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Technical Line

FASB — final guidance

How the FASB's new leases standard will affect retail and consumer products entities

In this issue:

What you need to know

- The FASB has issued final guidance that requires lessees to recognize most leases on their balance sheets. For retail and consumer product entity lessees, this means recognizing assets and liabilities for most leases of stores and distribution centers 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.
- Retail and consumer products entities will need to exercise judgment to determine whether contract manufacturing and other arrangements contain a lease.
- 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

Retail and consumer products 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 retail and consumer products entities' finances and operations. The requirement for lessees to

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recognize right-of-use assets and lease liabilities for most leases may have a significant effect on these entities' balance sheet metrics, given the number of leases they typically have. However, the recognition of expenses on their income statement would be similar to today's accounting.

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 retail and consumer products lessees, recognizing lease-related assets and liabilities could have significant financial reporting and business implications. Recognizing a lease obligation for most leases may affect certain key metrics, and the effect may be significant for entities that lease a large number of stores and/or stores in high-rent locations. Implementing the standard also 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 the 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

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 store located in a mall). 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.

Retail and consumer products entities enter into a variety of supply arrangements that will need to be evaluated to determine whether they involve the use of an identified asset. For example, some contract manufacturing arrangements require the use of an explicitly or implicitly specified asset (e.g., an entire facility) or involve the use of a portion of a larger asset (e.g., a production line within a facility). Even if the arrangement specifies an asset, retail and consumer products entities will also need to carefully evaluate whether the supplier has substantive substitution rights (i.e., whether it can use another production line to make the product) to determine if there is an identified asset that may be a lease.

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.
- Retail and consumer products entities will have to carefully analyze supply arrangements to determine whether a contract is or contains a lease. For example, the customer in a contract manufacturing arrangement may have the right to direct the use of the identified asset (e.g., the production facility, a dedicated production line) when it decides what type of output will be produced (e.g., different sizes or colors of shirts) and the timing and quantity of production or has the right to make changes to these decisions throughout the period of use.
- Example 8 in ASC 842 illustrates how a retail entity might determine whether a contract contains a lease.

Illustration 1 – Identification of a lease

842-10-55-100 Customer enters into a contract with a manufacturer (Supplier) to purchase a particular type, quality, and quantity of shirts for a three-year period. The type, quality, and quantity of shirts are specified in the contract.

842-10-55-101 Supplier has only one factory that can meet the needs of Customer. Supplier is unable to supply the shirts from another factory or source the shirts from a third-party supplier. The capacity of the factory exceeds the output for which Customer has contracted (that is, Customer has not contracted for substantially all of the capacity of the factory).

842-10-55-102 Supplier makes all decisions about the operations of the factory, including the production level at which to run the factory and which customer contracts to fulfill with the output of the factory that is not used to fulfill Customer's contract.

842-10-55-103 The contract does not contain a lease.

842-10-55-104 The factory is an identified asset. The factory is implicitly specified because Supplier can fulfill the contract only through the use of this asset.

842-10-55-105 However, Customer does not control the use of the factory because it does not have the right to obtain substantially all of the economic benefits from use of the factory. This is because Supplier could decide to use the factory to fulfill other customer contracts during the period of use.

842-10-55-106 Customer also does not control the use of the factory because it does not have the right to direct the use of the factory. Customer does not have the right to direct how and for what purpose the factory is used during the three-year period of use. Customer's rights are limited to specifying output from the factory in the contract with Supplier. Customer has the same rights regarding the use of the factory as other customers purchasing shirts from the factory. Supplier has the right to direct the use of the factory because Supplier can decide how and for what purpose the factory is used (that is, Supplier has the right to decide the production level at which to run the factory and which customer contracts to fulfill with the output produced).

842-10-55-107 Either the fact that Customer does not have the right to obtain substantially all of the economic benefits from use of the factory or the fact that Customer does not have the right to direct the use of the factory would be sufficient in isolation to conclude that Customer does not control the use of the factory.

How we see it

Under ASC 842, it will be more important for customers in supply agreements, including contract manufacturing agreements, to determine whether a contract contains a lease because lessees are now required to account for most leases on their balance sheets.

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 warehouse 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 store or warehouse), 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.

Retailers' store leases frequently include lease-related executory costs (e.g., insurance, maintenance, taxes). Under ASC 842, payments for maintenance activities, including common area maintenance, are considered non-lease components. In some leases, a lessee also may reimburse the lessor, or make certain payments on behalf of the lessor, that relate to the leased asset such as payments for insuring the lessor's asset and real estate taxes associated with the lessor's asset. Under ASC 842, insurance that protects the lessor's interest in the underlying asset and taxes related to the asset (e.g., real estate taxes on the lessor's asset) are not separate components of the contract because they do not represent payments for goods or services (i.e., the payments are for the use of the leased asset and are attributable to the lease component). Entities should evaluate whether lease payments made for insurance that protects the lessor's asset and taxes relating to the lessor's asset are variable lease payments or fixed (or in-substance fixed) lease payments. Fixed lease payments are considered for lease classification and initial measurement of the lease asset and liability. Variable payments that are not in-substance fixed lease payments are recognized in the period in which the obligation for those payments is incurred.[1]

How we see it

Identifying non-lease components of contracts (e.g., common area maintenance) may change practice for some lessees in the retail and consumer products industries. 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.

Judgment may be required to identify lease and non-lease components.

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 collectiblity 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.

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.

ASC 842 provides guidance on how to consider lessor incentives (e.g., tenant allowances for leasehold improvements) when measuring a lease liability and right-of-use asset. Lease incentives received or receivable are deducted from lease payments when determining lease classification. Lease incentives receivable by the lessee at lease commencement are deducted from the corresponding lease liability and right-of-use asset. Lease incentives received at or before the commencement date reduce the initial measurement of the right-of use asset.

Retail and consumer products entities will not change when they recognize variable lease payments that do not depend on an index or rate, such as those based on performance (e.g., percentage of sales). Under ASC 842, these payments are not included as lease payments but instead are expensed in the period in which the achievement of the specified target that triggers the variable lease payments becomes probable.

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

Retail and consumer products entities may be lessors if they sublease assets or have supply or contract manufacturing arrangements with the customer that are determined to contain a lease. See section 6, *Subleases*, in our general Technical Line for a discussion of the accounting for subleases.

ASC 842 requires lessors to account for sales-type leases using an approach that is similar to ASC 840's sales-type lease accounting. That is, lessors derecognize the carrying amount of the underlying asset, recognize the net investment in the lease and recognize, in net income, any selling profit or selling loss.[2] However, if collection of lease payments and any residual value guarantee provided by the lessee is not probable at lease commencement, a lessor does not derecognize the underlying asset and does not recognize its net investment in the lease. Instead, a lessor continues to account for the underlying asset using other US GAAP and recognizes lease payments received, including variable lease payments that do not depend on an index or rate, as a deposit liability until the earlier of either of the following:

- Collection of lease payments, plus any amounts necessary to satisfy a residual value guarantee provided by the lessee, becomes probable.
- Either (1) the contract is terminated, and the lease payments received from the lessor are nonrefundable, or (2) the lessor repossesses the underlying asset and has no further obligation to the lessee under the contract and the lease payments received from the lessee are nonrefundable.
- Lessors account for direct financing leases using an approach that is similar to the accounting for sales-type leases for which collectibility is probable. However for a direct financing lease, any selling profit is deferred at lease commencement and included in the initial measurement of the net investment in the lease. The lessor recognizes interest income over the lease term in an amount that produces a constant periodic discount on the remaining balance of the net investment in the lease.

Lease incentives affect the initial measurement of lease assets and liabilities.

Under ASC 842, lessors account for operating leases in a manner similar to how they account for operating leases under ASC 840. That is, lessors continue to recognize the underlying asset, and lease payments for which collectibility is probable at lease commencement are recognized over the lease term on a straight-line basis unless another systematic and rational basis better represents the pattern in which benefit is expected to be derived from the use of the underlying asset. However, when collectibility of lease payments is not probable at the commencement date for an operating lease (including a lease that would otherwise have qualified as a direct financing lease if it had met the related collectibility requirements), lease income is limited to the lesser of (1) the straight-line amount and (2) the lease payments, including any variable lease payments, that have been collected from the lessee.

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.

Lessee involvement in asset construction

Often, retail and consumer products entities enter into agreements with real estate developers for the construction and subsequent lease of buildings (e.g., stores, corporate buildings, warehouses, data centers). If a retail and consumer products entity is involved in the construction of the lease space the arrangement is often referred to as a build-to-suit transaction.

ASC 842 makes significant changes to how a lessee would evaluate whether their involvement in asset construction subjects their lease to sale and leaseback accounting. While ASC 840 focuses on whether the lessee has substantially all of the construction-period risk to determine if it is the accounting owner of an asset under construction, ASC 842 changes the focus to whether the lessee controls the asset being constructed.

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

For guidance on accounting on lessee involvement in construction and related transition guidance refer to our general Technical Line.

Next steps

- Entities should perform a preliminary assessment as soon as possible to 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.
- Retail and consumer products entities should consider how they might communicate changes to their financial reporting to investors and other stakeholders.

Endnotes:

[1] A lessee should recognize costs from variable lease payments before the achievement of the specified target, provided the achievement of that target is probable.

[2] At the commencement date, selling profit or loss is calculated as the difference between the fair value of the underlying asset or the lease receivable, if lower, and the carrying amount of the underlying asset net of any unguaranteed residual asset.

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Appendix: Lessee accounting examples

Illustration 1 — Lessee accounting for an operating lease

Shoes Inc. (Lessee) enters into a three-year lease of retail space in a mall and concludes that the agreement is an operating lease. Shoes 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%. Shoes Inc. uses its incremental borrowing rate because the rate implicit in the lease cannot be readily determined. Shoes Inc. calculates that the annual straight-line lease expense is $12,000 per year [($10,000 + $12,000 + $14,000) ÷ 3].

***Analysis*:** At lease commencement Shoes 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
Income statement:				
Periodic lease expense (straight-line)		12,000	12,000	12,000
Prepaid (accrued) rent for period		$ (2,000)	$ –	$ 2,000
Balance sheet:				
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)	–	(2,000)	(2,000)	–
Right-of-use asset	$ 33,000	$ 22,398	$ 11,431	$ –

- 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

Food Corporation (Lessee) enters into a three-year lease of a forklift for use in its distribution warehouse and concludes that the agreement is a finance lease because ownership of the forklift transfers to Food Corporation at the end of the lease term. Food Corporation 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%). Food Corporation uses its incremental borrowing rate because the rate implicit in the lease cannot be readily determined. Food Corporation amortizes the right-of-use asset on a straight-line basis over the lease term.

Analysis: At lease commencement, Food Corporation 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
Lease expense recognized				
Interest expense		$ 1,398	$ 1,033	$ 569
Amortization expense		11,000	11,000	11,000
Total periodic expense		$ 12,398	$ 12,033	$ 11,569
Balance sheet				
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	$ –	$ –	569	11,000	11,569
			$ 3,000	$ 33,000	$ 36,000

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	$ –	$ –	$ –	12,000
				$ 36,000

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

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