



ASC Insights Series: Guide to Accounting Standards

Accounting Standards Codification 842, Leases

July 2024

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Foreword

Welcome to our “**Uniquus’ ASC Insights Series: Guide to Accounting Standards**”, where we combine our collective wisdom to understand various Accounting Standard Codifications (ASCs) comprehensively and in a crisp manner. This series is an invaluable tool for accounting professionals, offering detailed explanations, illustrative examples, and our expert point of view. Designed to support your professional journey, this guide helps you navigate complex accounting scenarios and deepen your knowledge.

This is the second publication in our “Uniquus’ ASC Insights Series: Guide to Accounting Standards”, focusing on “**ASC 842, Leases**”. In this installment, we delve into the specifics of ASC 842, exploring its implications, key considerations, and practical applications. Through clear illustrations and expert commentary, we aim to make the standard accessible and actionable for practitioners.

ASC 842 provides guidance on lease accounting. With the objective of recognizing most of the leases on the balance sheet, the FASB issued this new lease standard. Under ASC 842, leases are accounted for based on a “right-of-use model.”

We hope you enjoy reading this document and find this series valuable!

Thank you.

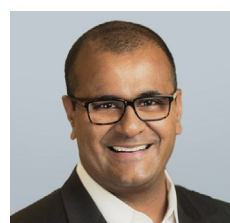
Yours faithfully

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Purpose

For many reporting entities, leasing is an important way of gaining asset access. Through leasing arrangements, lessees can finance the use of required assets, often simplifies the disposal of used asset, and thereby enables lessee's to reduce the exposure to the risks inherent in asset ownership.

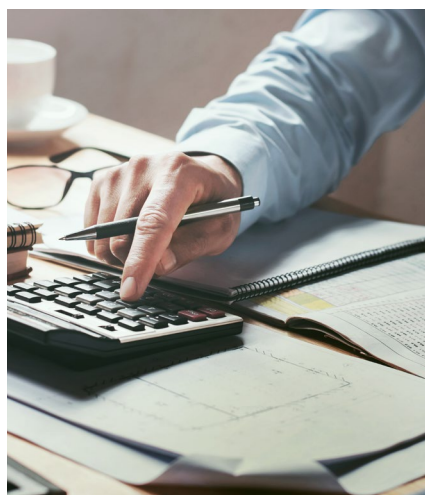
This publication provides an overview of the key accounting considerations and implementation matters relating to lease accounting after adopting Accounting Standards Codification (ASC) 842, Leases. The technical views and accounting positions on the framework continue to improve depending on the results of further technical evaluations.

We sincerely hope you find the enclosed publication informative. We will be happy to participate in any discussions required to clarify our views, which are enclosed in the attached publication. We look forward to hearing from you.

Background

With the objective of recognizing most of the leases on the balance sheet, the Financial Accounting Standards Board (FASB or Board) issued ASU 2016-02 in February 2016, which was subsequently amended in some aspects by Accounting Standards Updates (collectively the "new leases standard" or "ASC 842").

Under ASC 842, leases are accounted for based on what FASB refers to as a "right-of-use model." The substance of the model is, at the lease commencement date, for a lessee there exist financial obligation to make lease payments to the lessor for its right to use the underlying asset over the period of lease term. On the other hand, at lease commencement, the lessor conveys that right to use the underlying asset, which is the point in time when lessor makes the underlying asset available for use by the lessee.



In comparison to legacy guidance under ASC 840, Leases, which did not require lessees to recognize assets and liabilities under operating leases, the new leases standard results in a true representation of lessees' assets and liabilities and more transparency about the lessee's obligations and leasing activities by recognizing most of the leases on the balance sheet from day one. Accounting for leases under ASC 842 create new risks and require more judgment than accounting for leases under legacy guidance. While ASC 842 does not make fundamental changes to lessor accounting model under legacy guidance, it does modify the criteria for sales-type leases and direct financing leases and related accounting.

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01 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 production process for sale, and assets to be currently consumed in producing goods or services to be available for sale).
- Leases of assets under construction.

02 Identification of lease

A lease is defined as 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**.

ASC 842 requires an entity to assess whether a contract is a lease or contains a lease at the contract's inception, considering all relevant facts and circumstances. For example, the fact that a contract is labeled a "transportation contract" or a "lease" does not necessarily mean the arrangement is or is not a lease. Therefore, the parties to the contract must carefully analyze the terms to determine whether the arrangement conveys the right to control the use of an asset.

The following diagram highlights the two conditions required to meet the definition of a lease, plus the specific tests that must be passed to meet those conditions:

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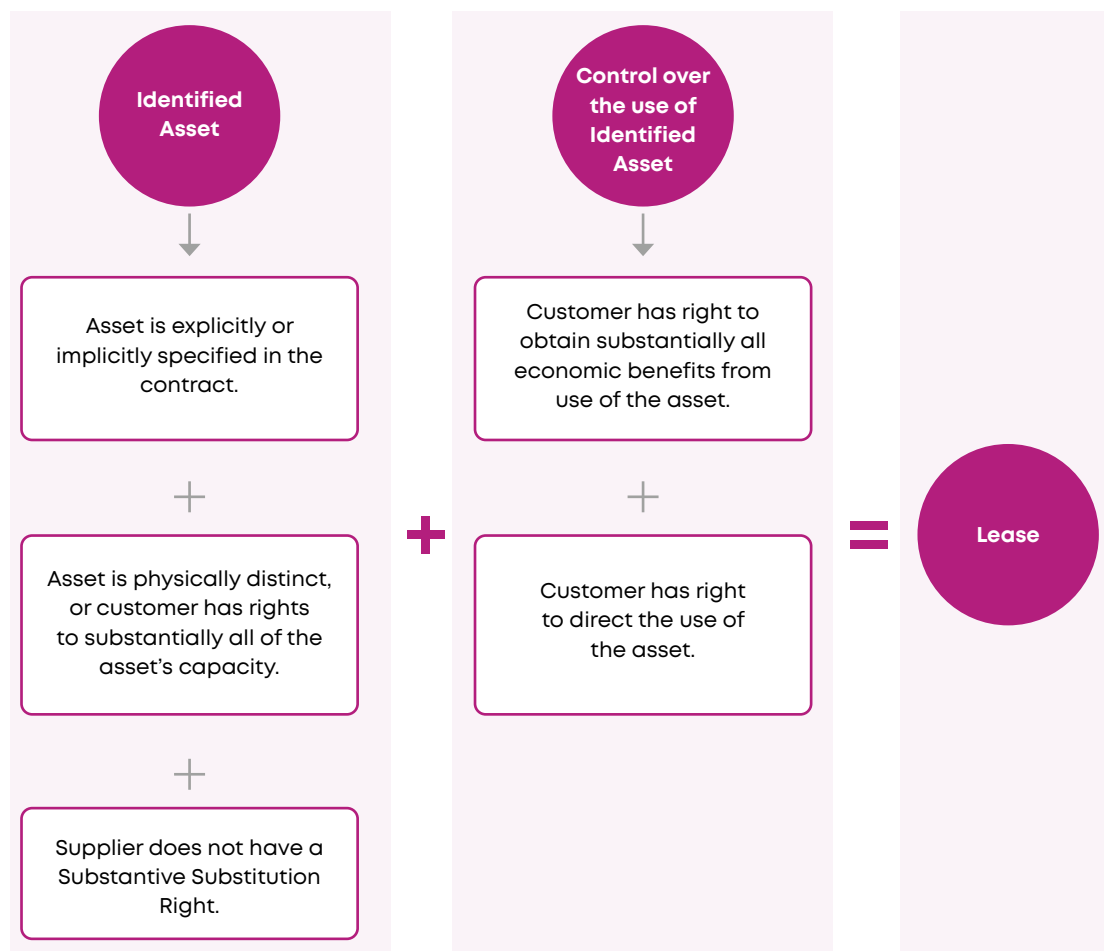
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Separating lease and non-lease components

If a contract is or contains, a lease, the entity follows the below steps in accounting for the components of the contract:

Step 1: Identify and separate the lease components.

Step 2: Identify any non-lease components – e.g. a maintenance or operating service.

Step 3: Measure the 'consideration in the contract'.

Step 4: Separate and allocate the consideration in the contract between the lease and non-lease components.

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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 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 conditions 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 building), ASC 842 requires an entity to classify and account for the right to use land as a separate lease component unless the accounting effect of not separately accounting for land is insignificant.

Many contracts contain a lease and an agreement to purchase or sell other goods or services (non-lease components). 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 not to 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).

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.



Lessees not electing the practical expedient of separating lease and non-lease components, requires applying significant judgment in identifying, and allocating the consideration to non-lease components, since these shall be excluded from the lease payments, considered for computation of lease liability.

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Lease Term and lease commencement date

The lease term begins at the lease commencement date (the date on which a lessor makes an underlying asset available for use by a lessee) and is determined on that date based on the noncancelable¹ term of the lease, together with all 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. Reasonably certain should be considered a high threshold. While there are no bright lines, the FASB has highlighted that the threshold can be evaluated as “reasonably assured” under existing GAAP, i.e., a probability of 75%. When assessing whether a lessee is reasonably certain to exercise a renewal or termination, option management should consider the substance of the contract rather than its legal form .

¹ ASC 842 applies to contracts that are referred to as “cancellable,” “month-to-month,” “at-will,” “evergreen,” “perpetual” or “rolling” if they create enforceable rights and obligations. An arrangement is not enforceable if both the lessee and the lessor each have the right to terminate the lease without permission from the other party and with no more than an insignificant penalty.



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Lease Payments

Lease payments are payments made by a lessee to a lessor (or a third party on behalf of the lessor) relating to the right to use an underlying asset during the lease term and include the following amounts:

Payment Type	Description
Fixed payments	Fixed (including in-substance fixed) payments, less any lease incentives paid or payable to the lessee
Variable lease payments based on an index or rate ^(a)	Variable lease payments that depend on an index or a rate (e.g., the Consumer Price Index (CPI), a market interest rate, etc.)
Purchase options	The exercise price of a purchase option if the lessee is reasonably certain to exercise that purchase option
Penalties for terminating the lease	Payments for penalties for terminating a lease if the lease term reflects the lessee exercising an option to terminate the lease
Fees – special-purpose entity	Fees paid by the lessee to the owners of a special-purpose entity for structuring the transaction
Residual value guarantees	The amounts that are probable, the lessee will owe under residual value guarantees. (lessees only)

(a) For lessees, these payments are not included in lease payments and are recognized when achieving the specified target that triggers the variable payments is considered probable. For lessors, these payments are recognized as income in profit or loss in the period in which the changes in facts and circumstances on which the variable lease payments are based occur.



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.

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06 Discount rate

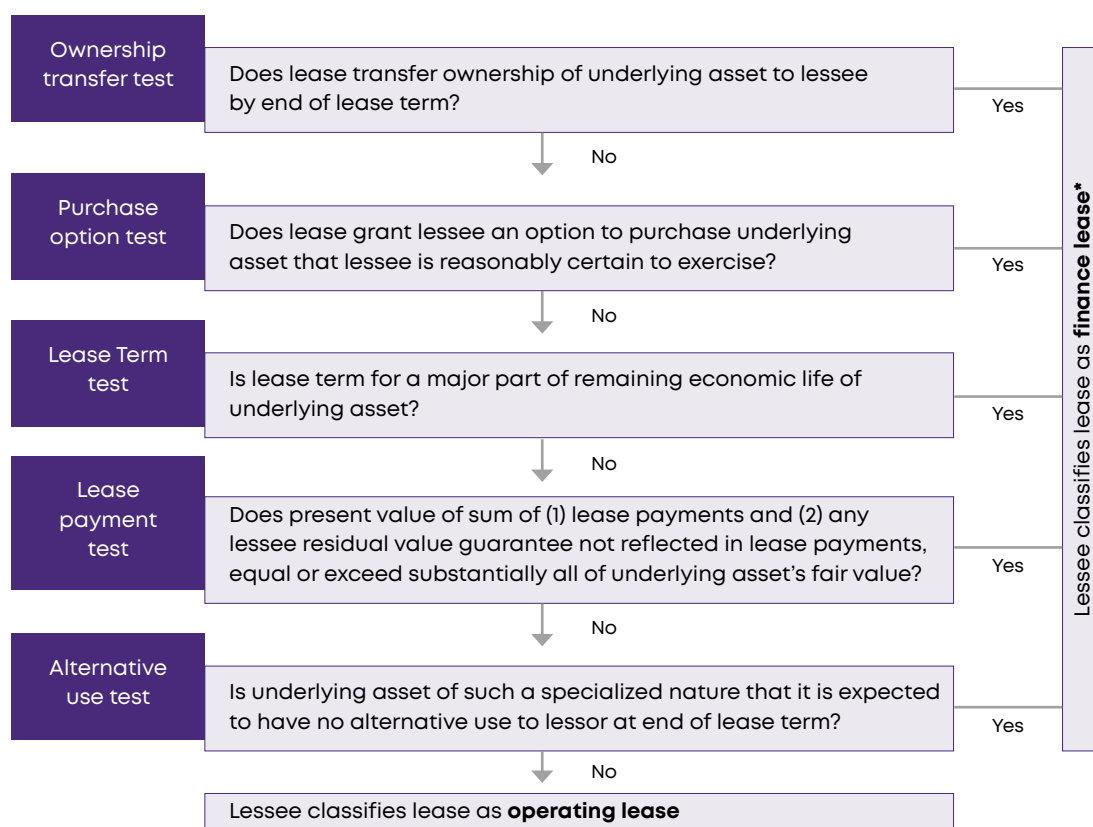
For lessors and lessees, discount rates are used to determine the present value of the lease payments and determine lease classification. They are also used to measure both a lessor's net investment in the lease for sales-type and direct financing leases and a lessee's lease liability.

- For a lessee, the discount rate is the rate implicit in the lease or, if that rate cannot be readily determined, its incremental borrowing rate.
- For a lessor, the discount rate is the rate implicit in the lease.

Non-public business entities (Non-PBEs) are allowed to make an accounting policy election to use the risk-free rate (e.g., in the US, the rate of a zero coupon US Treasury instrument) by class of underlying asset (rather than for all leases as originally required by ASC 842). However, a lessee must apply the rate implicit in the lease when it is easily determinable, even if it has made the risk-free rate election for the associated class of underlying asset.

07 Lease Classification

At lease commencement, a lessee applies the following lease classification test:



* Lessor classifies the lease as a “Sales-type lease”.

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ASC 842-10-55-3 provides relaxation for **Lease payment test criteria** when it is not practicable for an entity to determine the fair value of the underlying asset. As per the guidance, in those cases where it is not practicable to determine the fair value of an underlying asset, entity should assess the lease classification without consideration of the “Lease Payment test”.

In our view what is practicable is subjective and is an area of judgment. There may be a possibility that something that is, practicable for one entity may not be practicable for another entity or something that is practicable in one period may not be practicable in another period, and something that is practicable for one underlying asset (or class of underlying asset) may not be practicable for another asset (or class of underlying asset).

08

Lessee Accounting

a. Operating Lease and Finance Lease

Accounting for operating and finance leases by lessees is summarized below:-

	Operating leases	Finance lease
Initial recognition and measurement	Initially measure the ROU asset ¹ and lease liability at the present value of the lease payments to be made over the lease term	
Subsequent measurement — lease liability	Measure the lease liability at the present value of remaining lease payments using the discount rate determined at lease commencement ²	Accrete the lease liability based on the interest method using the discount rate determined at lease commencement ² and reduce the lease liability by the payments made
Subsequent measurement — ROU asset	Measure the ROU asset at the amount of the remeasured lease liability, adjusted for the remaining balance of any lease incentives received, any cumulative prepaid or accrued rents (i.e., uneven rent payments), any unamortized IDCs, and any impairment of the ROU asset	Amortize the ROU asset, generally on a straight-line basis, over the shorter of the lease term or the useful life of the ROU asset, and record any impairment of the ROU asset

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	Operating leases	Finance lease
Income statement effect	Includes: • A single lease cost for an operating lease on a straight-line basis. • Variable lease payments not considered for computation of lease liability i.e., variable rentals (other than those linked to index or rate). • Changes to variable lease payments that depend on an index or rate. • Impairment of ROU asset, if any.	Includes: • Amortization of ROU asset. • Interest on lease liability. • Variable lease payments not considered for the computation of lease liability, i.e., variable rentals (other than those linked to index or rate). • Changes to variable lease payments that depend on an index or rate. • Impairment of ROU asset, if any.

1 The initial measurement of the ROU asset also includes the lessee's IDCs and prepayments made to the lessor at or before the commencement date, as well as less lease incentives received from the lessor.

2 As long as the discount rate has not been updated due to a reassessment event.

b. Remeasurement of lease liabilities and ROU asset

In the following circumstances, a lessee re-measures the lease liability at the reassessment date and adjusts the right-of-use asset by the change in the lease liability. However, if the right-of-use asset is reduced to zero, a lessee recognizes any remaining amount in profit or loss.

	In remeasuring the lease liability/ ROU asset, reassess the following:	
Remeasurement of the lease liability and the ROU asset occurs when:	Discount rate	Lease term and classification
There is a lease modification that is not accounted for as a separate contract.	Yes	Yes
There is a change in lease term resulting from- • A triggering event within the lessee's control that changes the certainty of a lessee exercising an option to renew or terminate the lease; • Occurrence of contractual event that obligates the lessee to exercise or not exercise an extension or termination option.	Yes ¹	Yes
There is a change in the lessees' assessment of whether it is reasonably certain to exercise an option to purchase the underlying asset resulting from a triggering event.	Yes	Yes

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	In remeasuring the lease liability/ ROU asset, reassess the following:	
Remeasurement of the lease liability and the ROU asset occurs when:	Discount rate	Lease term and classification
A contingency is resolved that results in variable lease payments meeting the definition of lease payments.	No	No
There is a change in the lessees' assessment of the amount owed under a residual value guarantee.	No	No

¹ If the discount rate for the lease liability does not already reflect the lessee's option to extend or terminate the lease or purchase the underlying asset.



C. Lease Modification

ASC 842 defines 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 change to the terms and conditions of the contract that adds or terminates the right to use one or more underlying assets or extends or shortens the contractual lease term). Accounting of lease modification depends upon whether a lease modification is accounted for as a separate contract or not.

A lessee accounts for a lease modification as a separate contract (i.e., separate from the original contract) when both of the following conditions are met:

- The modification grants the lessee an additional right of use that is not included in the original lease (e.g., a right to use an additional underlying asset).
- The lease payments increase commensurate with the standalone price for the additional right of use, adjusted for the circumstances of the particular contract.

Lease modification, which grants the lessee the right to use the existing underlying asset for an additional period (i.e., a period not included in the original lease agreement), it shall not be accounted for as a separate contract. As stated in the Basis for Conclusions (BC 176(b)) of ASU 2016-02, such modification only changes an attribute of the lessee's existing right to use the underlying asset it already controls. This is the case even if the extended term is priced at market.

The following flowchart summarizes the lease modification accounting:-

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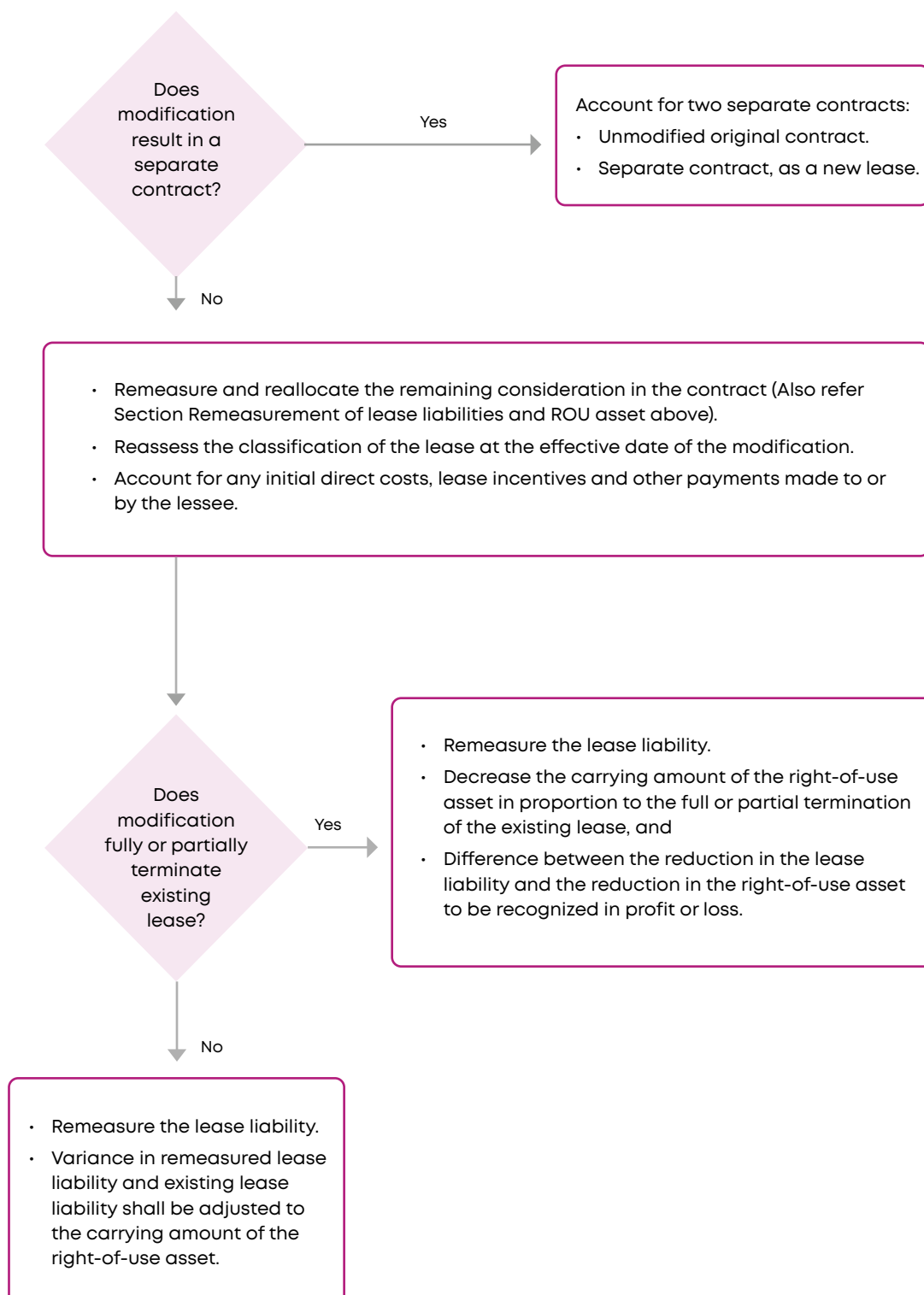
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d. Lease incentive and Leasehold improvement allowance

Lease incentives include Payments made by the lessor to or on behalf of the lessee and Losses incurred by the lessor due to assuming a lessee's preexisting lease with a third party. For e.g., leasehold improvement allowance, payment of costs for the lessee (such as moving expenses), or the assumption by the lessor of the lessee's preexisting lease with a third party.

Recognition of lessor's reimbursement of some (or all) of the costs incurred by a lessee for completion of leasehold improvements depends on whether improvements made to the underlying asset are lessee or lessor assets. Following summarizes the accounting of leasehold improvements costs incurred by lessee and its reimbursement by lessor-

	Leasehold improvement cost incurred by tenant and reimbursed by lessor	Leasehold improvement cost incurred by tenant and not reimbursed by lessor
Improvement represents lessee's asset	The payment made by lessor is a lease incentive which should be accounted as a reduction to fixed lease payments.	The Cost incurred by lessee shall be considered as leasehold improvement asset to be amortized. As per principles of ASC 842-20-35-12, leasehold improvements shall be amortized over the remaining lease term or the useful life of those leasehold improvements whichever is shorter. (Also refer amendment in ASU 2023-01, Leases Topic (842): Common Control Arrangements issued by FASB)
Improvement represents lessor's asset	Reimbursement of the cost incurred by tenant shall not be considered as lease incentive. The expenditure incurred by lessee on leasehold improvement shall be considered as prepaid rent and the reimbursement shall be considered as reduction to prepaid rent.	The expenditure incurred by lessee shall be considered as a lease payment.

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e. Common Control Arrangements ASU 2023-01, Leases Topic (842)

i. Lease classification assessment under Common Control Arrangements

Prior to the amendment in ASU 2023-01, ASC 842 required Leases between related parties to be classified in accordance with the lease classification criteria applicable to all other leases based on the **legally enforceable terms and conditions** of the lease. In other words, in a related party arrangement entities used the legally enforceable terms and conditions to determine whether the arrangement is or contains a lease, and if so, the classification of and accounting for that lease. This requirement applied to all related party arrangements, including common control arrangements. However, due to related party relationship, the legal lease provisions included in the contract may be uneconomic or there may not exist a detailed contract. For example, within office space leased from a related party under a non-renewable, two-year managed service arrangement, a lessee may install leasehold improvements with an economic life of six years. This may be considered as an indication that the lessee is expecting to use the space longer than the two-year lease term, and therefore, the written contractual terms of the managed service arrangement may be considered uneconomic. Because of this, in some cases, identifying the enforceable terms and conditions could necessitate a formal legal opinion.

In response to feedback from users of financial statement FASB in March 2023, issued **ASU 2023-01, Common Control Arrangements**. The amendment in ASU provides an optional practical expedient under which private companies, not-for-profit entities that are not conduit bond obligors and employee benefit plans that file or furnish financial statements with or to the SEC, are allowed on an arrangement-by-arrangement basis to use the written terms and conditions of an arrangement between entities under common control to determine (1) whether a lease exists and (2) the subsequent accounting for (and classification of) the lease without requiring to consider the legal enforceability of such written terms and conditions.



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ii. Leasehold improvements related to common control leases

In March 2023, the FASB issued an **Accounting Standard Update (ASU) 2023-01, Leases Topic (842): Common Control Arrangements**, which requires a lessee in a common control lease arrangement to amortize leasehold improvements that it owns as a lessee's asset over the improvements useful life to the common control group regardless of the lease term, if the lessee continues to control the use of the underlying asset through a lease. Further, if lessee ceases to control the use of the underlying asset before the end of the leasehold improvement's useful life, the improvements are deemed to be transferred to the lessor and lessee derecognizes the remaining carrying amount of the improvements and makes a corresponding adjustment to equity (or net assets for not-for-profit entities). The amendment in ASU is applicable to all entities in fiscal years beginning after December 15, 2023, including interim periods within those fiscal years. Early adoption is permitted for both interim and annual financial statements.

In case of sub-lease arrangement between entities under common control, wherein a lessee obtains control of an underlying asset through a lease arrangement with an unrelated party and subsequently subleases the asset to a group entity under common control, the sublessee would generally amortize the leasehold improvements over a period that does not exceed the lease term as per lease arrangement between the lessee/intermediate lessor and the unrelated party. However, if the lease between the lessee/intermediate lessor and the unrelated party contains an option to purchase the underlying asset and the lessee/intermediate lessor is reasonably certain to exercise that option, the leasehold improvements should be amortized over the useful life to the common control group.

f. Short-term leases

- As per ASC 842, 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.
- ASC 842 allows Lessees to make an accounting policy election (by class of underlying asset to which the right-of-use asset relates) to apply accounting like 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 exemption²).
- The 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 in profit or loss on a straight-line basis over the lease term and variable lease payments (other than linked to 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.

² The short-term lease election can only be made at the commencement date, and it does not apply to lessors.



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Lessor Accounting

Sales-type leases	Direct Financing lease	Operating leases
Classification criteria		
A lease that meets any of the lease classification criteria is classified as a Sales-type lease.	A lease arrangement wherein the lessor obtains a residual value guarantee from an unrelated third party other than the lessee, which is sufficient to satisfy the “substantially all” criterion of lease classification is classified as a direct financing lease.	A lease which is neither a Sales-type lease nor a direct financing lease, is classified as an Operating lease.
Initial Recognition and measurement		
If Collectability of the lease payment and any residual value guarantee provided by the lessee is:		
(a) Probable at lease commencement		
• Derecognize the carrying amount of the underlying asset. • Recognize the net investment in the lease. • Recognize, in net income, any selling profit or selling loss. Note: Collectability of lease payments and any residual value guarantee provided by the lessee is continually reassessed.	• Derecognize the carrying amount of the underlying asset. • Recognize the net investment in the lease. • Recognize any selling loss in net income. • Defers any selling profit and initial direct costs and includes those amounts in the initial measurement of the net investment in the lease (i.e., selling profit reduces the net investment in the lease).	• Continue to recognize the underlying asset. • Recognize 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 using the underlying asset.

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(b) Not Probable at lease commencement ⁽¹⁾

- | | | |
|---|--|--|
| <ul style="list-style-type: none"> Do not derecognize the underlying asset. Account for lease payments received as a deposit liability.⁽²⁾ | <ul style="list-style-type: none"> The arrangement shall be classified as an Operating lease. | <ul style="list-style-type: none"> Continue to recognize the underlying asset. A lessor's lease income is constrained to the lesser of (1) the income that would have been recognized if the collection were probable, including income from variable lease payments, and (2) the lease payments, including variable lease payments, that have been collected from the lessee. |
|---|--|--|

Subsequent measurement

- | | |
|--|---|
| <p>Recognize interest income (in profit or loss) over the lease term in an amount that produces a constant periodic discount rate on the remaining balance of the net investment in the lease (i.e., using the rate implicit in the lease), including:</p> <ul style="list-style-type: none"> Interest on the lease receivable. Interest from accretion of the unguaranteed residual asset to its expected value at the end of the lease. Amortization of any deferred selling profit (in case of direct financing only). Reduce the net investment in the lease for lease payments received (net of interest income calculated above). Separately recognize income from variable lease payments that are not included in the net investment in the lease (e.g., performance- or usage-based variable payments). Recognize changes to variable lease payments that depend on an index or rate in profit or loss in the period of the change. Recognize any impairment (or credit losses) of the net investment in the lease. | <ul style="list-style-type: none"> Recognize depreciation in accordance with normal depreciation policy. Recognize 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. Recognize the difference between the cash received and the straight-line lease income as rent receivable or deferred rent (as the case may be). |
|--|---|

(1) The Collectability of lease payments and any residual value guarantee provided by the lessee is continually reassessed.

(2) When Collectability of lease payments and any residual value guarantee provided by the lessee is not probable at lease commencement, a lessor derecognizes the carrying amount of any deposit liability previously recognized and recognizes lease income when the lease payments received from the lessee are nonrefundable and either:

- The contract terminates.
- The lessor repossesses the underlying asset and has no further obligation to the lessee under the contract.

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Sale and leaseback transaction

In a sale and leaseback transaction, the seller-lessee sells an asset it owns to, the buyer-lessor and simultaneously leases back all or a portion of the same asset for whole, or part of, the asset's remaining economic life. The legal ownership of the underlying asset is transferred by seller-lessee to the buyer-lessor in exchange for consideration, and then seller-lessee makes periodic rental payments to the buyer-lessor to retain the right to use the asset.

For a transaction to be considered as a Sale and leaseback transaction, the first and foremost qualifying criteria is that the initial transaction qualifies as a sale as per the principles of ASC 606, Revenue from Contracts with Customers. In other words, the seller-lessee needs to ensure the buyer-lessor obtains control of the asset.

The following table summarizes the accounting for sale and leaseback transactions for the seller-lessee and the buyer-lessor.

Seller-lessee	Buyer-lessor
Sale and leaseback transaction	
Sale accounting - Recognition of the transaction price for the sale at the point in time when the buyer-lessor obtains control of the asset. - Derecognize the carrying amount of the underlying asset. - Recognition of any gain or loss, adjusted for off-market terms¹, immediately.	Purchase accounting Account for the asset in accordance with ASC 360.
Leaseback accounting Lessee accounting as any other lease, adjusted for off-market terms².	Leaseback accounting Lessor accounting is like any other lease adjusted for off-market terms.
Failed Sale and leaseback transaction	
- Do not derecognize the underlying asset and continue depreciating the asset. - Account for amounts received as a financial Liability. - Rental payments should be allocated between interest expense and principal repayment of the financial liability.	- Do not recognize the transferred asset. - Account for amounts paid as a financial asset i.e., receivable. - Rental payments received should be allocated between interest income and principal repayment of the receivable.

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- (1) If the sale of an asset is not at fair value or the lease payments are not at market rates, the seller-lessee and buyer-lessor should make adjustments so that the sale is recognized at fair value. Adjustment include-
- Any increase to the sale price of the asset as a prepayment of rent
 - Any reduction to the asset's sale price as additional financing provided by the buyer-lessor to the seller-lessee.
- (2) (i) If the present value of the contractual leaseback payments is less than the present value of market rental payments. A seller-lessee should increase the initial leaseback right-of-use asset to match the difference between the sale price and fair value, similar to prepaid rent.
- (ii) If the present value of contractual leaseback payments is greater than the present value of market rental payments, a seller-lessee should account for the excess of the leaseback payments over the asset's fair value as additional financing from the buyer-lessor separate from the lease liability.

Leases acquired under Business Combination

An acquirer often obtains the acquiree's leases as part of a business combination. As per the principles of ASC 805 business combination, leases acquired as part of a business combination shall be accounted for as per the principles of ASC 842. Unlike most other assets and liabilities acquired in a business combination, the lease liability and ROU asset are not recognized at fair values on the acquisition date.

In a business combination, an acquirer should retain the acquiree's classification of its leases, except if "there is a lease modification, and such a modification is not accounted for as a separate contract". The following summarizes initial recognition and measurement principles of leases acquired under business combination:-

Acquiree is a lessee

- Recognize the lease liability and ROU asset as per the principles of ASC 842 for the remaining lease term and the remaining lease payments as if the lease's commencement date is the acquisition date.
- The initial measurement of the ROU asset is the amount of the lease liability adjusted for favorable or unfavorable terms compared to the market.

Note: The difference between the amounts recognized for the lease liability and the ROU asset essentially affects the amount of goodwill (or gain from a bargain purchase) recognized in the broader accounting for the business combination.

Acquiree is a lessor

- If the lease is an operating lease, the entity will recognize the underlying asset at fair value. It will recognize an asset or a liability to reflect the favorable or unfavorable terms of the lease.
- If the lease is a sales-type lease or a direct financing lease, the entity will record a lease receivable at the present value of the remaining lease payments and the guaranteed residual value, as well as an unguaranteed residual asset for the difference between the fair value of the underlying asset at the acquisition date and the carrying amount of the lease receivable.

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01 Identification of Lease

The Customer and a freight carrier (Supplier) entered into a contract to provide the Customer with the use of 10 rail cars of a particular type for 5 years. The contract specifies the rail cars; the cars are owned by Supplier. As per the terms of the contract, the Customer determines when, where, and which goods are to be transported using the cars. When the cars are not used, they are kept at the Customer's premises. The Customer can use the cars for another purpose (for example, storage) if it so chooses. However, the contract specifies that the Customer cannot transport particular types of cargo (for example, explosives). If a particular car needs to be serviced or repaired, the Supplier is required to substitute a car of the same type. Otherwise, other than on default by the Customer, the Supplier cannot retrieve the cars during the five-year period.

The contract also requires the Supplier to provide an engine and a driver when the Customer requests. The Supplier keeps the engines at its premises and provides instructions to the driver detailing the Customer's requests to transport goods. The Supplier can choose to use any one of a number of engines to fulfill each of the Customer's requests. One engine could be used to transport not only the Customer's goods but also the goods of other customers (for example, if other customers require the transport of goods to destinations close to the destination requested by Customer and within a similar timeframe, Supplier can choose to attach up to 200 rail cars to the engine).

Does the conveyance of the right to use "10 rail cars for 5 years" meet the lease definition as per the principles of ASC 842?

Analysis:

As per the terms of the contract, there are 10 identified rail cars. The cars are explicitly specified in the contract. Once delivered to the Customer, the cars can be substituted only when they need to be serviced or repaired. The engine used to transport the rail cars is not an identified asset because it is neither explicitly specified nor implicitly specified in the contract.

The Customer has the right to control the use of the 10 rail cars throughout the 5-year period of use because:

- a. Customer has the right to obtain substantially all the economic benefits from the use of the cars over the five-year period of use. The Customer has exclusive use of the cars throughout the period of use, including when they are not being used to transport the Customer's goods.

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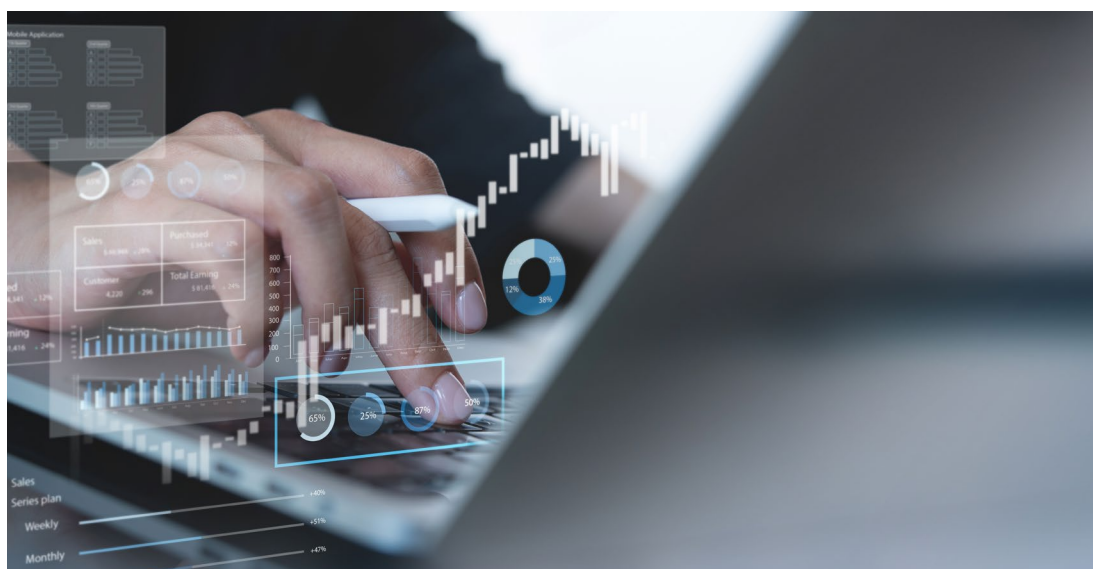
b. The Customer has the right to direct the use of the cars. The contractual restrictions on the cargo that can be transported by the cars are protective rights of the Supplier and define the scope of the Customer's right to use the cars. Within the scope of its right of use defined in the contract, the Customer makes the relevant decisions about how and for what purpose the cars are used by being able to decide when and where the rail cars will be used, and which goods are transported using the cars. The Customer also determines whether and how the cars will be used when not being used to transport its goods (for example, whether and when they will be used for storage). The Customer has the right to change these decisions during the five-year period of use.

Although having an engine and driver (controlled by the Supplier) to transport the rail cars is essential to their efficient use, the Supplier's decisions in this regard do not give it the right to direct how and for what purpose the rail cars are used. Consequently, the Supplier does not control the use of the cars during the period of use.

Based on the above, it can be concluded that the contract contains rail car leases. The Customer has the right to use 10 rail cars for 5 years.



Under ASC 842, it is very critical to determine whether an arrangement contains a lease. In the event of the lessee's failure to identify leases, including those embedded in service arrangements, there is a likelihood of financial statement error, given that ASC 842 requires lessees to reflect all leases (other than short-term leases), on the balance sheet. Entities must evaluate service arrangements involving PP&E to determine whether the arrangements contain a lease at contract inception. The assessment will be more complicated under circumstances wherein a service arrangement involves a specified physical asset or arrangements wherein the supplier and the customer both make decisions about using the underlying asset. This may require judgement.



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02 Identification and separation of leases and non-lease components

On 1 January 20X3, Lessee enters a three-year lease for office space with Lessor. The following are the terms of the lease arrangement:

- A fixed payment payable on 31 December of each year starting at \$300,000 and increasing 10% each year. The lessor shall be providing common area maintenance (CAM) services in the office space for which no separate rentals are charged.
- The lessee is provided with 10 dedicated parking slots exclusively reserved for the lessee, which are rented monthly at \$300 per slot at its standalone selling price, increasing 10% annually. In addition to the dedicated parking slot, the lessee is also allowed non-reserved parking for 10 additional vehicles, for which the charges are based on daily usage.
- Lessee shall be liable to incur Lessor's real estate taxes and insurance related to the underlying asset. Amounts incurred are payable on 31 December of each year.
- All rentals and other incidental expenses shall be subject to additional payment of VAT.
- The right to use the office space for three years is a lease component and is classified as an operating lease.
- The standalone price for the right to use the office space and CAM services for three years is \$800,000 and \$ 123,000, respectively.
- Lessee does not elect the practical expedient to combine the lease and non-lease components.
- The incremental borrowing rate at lease commencement is 4%.

Identify various lease and non-lease components in the arrangement and how the consideration shall be allocated to different components of the arrangement.

Analysis:

Contracts generally include different types of obligations to the supplier, which might be a combination of lease components or a combination of lease and non-lease components. In a multi-element arrangement, the entity lessee shall follow the below-mentioned steps in accounting for the components of the contract:

Step 1: Identify and separate the lease components.

As per the terms of the contract, the lessee has been granted the right to use the office space along with reserved parking space for 10 vehicles for exclusive use by the lessee. Therefore, it can be concluded that the contract contains the right to use multiple assets, i.e., office space and reserved parking space. Lessee cannot derive benefits from using reserved parking spaces without office space, and the right to use parking space is highly dependent and highly interrelated with the use of office space. Therefore, the right to use multiple assets shall be considered a single lease component.

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There exists no identified asset in respect of the right to use non-reserved parking space on a daily usage basis, so it does not meet the definition of a lease and is not considered a lease component.

Step 2: Identify any non-lease components.

- As per the terms of the arrangement, the lessee shall also be providing the following services, which are distinct elements of a contract and are not related to securing the right of use of the office space -
 - Common Area Maintenance services for which no additional rentals are charged.
 - Parking facility for an additional 10 vehicles on a non-reserved basis for which rentals are charged on an actual daily usage basis.
- Lessee's payments for Lessor's real estate taxes and insurance related to the underlying asset are not components of the contract because they do not represent payment for goods or services, in addition to the right to use the space transferred to the lessee and shall be expensed as incurred.
- VAT is also not part of the consideration of the contract, regardless of whether the lessor or the lessee is the primary obligor for the tax. Therefore, the same shall not be considered as a non-lease component and shall be expensed as incurred.

Step 3: Measure the 'consideration in the contract'.

Consideration in the contract includes:-

Component	Consideration	Nature of Component
Lease rentals for Office Space	Year-1: \$300,000 Year 2: \$330,000 Year 3: \$363,000	Lease Component
Rentals for Reserved Parking space	Year-1: \$36,000 Year 2: \$39,600 Year 3: \$43,560	Lease Component
Charges for CAM maintenance	No additional rentals charged	Non- Lease Component
Parking charges for non-reserved parking space	Actual usage basis	Non- Lease Component
Real estate taxes and insurance	Actual expense	Not a component of the contract
VAT charges	Actual expense	Not a component of the contract

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Components	Year 1	Year 2	Year 3	Total
Lease	300,000	330,000	363,000	993,000
Parking	36,000	39,600	43,560	119,160
CAM	-	-	-	-
Total	336,000	369,600	406,560	1,112,160

Step 4: Separate and allocate the consideration in the contract between the lease and non-lease components.

Considering the fact that the lessee has not exercised the practical expedient to combine the lease and non-lease components, the lessee shall allocate the fixed consideration in the contract as follows:

		Allocation of fixed consideration			
Components	Relative%	Year 1	Year 2	Year 3	Total
Lease	77% ^(a)	257,926	283,718	312,090	853,735
Parking	12% ^(b)	39,656	43,622	47,984	131,262
CAM	11% ^(c)	38,418	42,260	46,486	127,164
Total	100%	336,000	369,600	406,560	1,112,160

(a) $800,000 / (800,000 + 123,000 + 119,160) = 77\%$

(b) $123,000 / (800,000 + 123,000 + 119,160) = 12\%$

(c) $119,160 / (800,000 + 123,000 + 119,160) = 11\%$



For many lessees in different sectors such as retail, automotive, telecom, and healthcare, identifying non-lease components (e.g., maintenance services, security services etc.) of contracts has been a change in practice. Under legacy guidance, entities did not focus much 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, under new lease standards, because most leases are recognized on lessees' balance sheets, lessees are required to put more robust processes in place to identify the lease and non-lease components of contracts, particularly where the lessee is not adopting the Practical expedient not to separate non-lease and associated lease components.

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Determination of lease
commencement date

On January 1, 20X1, Lessee X signed a lease with Lessor P for a new building to be constructed that will serve as X's new headquarters. P will construct the building and is the legal and accounting owner of the building both during and after construction. The construction of the building is expected to be completed on November 1, 20X3.

As of September 1, 20X3, construction is mostly completed. P grants X access to the building for X to begin installing leasehold improvements, which X will own. X's access to the building is restricted by P's certificate of occupancy to construction personnel working on behalf of X to install leasehold improvements. As of September 1, 20X3, X cannot begin using the building for its intended purpose (i.e., its corporate headquarters).

Construction on the building was completed on November 1, 20X3. On December 1, 20X3, X's leasehold improvements were completed, and X began using the building as its headquarters.

What is the lease commencement date?

Analysis:

The lease commencement date is September 1, 20X3. Once X is given permission to access the building to begin installing its own leasehold improvements, P will make the building available for X's use, and the lease will commence.

It is not relevant that X cannot begin to use the building for its intended purpose due to the ongoing P construction and X's restricted access rights. Lease commencement occurs, despite the restrictions, because X's access permits it to install the leasehold improvements it needs for the building to fulfil its role as a corporate headquarters. Without such access, X could not commence headquarters operations in the building by December 1, 20X3.



The lease commencement date is important under ASC 842 because it is the date when (1) lease classification is determined and (2) the lease is initially measured. The lease commencement date may differ from the date stated in the contract and is not affected by when the lessee (1) must make lease payments (e.g., if the lessor grants the lessee a rent holiday) or (2) expects to use or actually uses the underlying asset. The judgmental aspects are associated with the determination of the lease commencement date.

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04 Lease Classification

ABC Inc., a real estate entity (Lessee) enters a ground lease of land in New York City with a term of 99 years. The Lessee will construct and operate an office building on the land and will lease office space to tenants.

There is no transfer of ownership or option to purchase the land at the end of the lease term, and Lessee does not guarantee residual value at the end of the lease term. The present value of the lease payments is \$100 million. The fair market value (FMV) of the land is \$105 million.

Determine the Classification of Land lease.

Analysis:

The arrangement meets the definition of a lease. Lessee then assesses the classification criteria in ASC 842-10-25-2:

- The lease does not transfer land ownership to the Lessee at the end of the lease term.
- The lease does not grant Lessee an option to purchase the land.
- The lease term (99 years) is not for a major part of the remaining economic life of the land because land has an indefinite life.
- The present value of the sum of the lease payments (\$95 million) equals substantially all the FMV of the land (\$100 million).
- The land is not of such a specialized nature that it is expected to have no alternative use at the end of the lease term.

Because the present value of the sum of the lease payments equals or exceeds substantially all the underlying asset's fair value, the Lease shall be classified as a finance lease.



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Tenant Improvement Allowance

ABC Inc. (lessee) enters a 5-year contract with XYZ Inc. (lessor) for the use of office space located on 10th Floor of the building. The arrangement is concluded as a lease since it conveys the right to use the office space over a period of lease term. XYZ Inc. agrees to reimburse for some (or all) of the costs a lessee incurs to complete leasehold improvements. ABC Inc. has the option to terminate the lease after 3 years. The relevant terms of leasehold improvement cost reimbursement are as follows:-

Tenant Improvements:-

Tenant shall be responsible for the design, permitting, and construction of the Tenant Improvements, which, when constructed shall comply with all applicable Governmental Requirements.

Plans and Specifications approval by lessor:-

Prior to making the Tenant Improvements, the tenant shall submit the Plans and Specifications to the Landlord for the Landlord's approval, which approval shall not be unreasonably withheld, conditioned, or delayed. Landlord shall review and provide its approval or denial of the Plans and Specifications within ten (10) Business Days after such Plans and Specifications are delivered to Landlord by Tenant.

Tenant Improvement Allowance:-

The maximum aggregate amount, if any, to be expended by XYZ Inc. for (i) the cost of Tenant Improvements (including architectural, engineering, permitting and fees, repair and renovation of the Premises, carpet cleaning, and the Construction Management Fee), which maximum shall not exceed a total \$2 million. The cost incurred above \$2 million shall be borne by ABC Inc. No portion of the Tenant Improvement Allowance shall be used to pay for the costs and expenses of any work at the Premises not included in the Plans and Specifications, and Tenant shall be responsible, at its sole cost and expense, for all costs and expenses incurred in connection with such work.

Removal of Tenant Improvements:-

All Tenant Improvements, regardless of which party constructed or paid for them, shall become the property of XYZ Inc. and remain upon and be surrendered with the Premises on the expiration or earlier termination of this Lease. However, ABC Inc. shall be allowed to remove (i) all trade fixtures and other movable fixtures, furniture and equipment and (ii) any Telecommunication Facilities installed at the Premises by ABC Inc. as part of the Tenant Improvements.

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- In the event of the exercise of an early termination option, the lessee shall be liable to pay early termination fees, which also include the leasehold improvement cost incurred by the landlord.

- The actual cost incurred by ABC Inc. on leasehold improvement amounted to \$2.20 million.

How leasehold improvement cost incurred by ABC Inc. and its reimbursement made by XYZ Inc. shall be accounted for in the books of ABC Inc.

Analysis:

As per the principles of ASC 842, lease payments include Fixed payments, including in substance fixed payments, **less any lease incentives** paid or payable to the lessee. Reimbursement made by a lessor for some (or all) of the costs incurred by a lessee to complete leasehold improvements is a common example of a lease incentive.

To determine whether a payment from the lessor to the lessee represents a lease incentive, an entity must determine whether the leasehold improvement represents a lessee's or a lessor's asset.

- If an improvement represents the lessee's asset, the payment made by the lessor is considered a lease incentive, and the same should be recorded as a reduction to fixed lease payments.
- On the other hand, when a lessee pays for an improvement that is a lessor's asset, the expenditure incurred by the lessee is in the nature of prepaid rent rather than a lease incentive; the reimbursement is a reduction to prepaid rent. Under the circumstance wherein a lessee was not fully reimbursed, the deficit (i.e. the difference between the expenditure incurred and the amount received as reimbursements) would be included in lease payments.

As per the facts of the given case, all the tenant improvements shall be surrendered to the lessor on the expiration of the lease or on early termination of the lease except for (i) all trade fixtures and other movable fixtures, furniture, and equipment, (ii) any Telecommunication Facilities installed at the Premises by ABC Inc. as a part of tenant improvements. Moreover, in the event of the exercise of the early termination option, the lessee shall be liable to pay early termination fees, which also include the leasehold improvement cost incurred by the landlord. The accounting considerations for leasehold improvement cost and leasehold improvement allowance are as follows:-



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- A.** Reimbursement of leasehold improvement cost incurred on (i) all trade fixtures and other movable fixtures, furniture, and equipment, (ii) any Telecommunication Facilities installed at the Premises by ABC Inc.

Leasehold improvement cost incurred by the tenant and reimbursed by lessor amounting to \$2 million

Since the improvement represents a lessee's asset, the payment made by lessor is in the nature of lease incentive that should be recorded as a reduction to fixed lease payments.

Leasehold improvement cost incurred by the tenant and not reimbursed by lessor amounting to \$0.5 million

Since Leasehold improvement represents the lessee's asset, the expenditure incurred by ABC Inc. over and above the reimbursement cap shall be considered leasehold improvement assets to be amortized. As per principles of ASC 842-20-35-12, leasehold improvements shall be amortized over the shorter of the useful life of those leasehold improvements and the remaining lease term.

- B.** Reimbursement of leasehold improvement cost (other than stated in (a)).

Leasehold improvement cost incurred by the tenant and reimbursed by lessor amounting to \$2 million

Since the tenant's improvement is not the lessee's asset, therefore, reimbursement of the cost incurred by the tenant shall not be considered a lease incentive.

The expenditure incurred by ABC Inc. on leasehold improvement shall be considered prepaid rent, and the reimbursement shall be considered a reduction to prepaid rent.

Leasehold improvement cost incurred by the tenant and not reimbursed by lessor amounting to \$0.5 million

Since the tenant's improvement is not the lessee's asset, ABC Inc.'s expenditures over and above the reimbursement cap shall be considered a lease payment.



Accounting for leasehold improvement allowance requires an assessment of which party will have the ultimate ownership of leasehold improvements at the end of the lease term. This requires a critical evaluation of contractual terms and judgment. In our experience, the contractual terms are silent in most cases on the ownership of leasehold improvements and may require management assessment and judgment for correct accounting.

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Leasehold improvements related to common control leases

ABC Inc. leases a building from XYZ Inc. under the same common control group for a lease term of three years for accounting purposes. It installs leasehold improvements with a useful life of seven years to the common control group. Over what period should the leasehold improvements be amortized?

Analysis:

Applying the amendment guidance in ASU 2023-01, ABC Inc. should amortize the leasehold improvements over seven years, provided it continues to control the use of the underlying asset through a lease. The amortization period shall not be limited to the three-year lease term (as in the case of leasehold improvements in “leases not with a common control entity”).

If ABC Inc. ceases to control the use of the underlying leased asset before the end of the leasehold improvements' useful life to the common control group (i.e., before year seven), it must account for the improvements by as they are transferred to XYZ Inc. In this case, ABC Inc. would derecognize the remaining carrying amount of the leasehold improvements with a corresponding adjustment to equity.

07

Failed Sale and leaseback transactions

A seller-lessee a telecom operator sells data center assets for \$1,150,000 cash consideration and agrees to lease the assets back for five years. Consider the following facts about this transaction:

- The net carrying amount of the data center assets as of the date of sale is \$720,000.
- The annual leaseback payment is \$130,000.
- Annual depreciation expense is \$80,000.
- The seller-lessee does not guarantee the asset's residual value at the end of the leaseback term.
- The seller-lessee has a repurchase option that allows it to buy the data center assets at the then-prevailing fair market value at any time during the lease term.
- There are no alternative data center assets that are substantially the same and readily available in the marketplace.
- The seller-lessee's incremental borrowing rate is 9.5%, and the interest rate implicit in the leaseback is not known.

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Assume the lease contract is modified at the end of the third year to remove the seller-lessee's repurchase option. As a result, the buyer-lessor obtains control of the asset at the end of the third year.

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How should the seller-lessee account for the sale and leaseback of the data center assets?

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Analysis:

As per the principles of ASC 842, when a sale and leaseback transaction does not qualify for sale accounting, the transaction must be accounted for as a financing transaction by the seller-lessee and a lending transaction by the buyer lessor. The following are the key accounting considerations-

- The seller-lessee does not derecognize the underlying asset and continues depreciating the asset as if it were the legal owner. The sales proceeds received from the buyer-lessor should be recognized as a financial liability.
- Rental payments made by seller-lessee should be allocated between interest expense and principal repayment of the financial liability. The interest allocation shall be based on the seller-lessee incremental borrowing rate.
- On completion of the sale during the leaseback period, the seller-lessee should recognize any remaining balance of the financial liability as the proceeds on the final sale of the underlying asset. The gain or loss equals the difference between those proceeds and the carrying amount of the underlying asset.
- The date that control transfers to the buyer-lessor is the lease commencement date.

As per the facts of given case, the seller-lessee has a repurchase option and there are no alternative assets that are substantially the same and readily available in the marketplace. Therefore, the buyer-lessor does not obtain control of the building at the transaction effective date. The transaction would not qualify for sale accounting and should be accounted for as financing at the transaction effective date.

At the end of the third year, the buyer-lessor obtains control of the asset due to the modification. At that time, the seller-lessee would recognize the asset's sale and any gain resulting from removing the underlying asset and financial liability from its books.

Application of the financing method for this scenario is illustrated below:

Period	Inception	Year 1	Year 2	Year 3
Net Carrying amount	\$720,000	640,000	560,000	480,000
Asset Value	\$800,000	800,000	800,000	800,000
Accumulated depreciation	\$80,000	160,000	240,000	320,000
Financial Liability	\$1,150,000	1,129,250	1,106,529	1,081,649
Reduction Liability	-\$	20,750	22,721	24,880
Interest Expense	-\$	109,250	107,279	105,120

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When the repurchase, option is removed at the end of the third year, the seller-lessee would assess the lease's classification because it was contractually modified.

- If classified as an operating lease, the seller-lessee would derecognize the financial liability and assets from its books and recognize a gain of \$601,649 (\$1,081,649 financial liability – \$480,000 net carrying amount). The date of transfer of control is considered the lease commencement date.
- If the seller-lessee classified the lease as a finance lease, no sale has occurred, and the transaction would continue to be accounted for as a failed sale and leaseback.



For a transaction to be accounted for as a sale of an underlying asset and a leaseback of that underlying asset, the pre-condition is that the initial transaction qualifies as a sale as per the principles of ASC 606. To qualify as a sale of an asset under ASC 606, the seller-lessee is required to ensure that the customer (the buyer-lessor) obtains control of the asset. Therefore, the key considerations to be evaluated and require judgment include identifying the date of "transfer of control," which may or may not coincide with the sale transaction date.

Due to third-party approval, the seller-lessee may not be able to transfer the legal ownership of the assets under consideration on the sale transaction date. In such a case factors to be evaluated include determining when the control is transferred to the buyer-lessor as per the principles of ASC 606. Some of such indicators include transfer of significant risks and rewards of ownership, present right to payment etc.



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08 Leases modification

- ABC Inc. (Lessee) and Real Work (Lessor) entered into the Real Work membership enterprise agreement dated November 1, 2019 (hereinafter also referred to as membership agreement). As per the membership agreement terms, ABC Inc. was granted dedicated access to and use of the office space on the 18th and 19th floors. As per membership agreement, the lease termination date was November 30, 2023.
- On November 1, 2023, ABC Inc. entered into a separate agreement, "Amendment and restatement of the lease agreement (the "Agreement")" dated November 1, 2023, with the lessor. As per the terms of the Agreement, the Lessee will continue to be in possession of leased premises office space on the 18th and 19th floors effective lease commencement date of November 1, 2023, with an Initial Lease Term of 6 years and 6 months ending on April 30, 2030, as per the terms of the Agreement.
- In addition to an extension of the right to use the existing leased premise i.e. 18th and 19th floors of the building, the Agreement also provides:
 - The Lessee with an option to lease additional space (16th Floor Expansion space) which shall be exercised on or before March 1, 2024. As per the terms of the Agreement, if the lessee exercises the 16th Floor Expansion Option, then the Lessor shall exercise commercially reasonable efforts to deliver possession of the 16th Floor Expansion Space on or before August 1, 2024, as per the terms of the Agreement.
 - Right of first offer (ROFO) for the entire 20th floor of the building: As per the terms of the Agreement, if at any time during the Lease Term, the entire 20th floor of the Building becomes available for lease and is not subject to any Prior Rights, and if Lessor intends to lease the Offer Space, then Lessor shall notify Tenant of the particulars of the Offer Space, including, without limitation, the terms and conditions upon which Lessor is amenable to leasing the Offer Space to Tenant.
- Effective November 1, 2023, the terms of the lease arrangement shall be governed by the terms of the Agreement.

Should the Amendment be accounted for as a lease modification? And if so, should the lease modification be accounted for as two contracts or one modified contract?



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Analysis:

ASC 842 defines 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 change to the terms and conditions of the contract that adds or terminates the right to use one or more underlying assets or extends or shortens the contractual lease term).

As per the facts of the given case, amendment and restatement of the Agreement resulted in the extension of the lease term for the right to use leased premises already occupied by the lessee. The Agreement extended the lease term by 6 years and 6 months commencing from November 1, 2023, and expiring on April 30, 2030. In addition to an extension of the lease term for the right to use the existing leased premise i.e. 18th and 19th floors of the building, the agreement also provides:

- The Lessee with an option to lease additional space 16th Floor Expansion space which shall be exercised on or before March 1, 2024.
- Right of first offer (ROFO) for the entire 20th floor of the building.

The aforesaid amendments to the terms of the existing agreement resulted in a change in the scope of the existing lease in the form of an extension of the contractual term and hence met the ASC 842 definition of a lease modification.

As per the principles of ASC 842, the modification shall be considered as a new contract (separate from the existing contract) if the modification provides the lessee an additional right of use which was not included in the original lease and the lease payments increase due to modification commensurate with the standalone price for the additional right of use, adjusted for the circumstances of the particular contract. Further, a modification to increase the lease term cannot be considered an additional right of use.



The agreement has primarily resulted in an extension of the lease term of the existing Right of Use leased asset i.e., 18th and 19th floor, without any additional right of use not included in the original lease. The option to lease additional space, i.e., 16th Expansion floor and Right of first offer for lease of the entire 20th floor once available, cannot be considered as an additional right of use assets not included in the original lease on the modification date. The terms of the agreement allow the lessee an option to lease additional space, which, even if exercised, will result in an additional right to use commencing from the date of commencement of lease for the 16th floor and cannot be construed as an additional right to use on the date of lease modification and hence lease modification shall not be considered as a new contract. The lease modification shall be accounted for as one modified lease.

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The FASB issued ASC 842 after joint deliberations with the IASB, which issued a similar standard, IFRS 16, Leases. While ASC 842 and IFRS 16 both require lessees to put most leases on their balance sheets, there are a number of differences between the two standards. The following table summarizes the key differences:

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Key Provisions	ASC 842	IFRS 16
Low-value asset exemption	There is no recognition exemption for leases based on the value of the underlying asset.	Lessees may elect, on a lease-by-lease basis, not to recognize leases when the value of the underlying asset is low (e.g., \$5,000 or less when new).
Scope exemption for intangible assets	All leases of intangible assets are excluded from the scope of ASC 842.	- Lessees may apply IFRS 16 to leases of intangible assets, other than rights held by a lessee under licensing agreements within the scope of IAS 38, Intangible Assets, for items such as motion picture films, video recordings, plays, manuscripts, patents and copyrights. - Lessors are required to apply IFRS 16 to leases of intangible assets, except for licenses of intellectual property that are in the scope of IFRS 15, Revenue from Contracts with Customers.
Reassessment of variable lease payments that depend on an index or rate	For variable payments (linked to an index or rate), reassessment is required by the lessee only under the circumstances when the lease obligation is remeasured for other reasons (for e.g., in the event of a change in lease term or modification).	For variable payments (linked to an index or rate), reassessment is required by the lessee whenever there is a change in contractual cash flows (for e.g., the lease payments are adjusted for a change in the CPI) or when the lease obligation is to remeasured for other reasons (for e.g., in the event of a change in lease term or modification).

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Key Provisions	ASC 842	IFRS 16
Lessee lease classification	Recognized leases are classified as either finance or operating. Lessees classify leases at the lease commencement date.	All recognized leases are accounted for similarly to finance leases under ASC 842.
Lessor lease classification	Leases are classified as operating, direct financing, or sales-type leases at the lease commencement date.	Leases are classified as operating or finance leases at the inception date of the lease.
Short-term leases — existence of a purchase option	FA lease does not qualify as a short-term lease if it includes a purchase option that is reasonably certain to be exercised.	A lease does not qualify as a short-term lease if it includes a purchase option, regardless of whether the lessee is reasonably certain to exercise the option.
Short-term leases — change in lease term	A lease no longer qualifies as a short-term lease when there is a change in a lessee's assessment of either of the following: - The lease term so that, after the change, the remaining lease term extends more than 12 months from the end of the previously determined lease term. - Whether the lessee is reasonably certain to exercise an option to purchase the underlying asset.	A change in the terms of a short-term lease creates a new lease. If that new lease has a lease term greater than 12 months, it cannot qualify as a short-term lease.
Allocating variable consideration not dependent on an index or rate between lease and non-lease components of a contract	Lessees allocate variable consideration not dependent on an index or rate to the lease and non-lease components of a contract on a relative standalone price basis.	Lessees may allocate variable consideration not dependent on an index or rate entirely to a non-lease component of a contract.

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Key Provisions	ASC 842	IFRS 16
Lease modifications that do not result in a separate contract and shorten the contractual lease term	Lease modifications that do not result in a separate contract and shorten the contractual lease term do not result in the recognition of a gain or loss. A lessee recognizes the amount of the remeasurement of the lease liability as an adjustment to the corresponding right-of-use asset without affecting profit or loss. However, if the right-of-use asset is reduced to zero, a lessee would recognize any remaining profit or loss amount.	Lease modifications that do not result in a separate contract and shorten the contractual lease term result in the recognition of a gain or loss for the variance between the decrease in the lease liability and the proportionate decrease in the right-of-use asset.
Accounting for all entities other than PBEs — incremental borrowing rate	Entities that are not PBEs may elect to use a risk-free rate for initial and subsequent measurements of the lease liability.	IFRS 16 does not provide accounting alternatives for private companies.
Subleases	When classifying a sublease, the sublessor classifies the sublease based on the underlying asset rather than the right-of-use asset on the head lease.	When classifying a sublease, a sublessor classifies the sublease based on the right-of-use asset recognized as part of the head lease rather than the underlying asset subject to the sublease.
Failed Sale-and-leaseback Arrangements	The transaction would not be considered a sale if (1) it does not qualify as a sale under ASC 606 or (2) the leaseback is a finance lease. A repurchase option would result in a failed sale unless (1) the exercise price of the option is at fair value and (2) alternative assets are readily available in the marketplace.	The transaction would not be considered a sale if it does not qualify as a sale under IFRS 15. A repurchase option would always result in a failed sale.
Sale-and-leaseback Arrangements-Recognition of Gain	If the transaction qualifies as a sale, the entire gain on the transaction would be recognized.	For transactions that qualify as a sale, the recognition of gain would be limited to the amount related to the portion of the asset sold. The amount of the gain related to the underlying asset leased back to the lessee would be offset and adjusted against the lessee's ROU asset.
Full retrospective transition	This is prohibited under US GAAP.	This is permitted under IFRS.

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