$ 25,000	$ 25,000

[7] This simplified example is designed to illustrate the accounting impacts and measurements involved in accounting for a sales-type lease by a lessor. Lease classification is assumed to be appropriate and is not illustrated. Net cash impact information in the Statement of Cash Flows section is for information only,

Exhibit V – Example Illustration of Direct Financing Lease of Lessor[8]

Lessor Direct Financing Lease - Assumptions

Fair value of underlying asset	$ 74,000
Carrying value of underlying asset	$ 69,000
Lease term - years	5
Rate implicit in the lease	4.128%
Rate used to recognize deferred gain	5.032%
Lease payments	
Year 1	$ -
Year 2	10,000
Year 3	15,000
Year 4	25,000
Year 5	25,000
	$ 75,000
Initial direct costs	$ 2,500
Third-party guaranteed residual value	$ 12,000
Net investment in the lease	$ 71,500

Lessor Direct Financing Lease - Financial Statement Impacts

	Commencement	Year 1	Year 2	Year 3	Year 4	Year 5
Balance sheet						
Assets						
Net investment in the lease	$ 71,500	$ 75,098	$ 68,877	$ 57,343	$ 35,228	$ 12,000
Income statement						
Gain on sale of leased asset	$ -	$ -	$ -	$ -	$ -	$ -
Lease income	-	3,598	3,779	3,466	2,885	1,772
Total revenue	$ -	$ 3,598	$ 3,779	$ 3,466	$ 2,885	$ 1,772
Statement of Cash Flows						
Operating - source (use)						
(Increase) decrease in net investment in the lease	$ (2,500)	$ (3,598)	$ 6,221	$ 11,534	$ 22,115	$ 23,228
Investing - source (use)	$ -	$ -	$ -	$ -	$ -	$ -
Financing - source (use)	$ -	$ -	$ -	$ -	$ -	$ -
Noncash - source (use)						
Underlying asset	$ 69,000	$ -	$ -	$ -	$ -	$ -
Net investment in the lease	(69,000)	-	-	-	-	-
Net noncash impact	$ -	$ -	$ -	$ -	$ -	$ -
Net cash impact	$ (2,500)	$ -	$ 10,000	$ 15,000	$ 25,000	$ 25,000

[8] This simplified example is designed to illustrate the accounting impacts and measurements involved in accounting for a direct financing lease by a lessor. Lease classification is assumed to be appropriate and is not illustrated. The net investment in the lease in a direct financing lease is different from a sales-type lease as a result of the deferral of selling profit. Additionally, the discount rate applied to the net investment in the lease is different than the rate implicit in the lease due to the effects of the deferred selling profit. Net cash impact information in the Statement of Cash Flows section is for information only,

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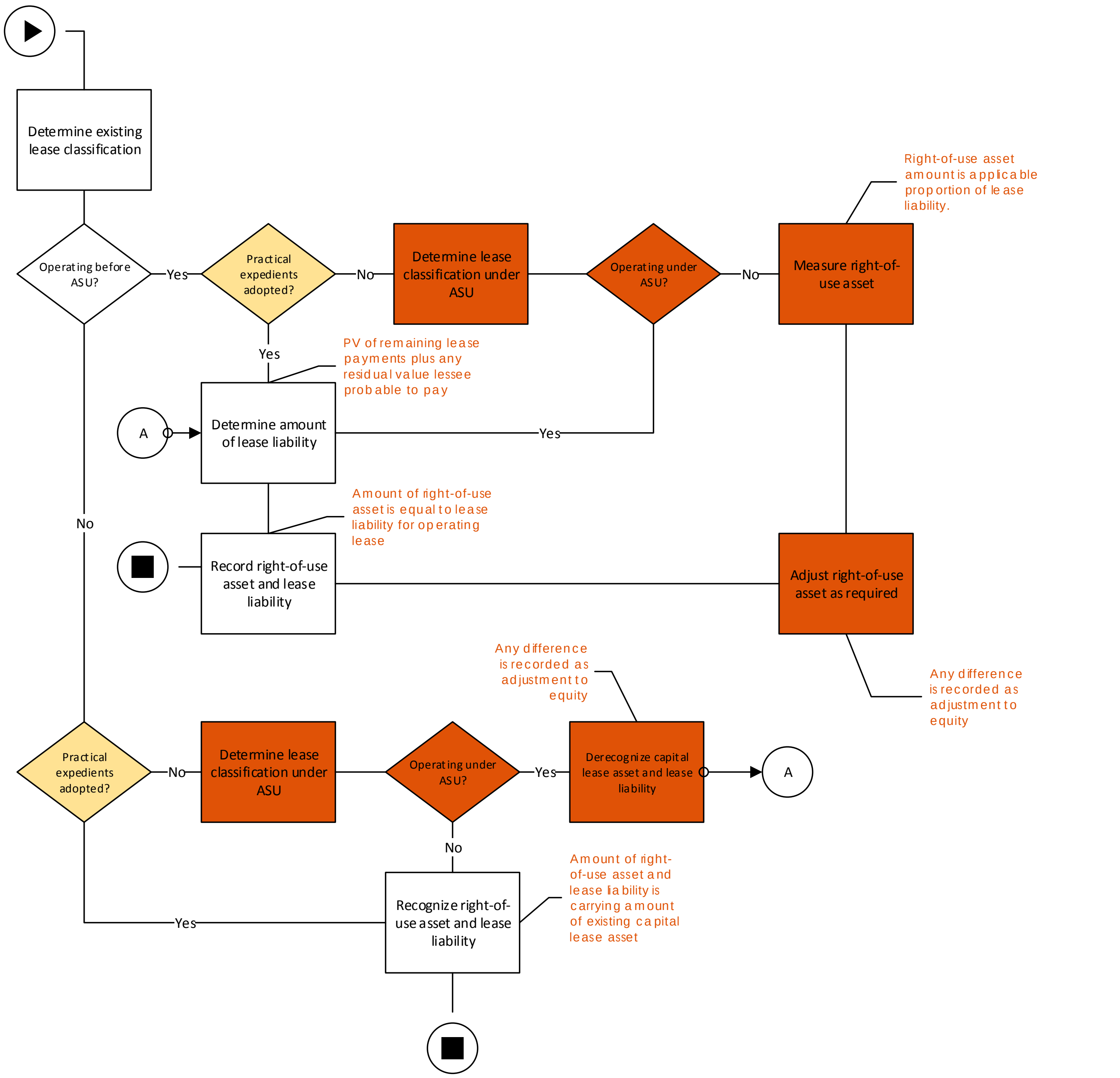
Exhibit VI – Why Lessee Transition Practical Expedients Matter[9]

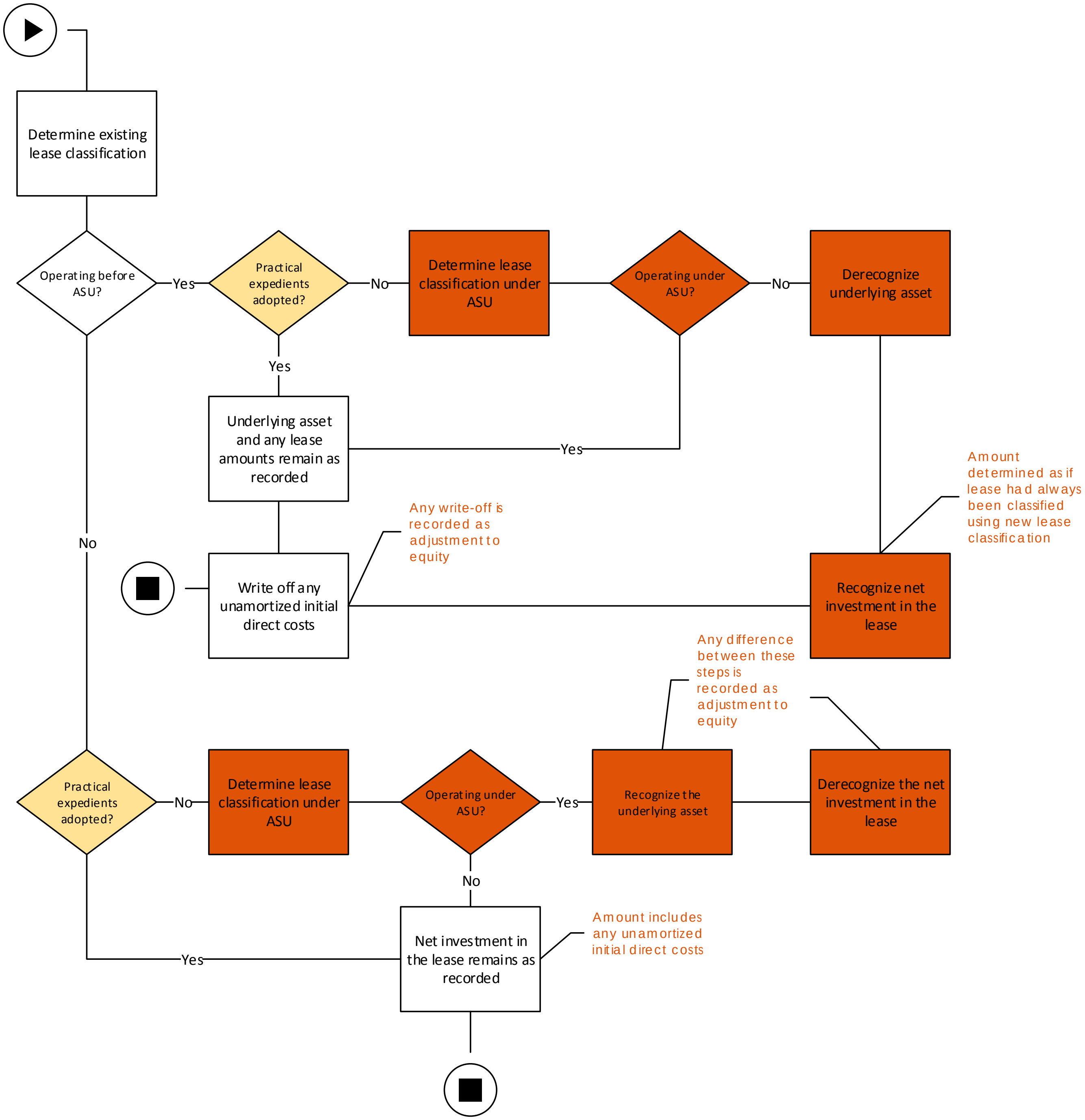
The information in this Exhibit is for illustration. For more information on practical expedients and transition see the section Transition and Implementation Considerations.



[9] The procedural impacts of not adopting the practical expedients are reflected in the orange shaded boxes. The procedures required in transition regardless of whether or not the practical expedients are adopted are shown in the boxes without shading. Additional considerations may apply in situations where the lessee has also adopted an accounting policy related to the short-term lease election.

Exhibit VII – Why Lessor Transition Practical Expedients Matter[10]

The information in this Exhibit is for illustration. For more information on practical expedients and transition see the section Transition and Implementation Considerations.



[10] The procedural impacts of not adopting the practical expedients are reflected in the orange shaded boxes. The procedures required in transition regardless of whether or not the practical expedients are adopted are shown in the boxes without shading.

Exhibit VIII – Key Terms

Commencement date of the lease (commencement date)

The date on which a lessor makes an underlying asset available for use by the lessee.

> ***CR Comment – The commencement date can be different than the inception date of the lease, and is the date used to determine the present value measurements when the lease is recognized. Determination of the commencement date is based on when the lessee has the right to use the underlying asset. It does not depend on when a lessee actually uses the asset or when lease payments begin.***

Discount rate for the lease (discount rate)

The discount rate can be different for the lessee and the lessor. It can also be different for lessees depending on whether or not the lessee is a public business entity or a private business entity. Whichever discount rate is required to be applied, all leases which are recognized on the balance sheet generally are required to be measured at their present value amount using a discount rate.

> ***CR Comment – Obtaining the information necessary to determine the appropriate discount rate is an important data requirement applicable to most leases. The only exceptions would be leases classified by lessors as operating leases and leases of lessees under a short-term lease election.***
>
> ***Lessor discount rates - The lessor must use the rate implicit in the lease as its discount rate (defined separately below). That rate is used by the lessor in connection with both sale-type leases and direct financing leases. No discount rate would be applicable to lessor operating leases.***
>
> ***Lessee discount rates – The lessee may use a variety of discount rates depending on what information is available and on whether the lessee is a public business entity or a private business entity. The lessee should always use the lessor's rate implicit in the lease unless that rate cannot be readily determined. In that case, the lessee is required to use an incremental borrowing rate[11] unless the lessee is a private business entity. A lessee which is a private business entity can adopt an accounting policy and elect to use a risk-free rate.[12] If the lessee adopts such an accounting policy it is required to use an appropriate risk-free rate in connection with all of its leases. In addition, lessees may be able to determine a single discount rate which could be applied to a portfolio of leases.***

Initial direct costs

Initial direct costs are applicable to both lessees and lessors and include incremental costs that would not have been incurred if the lease had not been obtained. It would not include any costs that would have been incurred regardless of whether the lease was obtained. The accounting for initial direct costs by the lessor depends on lease classification and, for sales-type leases, on the fair value and the carrying amount of the underlying asset.

> ***CR Comment – Certain costs which are incurred in connection with a lease may not qualify as initial direct costs. Examples of costs which do not qualify as initial direct costs would be any cost which would be incurred regardless of whether the lease was executed or not. The fact that the cost is related to the lease is not the determining factor. For example, legal costs related to a lease which would have been incurred whether the lease was executed or not do not qualify as initial direct costs. Other examples of costs which would not qualify as initial direct costs include travel costs and allocations of employee costs.***

[11] The incremental borrowing rate is the rate that a lessee would have to pay to borrow on a collateralized basis over a similar term an amount equal to the lease payments in a similar economic environment.

[12] The risk-free rate would be determined using a period comparable to that of the lease term.

Exhibit VIII – Key Terms (continued)

Lease

Under the ASU a lease is defined as a contract, or a portion of a contract, that conveys the right to control the use of an identified asset for a period of time in exchange for consideration.

Lease liability

A lease liability represents the lessee's discounted obligation to make lease payments.

Lease payments

Lease payments include several components applicable to both a lessee and a lessor as well as an additional component applicable solely to the lessee. The components applicable to both lessees and lessors include the following: i) Lease payments include fixed payments under the lease less any lease incentives paid or payable to the lessee; ii) they also include variable lease payments that depend on an index or a rate; iii) the exercise price of any option to purchase the underlying asset which the lessee is reasonably certain to exercise; iv) they could also include any penalties for terminating the lease which the lessee is expected to exercise; and v) fees paid by the lessee to the owners of a special-purpose entity for structuring the transaction. The additional component, which is only applicable to a lessee, would include any amounts which are probable (likely to occur) of being owed by the lessee under a residual value guarantee.

Lease receivable

The lease receivable is applicable to lessors and represents the lessor's right to receive lease payments arising from a sales-type lease or a direct financing lease. The lease receivable would also include any amounts that the lessor expects to derive from the underlying asset at the end of the lease term to the extent that such value is guaranteed either by the lessee or by a third party unrelated to the lessor. Both of the above amounts would be measured on a discounted basis.

Lease term

The lease term always includes the noncancelable period of time during which the lessee has the right to use an underlying asset. It also includes any periods covered by an option to extend the lease which the lessee is reasonably certain to exercise (more information related to "reasonably certain" is provided elsewhere in this publication of **INSIGHTS**), any periods covered by an option to terminate the lease which the lessee is reasonably certain not to exercise, and any periods covered by an option to extend or not terminate the lease where the exercise of that option is controlled by the lessor.

Net investment in the lease

The net investment in the lease is applicable to lessors and depends on lease classification. For both sales-type and deferred financing leases, the net investment in the lease includes the sum of the lease receivable and the unguaranteed residual asset (separate definition provided below).

> ***CR Comment – For deferred financing leases, the above amount is reduced by any deferred selling profit.***

Rate implicit in the lease

The rate of interest that, at a given date, causes the aggregate present value of the lease payments and the amount that a lessor expects to derive from the underlying asset following the end of the lease term to equal the sum of the fair value of the underlying asset and any deferred initial direct costs of the lessor.

> ***CR Comment – The rate implicit in the lease is applicable to the present value measurements made in connection with both sales-type leases and direct financing leases. However, direct financing leases with any deferred selling profit also will require a separate discount rate to be determined. This separate discount rate is utilized in determining the amount of any deferred gain to be recognized over the lease term.***

Exhibit VIII – Key Terms (continued)

Residual value guarantee

A guarantee made to a lessor that the value of an underlying asset returned to the lessor at the end of the lease will be at least a specified amount.

> ***CR Comment –*** ***Residual value guarantees can be made by the lessee or by another party. Residual value guarantees made by either the lessee or a third-party unrelated to the lessor are included in the determination of the net investment in the lease. Identification of the party responsible for any residual value guarantee is a significant factor which can impact the determination of the amount of lease payments as well as the lessor's lease classification.***

Right-of-use asset

The right-of-use asset applies to lessees and represents the lessee's right to use the underlying asset during the lease term.

Short-term lease

A short-term lease (which is only available to lessees and can affect their recognition requirements under the short-term lease election) includes a lease that at its commencement date has a lease term of 12 months or less and which does not include an option to purchase the underlying asset that the lessee is reasonably certain to exercise.

> ***CR Comment –*** ***Changes to certain assessments made in connection with a short-term lease can result in the lease no longer qualifying as a short-term lease. Such assessments would include any changes to the lease term as well as any changes related to whether the lessee is reasonably certain to exercise a purchase option. If such changes occur and result in the lease no longer qualifying as a short-term lease, then the lessee would be required to recognize both a lease asset and a lease liability in connection with the lease.***

Underlying asset

Represents the asset that is the subject of a lease. It does not have to be a single asset. Rather, it could be a physically distinct portion of a single asset.

Unguaranteed residual asset

The amount that a lessor expects to derive from the underlying asset following the end of the lease term that is not guaranteed by the lessee or any other third party, measured on a discounted basis.

Variable lease payments

Under the ASU variable lease payments are intended to include payments which can vary because of changes in facts or circumstances occurring after the commencement date, other than the passage of time.

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