

Technical Line

FASB – final guidance

How the FASB's new leases standard will affect mining and metals entities

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What you need to know

- ▶ The FASB has issued final guidance that requires lessees to recognize most leases on their balance sheets. For mining and metals lessees, this means recognizing assets and liabilities for most leases of facilities and equipment that they may currently account for as operating leases.
- ▶ Lessees and lessors will classify most leases using a principle that is generally consistent with current US GAAP but without the bright lines. Lease classification determines how lease-related expense and revenue is recognized as well as what lessors record on the balance sheet.
- ▶ Mining and metals entities will need to exercise judgment when applying the definition of a lease and allocating consideration between lease and non-lease components of contracts.
- ▶ For calendar-year public business entities, the guidance is effective in 2019, and interim periods within that year. For other calendar-year entities, it is effective in 2020, and interim periods in 2021. Early adoption is permitted for all entities.

Overview

Mining and metals entities will need to change certain lease accounting practices when implementing the new leases standard, Accounting Standards Codification (ASC) 842, *Leases*, issued by the Financial Accounting Standards Board (FASB or Board). ASC 842 significantly changes the accounting for leases and could have far-reaching implications for mining and metals entities' finances and operations. For example, applying the definition of a lease and allocating consideration between lease and non-lease components of contracts will require judgment.

ASC 842 requires lessees to recognize most leases on their balance sheets. For lessors, ASC 842 does not make fundamental changes to today's lessor accounting model. However, it modifies what qualifies as a sales-type and direct financing lease as well as the related accounting. For all entities, ASC 842 eliminates the real estate-specific provisions included in the current guidance (i.e., ASC 840, *Leases*).

Like ASC 840, ASC 842 requires lessees to classify most leases as either finance leases (generally capital leases under ASC 840) or operating leases. Lessors are required to classify all leases as either sales-type, direct financing or operating leases.

Leases are classified using a principle that is generally consistent with ASC 840 but without today's bright lines (i.e., the "75% of economic life" and "90% of fair value" tests). Lease classification determines how and when a lessee and a lessor recognize lease expense and income, respectively, and what assets a lessor records.

For lessees, the income statement recognition pattern for finance leases and operating leases is similar to that of today's capital leases and operating leases, respectively. That is, finance leases generally have a front-loaded expense recognition pattern, and operating lease expense is generally recognized on a straight-line basis.

For mining and metals lessees, recognizing lease-related assets and liabilities could have significant financial reporting and business implications. Implementing the standard could require an entity to develop new processes and controls to track and account for leases, including: (1) identifying a lease, (2) initially and subsequently measuring lease-related assets and liabilities, (3) identifying and allocating consideration to lease and non-lease components and (4) collecting and aggregating information necessary for disclosure.

ASC 842 is effective for public business entities (PBE) for annual periods beginning after 15 December 2018, and interim periods within those years. For all other entities, it is effective for annual periods beginning after 15 December 2019, and interim periods the following year. Early adoption is permitted for all entities. Entities are required to use a modified retrospective approach for leases that exist or are entered into after the beginning of the earliest comparative period presented in the financial statements. For example, for a calendar-year PBE that presents three years of financial statements, the effective date will be 1 January 2019 and the transition provisions must be applied beginning 1 January 2017. Full retrospective application is prohibited.

This publication summarizes the new standard and describes some industry-specific issues you may want to start working on. Like all other entities, you'll also need to apply the new standard to leases of office space, office equipment and all other leased assets.

This publication is intended to complement our Technical Line, *A closer look at the new leases standard* (SCORE No. 00242-161US), which provides an in-depth discussion of ASC 842. We refer to that publication as our general Technical Line.

The views we express in this publication are preliminary as of April 14, 2016. We may identify additional issues as we analyze ASC 842 and entities begin to interpret it, and our views may evolve during that process.

Key considerations

Scope and scope exceptions

Consistent with ASC 840, 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 rights to explore for those natural resources and rights to use the land in which those natural resources are contained
- ▶ Leases of biological assets, including timber
- ▶ Leases of inventory
- ▶ Leases of assets under construction

Leases of mineral rights, including rights to use the land that contains the mineral resources, are outside the scope of ASC 842 (unless those rights of use include more than the right to explore for natural resources). However, a contract that includes the right to explore for or use minerals may also include a lease of other assets within the scope of ASC 842, such as a lease of equipment.

Definition of a lease

A lease is a contract (i.e., an agreement between two or more parties that creates enforceable rights and obligations), or part of a contract, that conveys the right to control the use of identified property, plant or equipment (i.e., an identified asset) for a period of time in exchange for consideration.

Identified asset

The concept of an identified asset is generally consistent with the “specified asset” concept in ASC 840. Under ASC 842, an identified asset could be either implicitly or explicitly specified in a contract and can be a physically distinct portion of a larger asset (e.g., a portion of a facility). Even if an asset is specified, a customer does not have the right to use an identified asset if, at inception of the contract, a supplier has the substantive right to substitute the asset throughout the period of use. A substitution right is substantive if the supplier has the practical ability to substitute alternative assets throughout the period of use and the supplier would benefit economically from the exercise of its right to substitute the asset.

In some cases, determining whether there is an identified asset is relatively straightforward. However, in other circumstances, determining whether there is an identified asset will require judgment. This may be the case for arrangements involving transportation or storage. Among other considerations, entities will need to carefully evaluate whether any supplier’s substitution right is substantive. For example, the supplier’s substitution right may not be substantive if (1) the asset is highly customized, (2) alternative assets are not readily available or (3) it is unclear that the supplier would economically benefit from the exercise of the right.

Some mining and metals entities enter into arrangements for the right to use a portion of an asset’s capacity, such as arrangements for storage capability or transportation on a vessel that moves goods. A capacity portion of an asset that is less than substantially all of that asset’s capacity would not be an identified asset because it is not physically distinct from the remaining capacity of the asset. However, if a capacity agreement provides a mining and metals entity with the right to use a physically distinct portion of an asset or substantially all of the capacity, it

may be an identified asset. For example, a contract to purchase substantially all of the energy produced by a power plant may contain an identified asset (i.e., the power plant). Determining whether a capacity purchase agreement has an identified asset will require judgment.

Right to control the use of the identified asset

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

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

A customer has the right to direct the use of an identified asset throughout the period of use when either:

- ▶ The customer has the right to direct how and for what purpose the asset is used throughout the period of use.
- ▶ The relevant decisions about how and for what purpose the asset is used are predetermined and the customer either (1) has the right to operate the asset, or direct others to operate the asset in a manner it determines, throughout the period of use without the supplier having the right to change the operating instructions or (2) designed the asset, or specific aspects of the asset, in a way that predetermines how and for what purpose the asset will be used throughout the period of use.
- ▶ When evaluating whether a customer has the right to direct how and for what purpose the asset is used throughout the period of use, the focus should be on whether the customer has the decision-making rights that will most affect the economic benefits that will be derived from the use of the asset. The decision-making rights that are most relevant are likely to depend on the nature of the asset and the terms and conditions of the contract. The standard also says that if the customer has the right to control the use of an identified asset for only a portion of the term of the contract, the contract contains a lease for that portion of the term.

ASC 842 provides examples of the decision-making rights that, depending on the circumstances, grant the right to direct how and for what purpose the asset is used, within the defined scope of the customer's right of use. Examples include the rights to change (1) the type of output that the underlying asset produces, (2) when the output is produced, (3) where the output is produced and (4) whether the output is produced and the quantity of the output.

Evaluating whether the customer controls the use of an identified asset will be straightforward in some arrangements. However, evaluating other arrangements will require more judgment. For example, in a mining operations contract the operator (i.e., customer) may have the right to direct when and how the mining equipment is used and the ability to

change those decisions. The supplier may have the right to determine whether conditions are safe for operation. These supplier rights would be considered protective rights, which, in isolation, are not the decisions that most significantly affect the economic benefits derived from the mining equipment throughout the period of use. Therefore, the customer may have the right to direct the use of the identified asset.

ASC 842's transition guidance is discussed in the general Technical Line. As part of a package of consistently applied practical expedients for transition, entities can make an accounting policy election to apply their existing lease identification and classification conclusions (i.e., those properly made based on ASC 840's definition of a lease and classification criteria) for certain contracts.

How we see it

Because accounting for operating leases under ASC 840 and accounting for service contracts is similar, determining whether an arrangement is a lease or service contract may not have been a focus for many entities. Under ASC 842, the difference between accounting for an arrangement as a service contract and a lease could be material. This may require entities to focus more than they have in the past on determining whether arrangements are leases or contain leases.

Evaluating whether the customer has the right to direct the use of an identified asset may require judgment.

Identifying and separating components of a contract and allocating contract consideration

For contracts that contain the rights to use multiple assets but not land (e.g., a building and equipment, multiple pieces of equipment), the right to use each asset is considered a separate lease component if both of these conditions are met: (1) 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 and (2) the right of use is neither dependent on, nor highly interrelated with, the other right(s) to use the underlying assets in the contract. However, 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, even if the criteria above for separating lease components are not met, unless the accounting effect of not separately accounting for land is insignificant.

Many contracts contain a lease coupled with an agreement to purchase or sell other goods or services (non-lease components). For these contracts, the non-lease components are identified and accounted for separately from the lease component, in accordance with other US GAAP. 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). 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.

Mining contracts that may contain a lease also may contain non-lease components for services provided by the supplier. Examples may include:

- ▶ Storage and transportation arrangements, which generally require the supplier to operate the facilities
- ▶ Operation service arrangements in contracts for exploration drilling or outsourced mining services

Lessees that don't elect the practical expedient to account for lease and non-lease components as a single lease component will have to allocate the consideration in the contract to the lease and non-lease components. These allocations may be difficult for some entities when the relative standalone prices for some services are not readily available.

How we see it

Identifying non-lease components of contracts (e.g., mining services arrangements) may change practice for some lessees in the mining and metals industry. Today, entities may not focus on identifying lease and non-lease components because their accounting treatment (e.g., the accounting for an operating lease and a service contract) is often the same. However, because most leases are recognized on lessees' balance sheets under ASC 842, lessees may need to put more robust processes in place to identify the lease and non-lease components of contracts.

Obtaining standalone selling prices for some services may be challenging for lessees.

Lease classification

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

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

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

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

- ▶ The present value of the sum of lease payments and any residual value guaranteed by the lessee and **any other third party unrelated to the lessor** equals or exceeds substantially all of the fair value of the underlying asset.
- ▶ It is probable that the lessor will collect the lease payments plus any amount necessary to satisfy a residual value guarantee.

A key difference between the sales-type lease and direct financing lease classification tests is the treatment of residual value guarantees provided by unrelated third parties other than the lessee. Those third-party guarantees are excluded from the evaluation of the “substantially all” criterion in the sales-type lease test. However, they are included in the evaluation in the direct financing lease test. In addition, the evaluation of the collectibility of lease payments and residual value guarantees affects direct financing lease classification, whereas it does not affect sales-type lease classification. However, the evaluation of collectibility does affect sales-type lease recognition and measurement.

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

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

Mining and metals entities currently consider the existing real estate-specific guidance for leases of integral equipment (e.g., railway facilities) or in-substance real estate to determine lease classification. The new standard eliminates the real estate-specific lease guidance. Instead, entities follow the same classification guidance for leases of all types of assets.

The new standard eliminates the real estate-specific lease guidance.

Lessee accounting

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

The initial recognition of the right-of-use asset and the lease liability is the same for finance leases and operating leases, as is the subsequent measurement of the lease liability. However, the subsequent measurement of the right-of-use asset for finance leases and operating leases differs under ASC 842. For finance leases, lessees are required to separately recognize the interest expense on the lease liability and the amortization expense on the right-of-use asset. This generally results in a front-loaded expense recognition pattern, which is consistent with the subsequent measurement of capital leases under ASC 840. The periodic lease expense for operating leases is generally recognized on a straight-line basis, similar to the accounting for operating leases under ASC 840.

Refer to the appendix for examples of lessee accounting for a finance lease and an operating lease.

Short-term leases recognition and measurement exemption

Lessees can make an accounting policy election (by class of underlying asset to which the right of use relates) to apply accounting similar to ASC 840’s operating lease accounting to leases that, at the commencement date, have a lease term of 12 months or less and do not include an option to purchase the underlying asset that the lessee is reasonably certain to exercise (short-term leases). If an entity applies this exception, short-term leases are not recognized on the balance sheet and the related lease expense is recognized on a straight-line basis over the lease term.

Lessor accounting

Entities in the mining and metals industry typically aren't lessors unless they sublease an asset they have leased from another entity. For a discussion of lessor accounting, refer to our general Technical Line.

Other considerations

Sale and leaseback transactions

Because lessees are required to recognize most leases on the balance sheet (i.e., all leases except for short-term leases if the lessee makes an accounting policy election to use this exemption), sale and leaseback transactions no longer provide lessees with a source of off-balance sheet financing.

ASC 842 requires seller-lessees and buyer-lessors to consider the new revenue recognition standard and other criteria in ASC 842 (e.g., a sale with a finance leaseback would not qualify as a sale) to determine whether a sale has occurred. If control of an underlying asset passes to the buyer-lessor, the transaction is accounted for as a sale (or purchase) and a lease by both parties. If not, the transaction is accounted for as a financing by both parties.

Next steps

- ▶ Because of the number and magnitude of contracts they will need to evaluate and potentially recognize on their balance sheets, mining and metals entities should start to accumulate information that will necessary to evaluate agreements that may contain lease components, particularly exploratory drilling contracts, transportation or capacity arrangements, storage agreements and land, building and equipment rental contracts.
- ▶ Entities should then determine how their lease accounting will be affected. Two critical first steps include (1) identifying the sources and locations of an entity's lease data and (2) accumulating that data in a way that will facilitate the application of ASC 842. For entities with decentralized operations (e.g., an entity that is geographically dispersed), this could be a complex process, given the possibility of differences in operational, economic and legal environments. Entities will also need to make sure they have processes (including internal controls) and systems in place to collect the necessary information to implement ASC 842.
- ▶ Entities also may want to monitor the discussions of the Board and others including the Securities and Exchange Commission (SEC) staff as they consider interpretations and the application of ASC 842 to common transactions.

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Appendix: Lessee accounting examples

Illustration 1 – Lessee accounting for an operating lease

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

Analysis: At lease commencement Best Mines Inc. would recognize the right-of-use asset and lease liability that it wouldn't recognize today:

Right-of-use asset	\$	33,000	
Lease liability			\$ 33,000

To initially recognize the lease-related asset and liability

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

Lease expense	\$	12,000	
Right-of-use asset			\$ 2,000
Cash			\$ 10,000
Lease liability	\$	8,602	
Right-of-use asset			\$ 8,602

- ▶ To record lease expense and adjust the right-of-use asset for the difference between cash paid and straight-line lease expense (i.e., accrued rent). To adjust the lease liability to the present value of the remaining lease payments with an offset to the right-of-use asset. The adjustment of \$8,602 is calculated as the initially recognized lease liability (\$33,000) less the present value of remaining lease payments (\$24,398) at the end of year one.
- ▶ A summary of the lease contract's accounting (assuming no changes due to reassessment) is as follows:

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

- ▶ Immaterial differences may arise in the re-computation of amounts in the example above due to rounding.

Illustration 2 – Lessee accounting for a finance lease

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

Analysis: At lease commencement, Best Mines Inc. would recognize the right-of-use asset and lease liability in a manner similar to what it would do today:

Right-of-use asset	\$ 33,000	
Lease liability		\$ 33,000

To initially recognize the lease-related asset and liability

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

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

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

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

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

Lease liability	\$ 10,000	
Cash		\$ 10,000

To record lease payment

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

	Initial	Year 1	Year 2	Year 3
Cash lease payments		\$ 10,000	\$ 12,000	\$ 14,000
<i>Lease expense recognized</i>				
Interest expense		\$ 1,398	\$ 1,033	\$ 569
Amortization expense		<u>11,000</u>	<u>11,000</u>	<u>11,000</u>
Total periodic expense		<u>\$ 12,398</u>	<u>\$ 12,033</u>	<u>\$ 11,569</u>
<i>Balance sheet</i>				
Right-of-use asset	\$ 33,000	\$ 22,000	\$ 11,000	\$ -
Lease liability	\$ (33,000)	\$ (24,398)	\$ (13,431)	\$ -

Immaterial differences may arise in the re-computation of amounts in the example above due to rounding.

Illustration 3 – Comparing the two types of leases for lessees

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

Finance lease:

Time	Lease liability	Right-of-use (ROU) asset	Interest expense	Amortization expense	Total expense
Initial	\$ 33,000	\$ 33,000			
Year 1	\$ 24,398	\$ 22,000	\$ 1,398	\$ 11,000	\$ 12,398
Year 2	\$ 13,431	\$ 11,000	1,033	11,000	12,033
Year 3	\$ -	\$ -	<u>569</u>	<u>11,000</u>	<u>11,569</u>
			<u>\$ 3,000</u>	<u>\$ 33,000</u>	<u>\$ 36,000</u>

Operating lease:

Time	Lease liability	Cumulative prepaid (accrued) rent ¹	ROU asset	Lease expense
Initial	\$ 33,000	\$ -	\$ 33,000	
Year 1	\$ 24,398	\$ (2,000)	\$ 22,398	\$ 12,000
Year 2	\$ 13,431	\$ (2,000)	\$ 11,431	12,000
Year 3	\$ -	\$ -	\$ -	<u>12,000</u>
				<u>\$ 36,000</u>

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

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