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NOTES

ASU No. 2020-07: So How Did That Work Out for You?

ASU No. 2020-07: So How Did That Work Out for You?

Learning objectives

Upon completion of this chapter, you will have an understanding of the changes which occurred in NFP[1] presentation and disclosures as a result of ASU No. 2020-07.

I. ASU No. 2020-07

In September 2020, the FASB issued ASU No. 2020-07, *Presentation and Disclosures by Not-for-Profit Entities for Contributed Nonfinancial Assets*, to address NFP reporting of contributed nonfinancial assets. ASU No. 2020-07 became effective for NFPs for annual periods beginning after June 15, 2021 (i.e., June 30, 2022, and later year-ends). Retrospective application was required (i.e., NFPs applied the standard to all years presented).

A. Background

NFPs receive many types of contributions to fuel their missions. In addition to contributed financial assets, NFPs may also receive contributed nonfinancial assets. The FASB believes that financial statement users need more information related to contributed nonfinancial assets, as: (1) contributed nonfinancial assets are inherently more subjective than other assets in terms of how they are valued; (2) many NFPs [e.g., food banks] rely heavily on such contributions and this may not have been apparent in prior reporting; and (3) a significant reliance on contributed nonfinancial assets and their utilization has ramifications for an NFP's operations. The following chart breaks down the FASB's definition of the term **contributed nonfinancial assets**.

ASU No. 2020-07 applies to *contributed nonfinancial assets*		
Contributed	➡	The FASB ASC defines a **contribution** as "an unconditional transfer of cash or other assets, as well as unconditional promises to give, to an entity or a reduction, settlement, or cancelation of its liabilities in a voluntary nonreciprocal transfer by another entity acting other than as an owner."
Nonfinancial assets	➡	The FASB ASC defines a **nonfinancial asset** as "an asset that is not a **financial asset**." **Nonfinancial assets** include fixed assets (such as land, buildings, and equipment), use of fixed assets or utilities, materials and supplies, intangible assets, and services.

Note. Financial assets are defined in the FASB ASC as cash, evidence of an ownership interest in an entity, or a contract that conveys to one entity a right to either: (a) receive cash or another financial instrument from a second entity; or (b) exchange other financial instruments on potentially favorable terms with the second entity. Financial assets can more simply be described as assets that are convertible to cash on a fairly easy basis (such as cash, receivables, and investments) and excludes assets like prepaid expenses, inventory, and fixed assets.

[1] "NFP" will be used in place of "not-for-profit entity" throughout these course materials.

1. Exercise 1-1

Please answer the following question.

Gifts-in-kind versus nonfinancial assets
When the FASB began the standard-setting project that culminated with the issuance of ASU No. 2020-07, the FASB used the term **gifts-in-kind** instead of **nonfinancial assets**. Why did the FASB decide to use the **nonfinancial assets** wording in the final standard?

2. Exercise 1-2

Please answer the following question.

Why were financial assets excluded from ASU No. 2020-07?
Why did the FASB exclude **financial assets** from the presentation and disclosure requirements of ASU No. 2020-07?

B. Requirements before ASU No. 2020-07

Prior to ASU No. 2020-07, FASB ASC 958 had specific disclosure requirements for contributed services (i.e., one type of contributed nonfinancial asset). However, FASB ASC 958 did not have specific **disclosure** requirements for other types of contributed nonfinancial assets. Also, prior to ASU No. 2020-07, FASB ASC 958 did not have specific **presentation** requirements for contributed nonfinancial assets (including contributed services). The following chart discusses the pre-ASU No. 2020-07 disclosure requirements related to contributed services. **Note.** The previous requirements did not disappear under ASU No. 2020-07; rather, contributed services are now also subject to the new presentation and disclosure requirements in ASU No. 2020-07.

NFPs have several disclosure requirements specific to contributed services in FASB ASC 958-605-50-1, including:	
♫	An NFP receiving contributed services will describe the programs or activities for which those services were used, including the nature and extent of contributed services received for the period and the amount recognized as revenues for the period. NFPs are encouraged to disclose the fair value of contributed services received but not recognized as revenues if that is practicable. The nature and extent of contributed services received can be described using nonmonetary information (such as the number and trends of donated hours received or service outputs provided by volunteer efforts) or other monetary information (such as the dollar amount of contributions raised by volunteers). Disclosure of contributed services is required regardless of whether the services received are recognized as revenue in the financial statements.

1. Exercise 1-3

Please answer the following question.

Thanks, I guess…
During the year, NFP Z paid Anne Attorney $7,000 in legal fees. Anne Attorney told NFP Z that she normally would have charged $10,000 for those services, but she wanted to be charitable. **Should NFP Z recognize $3,000 in contributed services revenue?**

II. New presentation and disclosure requirements

ASU No. 2020-07 has nothing to do with the **accounting** for contributed nonfinancial assets; rather, it deals with the **presentation and disclosure** of those contributions. Thus, the good news about ASU No. 2020-07 is that it did not change current recognition or measurement requirements for contributed nonfinancial assets. The bad news is that it did change the presentation and disclosure of contributed nonfinancial assets. The following chart discusses the changes to the reporting of contributed nonfinancial assets under ASU No. 2020-07.

NFP reporting of contributed nonfinancial assets under ASU No. 2020-07		
Under ASU No. 2020-07's presentation guidance	➡	NFPs will present contributed nonfinancial assets received in a separate line item on the statement of activities apart from contributions of cash or other financial assets.
Under ASU No. 2020-07's disclosure guidance	➡	NFPs will break down the amount of contributed nonfinancial assets received by category in the notes (**Note.** The standard provides NFPs with a lot of flexibility in deciding the categories used).
Under ASU No. 2020-07's disclosure guidance	➡	For each category of contributed nonfinancial assets received, the NFP will provide: [1] qualitative information about whether the contributed nonfinancial assets were either monetized or utilized during the reporting period (if utilized, a description of the programs or other activities for which those assets were used will be included); [2] its policy (if any) for monetizing rather than utilizing contributed nonfinancial assets; [3] a description of any associated donor restrictions; [4] a description of the valuation techniques and inputs used to arrive at a fair value measure at initial recognition; and [5] the principal market (or most advantageous market) used to arrive at a fair value measurement if it is a market in which the recipient NFP is prohibited by donor restrictions from selling or using the contributed nonfinancial asset.

A. An illustration of ASU No. 2020-07's presentation requirement

In this section, we will review how ASU No. 2020-07 may affect an NFP's financial statements. Let's begin by looking at how an NFP should present contributed nonfinancial assets as a separate line item on the statement of activities (apart from contributions of cash or other financial assets).

How the statement of activities will change under ASU No. 2020-07

Below is an example of a statement of activities prior to applying ASU No. 2020-07.

NFP D
Statement of Activities
Year Ended September 30, 20X1

	Without Donor Restrictions	With Donor Restrictions	Total
Revenues, gains, and other support:			
Contributions	$145,368	$56,776	$202,144
Fees	4,546		4,546
Investment return, net	63,181	63,670	126,851
Other	2,026		2,026
Net assets released from restrictions:			
Satisfaction of program restrictions	31,058	(31,058)	
Expiration of time restrictions	15,012	(15,012)	
Total revenues, gains, and other support	261,191	74,376	335,567
Expenses:			
Program Omega	97,068		97,068
Program Iota	83,012		83,012
Management and general	35,013		35,013
Fundraising	27,884		27,884
Total expenses	242,977		242,977
Change in net assets	18,214	74,376	92,590
Net assets at beginning of year	200,417	300,773	501,190
Net assets at end of year	$218,631	$375,149	$593,780

The following chart reflects how the statement of activities may appear after applying ASU No. 2020-07. As you can see, contributions of nonfinancial assets have been separated into another line item.

How the statement of activities will change under ASU No. 2020-07

Below is an example of a statement of activities after applying ASU No. 2020-07.

NFP D
Statement of Activities
Year Ended September 30, 20X1

	Without Donor Restrictions	With Donor Restrictions	Total
Revenues, gains, and other support:			
Contributions of cash and other financial assets	$103,211	$38,000	$141,211
Contributions of nonfinancial assets	42,157	18,776	60,933
Fees	4,546		4,546
Investment return, net	63,181	63,670	126,851
Other	2,026		2,026
Net assets released from restrictions:			
Satisfaction of program restrictions	31,058	(31,058)	
Expiration of time restrictions	15,012	(15,012)	
Total revenues, gains, and other support	261,191	74,376	335,567
Expenses:			
Program Omega	97,068		97,068
Program Iota	83,012		83,012
Management and general	35,013		35,013
Fundraising	27,884		27,884
Total expenses	242,977		242,977
Change in net assets	18,214	74,376	92,590
Net assets at beginning of year	200,417	300,773	501,190
Net assets at end of year	$218,631	$375,149	$593,780

1. Exercise 1-4

Please answer the following question.

Could I do this another way?
We have seen that ASU No. 2020-07 requires NFPs to present contributed nonfinancial assets as a separate line item on the statement of activities apart from contributions of cash and other financial assets. **Is there any way that an NFP can present this in the statement of activities differently than the dedicated line item we just saw in the previous illustration?**

2. Exercise 1-5

Please answer the following true or false question.

		True or False
1	NFP X receives only two types of contributed nonfinancial assets (i.e., contributed clothing and contributed food). To provide more information to its resource providers, NFP X would like to present two separate line items on the statement of activities (i.e., one for each type of contributed nonfinancial asset received) and present the required disclosures. This would be okay.	

B. An illustration of ASU No. 2020-07's disclosure requirements

Now, let's look at how an NFP might break down the amount of contributed nonfinancial assets received by category in the notes under ASU No. 2020-07.

Contributed Nonfinancial Assets

For the year that ended September 30, 20X1, contributed nonfinancial assets recognized within the statement of activities included:

	Without Donor Restrictions	With Donor Restrictions
Food	21,707	–
Clothing	10,200	–
Services	10,250	–
Vehicles	–	18,776
	$42,157	$18,776

The final chart below shows how an NFP might present the remaining new required disclosures under ASU No. 2020-07.

> NFP D recognized contributed nonfinancial assets within revenue, including contributed food, clothing, services, and vehicles. With the exception of contributed vehicles, contributed nonfinancial assets did not have donor-imposed restrictions.
>
> Contributed food was utilized in Program Omega to provide free meals to those in need. Contributed clothing was used in Program Iota to provide free clothing to those in need. In valuing food and clothing, NFP D estimated the fair value on the basis of estimates of wholesale values that would be received for selling similar products in the United States.
>
> Contributed services recognized comprise professional services from attorneys who advised NFP D on various administrative legal matters. Contributed services are valued and reported at the estimated fair value in the financial statements based on current rates for similar legal services.
>
> It is NFP D's policy to sell all contributed vehicles immediately upon receipt at auction or for salvage. Donors contributed three vehicles during the period and restricted the proceeds from the sale of the vehicles to Program Omega for use in providing free meals to those in need. All vehicles were sold and valued according to the actual cash proceeds of $18,776 upon their disposition.

1. Exercise 1-6

Please answer the following true or false question.

		True or False
1	**Expenses** of contributed nonfinancial assets must be separately broken down on the statement of functional expenses due to ASU No. 2020-07.	

III. So How Did That Work Out for You?

Most NFPs applied ASU No. 2020-07 in 2022. While we can't say how ASU No. 2020-07 affected the NFP(s) you work for or with, we can tell how ASU No. 2020-07 worked out for some NFPs. The following chart summarizes how ASU No. 2020-07 changed the statement of activities for three NFPs.

How ASU No. 2020-07 Changed the Statement of Activities for Three NFPs

	NFP 1	**NFP 2**	**NFP 3**
Brief description of NFP	Small NFP providing job training and meals	Large regional food bank	Large conservation organization
Fiscal year end selected	6/30/22	6/30/22	6/30/22
Were comparative f/s prepared in the year ASU No. 2020-07 was implemented?	Yes. 2021 comparative year was adjusted	No	Yes. 2021 comparative year was adjusted

How ASU No. 2020-07 Changed the Statement of Activities for Three NFPs			
	NFP 1	**NFP 2**	**NFP 3**
How did ASU No. 2020-07 change the statement of activities?	**In the past,** NFP 1 had a revenue line item *grants and contributions*. **NFP 1 now** has two line items: (1) *grants and contributions*; **and** (2) *in-kind contributions*	**No change** as NFP 2 has historically presented contributions of nonfinancial assets as separate line items before ASU No 2020-07 (i.e., *public support - in-kind* **and** *donated food and commodities*)	**In the past,** NFP 3 had a revenue line item *support and revenues*. **NFP 3 now** has two line items: (1) *cash and other financial support and revenues*; **and** (2) *other nonfinancial support and revenues*

Having observed the impact of ASU No. 2020-07 on the statement of activities, let us now look at selected ASU No. 2020-07 related disclosures from the three NFPs. **Note.** Each of the three NFPs had a somewhat generic disclosure mentioning the adoption of ASU No. 2020-07 which we will not show.

Selected excerpts from NFP 1's ASU No. 2020-07 disclosures

Donated Services and Materials

The Organization received the following in-kind contributions for the year ending June 30:

	2022	2021
Resale items	$ 198,996	$ -
Leasehold improvements	-	100,363
Food donations	-	106,443
Total In-kind Contributions	$ 198,996	$ 206,806

Contributed resale items received by the Organization are recorded as in-kind contribution revenue with a corresponding increase to inventory. It is the Organization's policy to sell these donated items at its Thrift Shop with gross proceeds used to support ongoing program activities. The Organization values the inventory using the current average price located on a publicly available website for similar items if a group of items are donated.

Leasehold improvements were received by the Organization for the construction of their facility and valued at the cost charged by the construction contractor. Food donations are utilized in the Organization's programs. Food donations are valued at the average price per pound of food on a publicly available website.

In addition, many individuals volunteer their time and perform a variety of tasks that assist the Organization with specific programs. This contribution of services by the volunteers is not recognized in the financial statements unless the services received (a) create or enhance nonfinancial assets or (b) require specialized skills which are provided by individuals possessing those skills and would typically need to be purchased if not provided by donation. The donated services by volunteers for the years ended June 30, 2022 and 2021, did not meet the requirements above, therefore, no amounts were recognized in the financial statements for volunteer time.

Selected excerpts from NFP 2's ASU No. 2020-07 disclosures

Note 17: Contributed Nonfinancial Assets, Stocks, and Gift Cards

For the year ending June 30, 2022, contributed nonfinancial assets recognized within the statement of activities included:

Donated food and commodities	
Food	$ 156,097,487
Public support - in-kind	
Stock	1,292,356
Gift cards	425,460
Professional services	345,713
Office space	95,198
Event good and services	84,580
Total public support - in-kind	2,243,307
Total contributed nonfinancial assets, stock and gift cards	$ 158,340,794

- **Food and Commodities** – In addition to receiving cash contributions, the Organization receives in-kind contributions of food and other products from various donors. In-kind donations of products, the related inventory and the cost of donated food distributed are valued at an average of the national wholesale prices as determined by Feeding America. The Organization received approximately 93 million pounds valued at $156,097,487 during the year ended June 30, 2022. The average price per pound used was $1.53 at June 30, 2022.

- **Stock** – The Organization received $1,292,356 in donated stock. Donated stock is valued based on the average market price on the date received. Stock is liquidated upon receipt in compliance with the Organizations investment policy. Proceeds from the sale of stock are used for operations, unless restricted by the donor. There were no restricted stock donations in FY2022. Of the stock received, $994,000 was donated to Feeding North Texas Foundation.

- **Gift Cards** – The Organization also received $425,460 in gift cards. These cards were given by donors for the purchase of food and other operational expenses. Approximately $395,000 in gift cards were given by one donor which the Organization is granting to its various partner agencies to assist with food purchases.

- **Professional Services** – Contributions of services are recognized as revenue at their estimated fair value only when the services received create or enhance nonfinancial assets or require specialized skills possessed by the individuals providing the service, and the service would typically need to be purchased if not donated. For the year ended June 30, 2022, revenue recognized from contributed services totaled $345,713. Services included legal, pest control, advertising, and delivery services.

Continued

Selected excerpts from NFP 2's ASU No. 2020-07 disclosures

- **Warehouse and Office Space –** North Texas Food Bank employees occupied donated office space following the sale of the Organization's Dallas Farmers Market location in FY2021. Management estimates the value of the donated office space to be approximately $95,198 based on fair market value per square foot.

- **Event Goods and Services** – The Organization receives donated goods and services used for fundraising. These include items for auction, as well as services to host donor events. These donated goods and services are valued based on fair market price provided by the donor or another third party used by the Organization to run the auction and assist in organizing the event.

Contributions of services are recognized as revenue at their estimated fair value only when the services received create or enhance nonfinancial assets or require specialized skills possessed by the individuals providing the service and the service would typically need to be purchased if not donated.

Volunteer Time

A substantial number of volunteers donate significant amounts of their time to enable the Organization to meet its mission. For the year ended June 30, 2022, volunteers donated approximately 70,600 hours of their services. Management estimates the value of volunteer services to be approximately $1,059,000 based on the fair market value for such services.

The value of volunteer hours was not recognized as revenues or expenses during the year ended June 30, 2022.

Selected excerpts from NFP 3's ASU No. 2020-07 disclosures

(18) Nonfinancial Support and Revenues:

Nonfinancial support and revenues for the years ended June 30, 2022 and 2021 included:

		2022	2021
Nonfinancial Support and Revenues:			
Donated conservation easements	$	2,667,250	104,342,054
Donated educational programming		10,717,315	8,917,227
	$	13,384,565	113,259,281

DU recognized donated conservation easements and donated educational programming as other nonfinancial support and revenues in the accompanying consolidated statements of activities. As described in notes 2(l) and 2(m), support without donor restrictions and expenses are recognized in equal amounts based upon the appraised value of the easement or estimated value of the media content.

IV. Suggested solutions to exercises

This section contains the suggested solutions to the exercises presented in this chapter.

A. Suggested solution to Exercise 1-1

Gifts-in-kind versus nonfinancial assets

When the FASB began the standard-setting project that culminated with the issuance of ASU No. 2020-07, the FASB used the term **gifts-in-kind** instead of **nonfinancial assets**. Why did the FASB decide to use the **nonfinancial assets** wording in the final standard?

Although the term **gifts-in-kind** has been used within the NFP community for many years (and even used in places within FASB ASC 958), it has never been formally defined by the FASB. As a result, the meaning of the term **gifts-in-kind** is a little subjective within the industry (e.g., the AICPA NFP A&A Guide states that the term **gifts-in-kind** is used broadly to refer to all noncash gifts). The FASB opted to use different wording because it believed that using a term defined in the FASB ASC (i.e., **nonfinancial assets**) would add more clarity to the standard. For example, if an NFP receives a gift of stock, some may call that a gift-in-kind because it is not cash. However, because stock is a **financial asset** (under the FASB ASC definition of a financial asset), it is excluded from the enhanced presentation and disclosure requirements of ASU No. 2020-07.

B. Suggested solution to Exercise 1-2

Why were financial assets excluded from ASU No. 2020-07?

Why did the FASB exclude **financial assets** from the presentation and disclosure requirements of ASU No. 2020-07?

The FASB decided to exclude contributed financial assets from the scope of ASU No. 2020-07 because contributed financial assets (other than cash) are typically liquidated (monetized) immediately and used in a similar manner to cash in funding an NFP's programs and other activities. Therefore, enhanced presentation and disclosure of contributed financial assets (other than cash) is unnecessary for purposes of increasing the transparency of contributions.

C. Suggested solution to Exercise 1-3

Thanks, I guess…

During the year, NFP Z paid Anne Attorney $7,000 in legal fees. Anne Attorney told NFP Z that she normally would have charged $10,000 for those services, but she wanted to be charitable. **Should NFP Z recognize $3,000 in contributed services revenue?**

It's a judgment call, but the author would not. In the author's mind, this should be treated as a 30 percent discount rather than a $3,000 contribution (i.e., negotiating a good deal over receiving a true gift). However, if Anne had charged a much lower amount (say, $1,000), NFP Z would certainly have to consider recognizing an inherent contribution. **Note.** ASU No. 2020-07 does not change the recognition rules for contributed services. Contributed services should continue to be recognized if they: (1) create or enhance nonfinancial assets; (2) require specialized skills, are provided by individuals possessing those skills, and would typically need to be purchased if not provided by donation; or (3) are provided by personnel of an affiliate that directly benefits the recipient NFP and the affiliate does not charge the recipient NFP.

D. Suggested solution to Exercise 1-4

Could I do this another way?
We have seen that ASU No. 2020-07 requires NFPs to present contributed nonfinancial assets as a separate line item on the statement of activities, apart from contributions of cash and other financial assets. **Is there any way that an NFP can present this in the statement of activities differently than the dedicated line item we just saw in the previous illustration?**
There is a little flexibility regarding the terminology and presentation used for contributed nonfinancial assets. For example, if the only type of contributed nonfinancial asset that an NFP food bank received was contributed food, the NFP might opt to call it **contributed food** instead of **contributed nonfinancial assets** on the statement of activities. Also, while not illustrated in ASU No. 2020-07, FASB staff have illustrated breaking contributed nonfinancial assets into a separate column on the statement of activities in some presentations. However, this presentation approach can add a lot of complexity regarding the presentation of expenses and restrictions.

E. Suggested solution to Exercise 1-5

		True or False
1	NFP X receives only two types of contributed nonfinancial assets (i.e., contributed clothing and contributed food). To provide more information to its resource providers, NFP X would like to present two separate line items on the statement of activities (i.e., one for each type of contributed nonfinancial asset received) and present the required disclosures. This would be okay.	**True.** In this case, NFP X is simply presenting more detail than required on the face of the statement of activities. As long as the added detail does not clutter the statement, this would be fine.

F. Suggested solution to Exercise 1-6

		True or False
1	**Expenses** of contributed nonfinancial assets must be separately broken down on the statement of functional expenses due to ASU No. 2020-07.	**False.** Though some may consider this to be the best practice and it was considered in the development of the standard, this is not a requirement in ASU No. 2020-07. In part, the FASB felt the new disclosures regarding how contributed nonfinancial assets were monetized or utilized provided effective information more efficiently. ASU No. 2020-07 focuses on the revenue side.

FASB ASC 842 and Leases

FASB ASC 842 and Leases

Learning objectives

Upon completing this chapter, you will be able to prepare for and implement FASB ASC 842 on leases as it relates to NFPs. (**Note.** In Appendix 2A, the author has provided additional tips for implementing FASB ASC 842.)

I. The big picture view of FASB ASC 842

NFPs enter into leases for many types of assets. In recent years, the FASB (like its GASB counterpart) began to reconsider the accounting and reporting guidance for leases. In particular, the FASB lamented that operating leases have historically not been reflected in the financial statements of lessees. Thus, in February 2016, ASU No. 2016-02, *Leases (Topic 842)*, was issued to provide new requirements for the treatment of leases by both **lessees** and **lessors**. The requirements of FASB ASC 842 are effective for most NFPs for fiscal years beginning after December 15, 2021 (due to ASU No. 2020-05). The following chart discusses the big picture view of lease accounting under FASB ASC 842.

The big picture view of lease accounting under FASB ASC 842

FASB ASC 842 requires recognition of lease assets and lease liabilities by **lessees** for leases classified as operating leases under previous GAAP. FASB ASC 842 retains a distinction between **finance leases** (previously called capital leases) and **operating leases**. Under FASB ASC 842, a **lessee** is required to recognize in the statement of financial position a liability to make lease payments (the lease liability) and a right-of-use asset representing its right to use the underlying asset for the lease term. Under FASB ASC 842, the accounting applied by a **lessor** is largely unchanged from previous GAAP (e.g., the vast majority of operating leases will remain classified as operating leases, and lessors will continue to recognize lease income for those leases on a generally straight-line basis over the lease term). However, some refinements are occurring to lessor accounting. FASB ASC 842 also requires qualitative disclosures along with specific quantitative disclosures related to leasing activities.

A. Exercise 2-1

Please indicate whether the following statement is true or false.

		True or False
1	Ann Auditor works with both governmental and NFP clients. She has successfully guided her governmental clients through implementation issues involving GASB No. 87, *Leases*. Ann expects to be able to apply the same knowledge she attained related to GASB No. 87 to her NFP clients in their implementation of FASB ASC 842.	

II. Concepts that must be understood upfront

FASB ASC 842 is a lengthy (e.g., ASU No. 2016-02 is approximately 500 pages!) and complex standard. In this section, we are going to explore the following concepts that must be understood upfront to implement the standard: [1] the definition of a **lease**; [2] the definition of **reasonably certain**; [3] the definition of **lease term**; [4] the definition of a **short-term lease**; [5] contracts with multiple components and contract combinations; [6] distinguishing **finance leases** from **operating leases**; and [7] the elephant in the room (i.e., materiality).

A. The definition of a *lease*

Under FASB ASC 842, at the inception of a contract, an NFP will determine whether that contract is or contains a lease. Thus, a fundamental aspect of applying FASB ASC 842 is understanding the definition of a lease.

> **FASB ASC 842 defines a *lease* as being…**
>
> A contract, or part of a contract, that **conveys the right to control the use** of identified property, plant, or equipment (an identified asset) **for a period of time** in **exchange for consideration**.

FASB ASC 842 is a very "substance over form" standard. A contract will be evaluated for accounting as a lease based on the substance of the arrangement rather than the label on the contract (i.e., the presence or absence of the word **lease** in a contract is not a determinative factor).

1. Conveys the right to control the use

For a contract to meet the definition of a lease, the contract needs to **convey the right to control the use** of identified property, plant, or equipment (an identified asset) for a period of time in exchange for consideration. To determine whether a contract **conveys the right to control the use** of an identified asset for a period of time, an entity will assess whether, throughout the period of use, the customer has **both**: (1) the right to obtain substantially all of the economic benefits from use of the identified asset; **and** (2) the right to direct the use of the identified asset. **Note.** Contracts for services, except those contracts that contain both a lease component and a service component, would not meet the definition of a lease as they do not convey the right to control the use of identified property, plant, or equipment.

2. Exercise 2-2

Please answer the following question related to whether an agreement meets the definition of a lease.

As part of its mission, NFP X distributes medical supplies to impoverished countries. NFP X enters into an agreement with Company Z for the use of a cargo plane for a three-year period in exchange for consideration. The plane is specifically identified in the agreement and Company Z does not have the right to substitute the plane. NFP X determines what cargo will be sent and whether, when, and to which airports the plane will fly, during the three-year period, subject to restrictions specified in the agreement. Those restrictions prevent NFP X from flying to certain unsafe regions or tranporting hazardous cargo. Company Z maintains and operates the plane and is responsible for the safe passage of the cargo on the plane. NFP X is required to use Company Z for maintaining and operating the plane during the three-year period. **Does this agreement meet the definition of a lease?**

3. Exercise 2-3

Please answer the following question related to whether an NFP lessee controls the use of identified property, plant, or equipment.

How do I know if the NFP is in control?

We have seen that an important determination under FASB ASC 842 is whether the contract, or part of a contract, conveys the right to control the use of identified property, plant, or equipment (an identified asset). **Is there a simple way to think through whether an NFP lessee controls the use of an asset?**

4. For a period of time

For a contract to meet the definition of a lease, the contract needs to convey the right to control the use of identified property, plant, or equipment (an identified asset) **for a period of time** in exchange for consideration. Now, a period of time could potentially be for a very long term (e.g., a 99-year lease of land) and still not scoped out of FASB ASC 842. However, a truly perpetual agreement would lack this characteristic (as it would not contain a defined period of use) and would be more similar to the acquisition of an asset.

For a period of time

Under FASB ASC 842, one element of a lease agreement is that the contract needs to be **for a period of time**. FASB ASC 842 also discusses that a period of time may be described in terms of the amount of use of an identified asset (e.g., the number of production units that an item of equipment will be used to produce).

5. Exercise 2-4

Please answer the following question related to whether certain contracts are leases under FASB ASC 842.

Is this a lease?
Private School A enters into an agreement with Church B to use Church B's classroom facilities. In exchange for consideration, the three-year agreement allows Private School A the exclusive use of Church B's classroom facilities for five days a week for 32 weeks a year. **Does this agreement appear to meet the FASB ASC 842 definition of a lease?**

6. An exchange transaction

For a contract to meet the definition of a lease, the contract needs to convey the right to control the use of identified property, plant, or equipment (an identified asset) for a period of time in **exchange for consideration**.

	For a contract to meet the definition of a lease, it needs to be in exchange for consideration
	Occasionally, NFPs receive donations of the right to use an asset (e.g., office space). Donated rent (i.e., the difference between the value of assets given to the lessor and market rent) would be recorded as a contribution (as it is not in **exchange for consideration**). When an NFP is calculating its lease liability and lease asset, NFPs would exclude the market value of donated rent.

7. Certain types of leased assets are specifically excluded from FASB ASC 842

We have been looking at the FASB ASC 842 definition of a lease. However, we should also mention that certain types of leased assets are not subject to FASB ASC 842. FASB ASC 842 specifically excludes certain contracts from its scope as discussed in the following chart.

FASB ASC 842 does not apply to:	
	Leases of intangible assets.
	Leases to explore for or use minerals, oil, natural gas, and similar nonregenerative resources. This includes the intangible right to explore for those natural resources and rights to use the land in which those natural resources are contained (i.e., unless those rights of use include more than the right to explore for natural resources), but not equipment used to explore for the natural resources.
	Leases of inventory.
	Leases of biological assets, including timber.
	Leases of assets under construction.

8. Exercise 2-5

Please indicate whether the following statement is true or false.

		True or False
1	An NFP zoo leases two turtledoves and a partridge in a pear tree for a specific period of time in exchange for consideration. This contract would be excluded from FASB ASC 842 as a lease of biological assets.	

B. The definition of *reasonably certain*

We will soon look at the FASB ASC 842 definition of the lease term. However, before we look at the definition of the lease term, it is important to understand the FASB ASC 842 interpretation of the term **reasonably certain**.

What is *reasonably certain*?

FASB ASC 842 utilizes the term **reasonably certain** in considering whether options to extend or terminate a lease should be factored into the lease term. The FASB intends **reasonably certain** to be a high threshold of probability (and synonymous with the term **reasonably assured** as used in the prior leasing guidance). For example, does the lessee have a compelling economic reason to exercise a renewal option **or** not to exercise a termination option?

1. Exercise 2-6

Please answer the following question related to the reasonably certain threshold.

Reasonably certain

Under FASB ASC 842, at the commencement date, an entity assesses whether the lessee is **reasonably certain** to exercise or not to exercise an option by considering all economic factors relevant to that assessment. **What are some examples of economic factors that should be considered as part of this assessment?**

2. Exercise 2-7

Please answer the following related to the reasonably certain threshold.

Are you reasonably certain? Below are two scenarios for lessee options to extend a lease. Please indicate whether you would consider the reasonably certain threshold to be met.
NFP A signs a ten-year lease for office space. At the end of ten years, NFP A has an option to renew the lease for five years based on the current market rates at that date. In the past, NFP A has been reluctant to relocate even though office space is rather abundant in the area. **Do you believe the reasonably certain threshold has been met?**
NFP B signs a five-year lease for office space. At the end of five years, NFP B has an option to renew the lease for five years at the original lease rate. NFP B made some significant leasehold improvements that it will not be able to recover if it relocates to another location. Office space is somewhat sparse in the area. **Do you believe the reasonably certain threshold has been met?**

C. The definition of *lease term*

A critical aspect of applying FASB ASC 842 is understanding and properly calculating the **lease term**. In general, the determination of the lease term starts with the noncancellable period since it is the period for which both the lessee and lessor are legally obligated. Many leases grant the lessee a right to extend a lease beyond the initial noncancellable period or to terminate a lease before the end of the lease period. Depending on the terms and conditions of the option, a two-year lease with an option to extend for two years may or may not be economically similar to a two-year noncancellable lease or a four-year noncancellable lease. The lease term will include **certain periods** covered by options to extend or terminate the lease (based on the likelihood of those options being exercised) so that the lease term reflects how long the lease is expected to be in effect. The following chart discusses the formal FASB ASC 842 definition of the lease term.

FASB ASC 842 defines the *lease term* as being…
The noncancellable period for which a lessee has the right to use an underlying asset, together with all of the following: (1) periods covered by an option to extend the lease if the **lessee** is **reasonably certain to exercise** that option; (2) periods covered by an option to terminate the lease if the **lessee** is **reasonably certain not to exercise** that option; and (3) periods covered by an option to extend (or not to terminate) the lease in which **exercise of the option is controlled by the lessor**. **Critical Note.** When assessing the length of the noncancellable period of a lease, an entity should apply the definition of a contract (i.e., an agreement between two or more parties that creates enforceable rights and obligations) and determine the period for which the contract is enforceable. A lease is **no longer enforceable** when **both** the **lessee** and the **lessor** each have the right to terminate the lease without permission from the other party with no more than an insignificant penalty.

The following chart provides two illustrations of calculating the lease term under FASB ASC 842.

	Two illustrations of calculating the lease term
1	A lease agreement has a noncancellable period of three years and states that at the end of the three years, both the lessee and lessor have the right to cancel the lease (without a significant penalty) or may continue the lease, using the same terms on a month-to-month basis. **What is the initial lease term under FASB ASC 842?** **Three years** as **both** the lessee and the lessor have the right to terminate the lease at the end of the three years without permission from the other party and without a significant penalty.
2	A lease agreement has a noncancellable period of four years and states that at the end of the four years, the lessor may unilaterally terminate the lease. If the lessor does not terminate the lease, the lease continues for two additional years. **What is the initial lease term under FASB ASC 842?** **Six years** as **only** the lessor has an option to terminate the lease at the end of the four years. Under FASB ASC 842, if **only a lessor** has the right to terminate a lease, the lease term would automatically include the optional period controlled by the lessor (i.e., we do not weigh the reasonably certain criterion).

1. Exercise 2-8

Please answer the following question related to the lease term.

When will this lease term ever end?

Trade Association Z (the lessee) enters into a lease agreement for 48 months. Trade Association Z has an option to extend the lease for an additional 12 months. Trade Association Z is uncertain as to whether it will exercise the option to extend the lease. After the end of the 48 months (if Trade Association Z does not extend the lease) or 60 months (if Trade Association Z does extend the lease), the lease may be continued on a month-to-month basis, which either Trade Association Z or the lessor can cancel without penalty. **Based on these facts alone, what is the initial lease term under FASB ASC 842?**

2. Fiscal funding clauses

Although a bigger issue for governments (see GASB No. 87), FASB ASC 842 also contains guidance related to the effect of fiscal funding clauses on the lease term calculation.

Should fiscal funding clauses be factored into the lease term calculation?

A fiscal funding clause is a provision by which the lease is cancellable if the legislature or other funding authority does not appropriate the funds necessary for the governmental unit to fulfill its obligations under the lease agreement. The existence of a fiscal funding clause in a lease agreement requires an assessment of the likelihood of lease cancellation through exercise of the fiscal funding clause. If the likelihood is more than remote that the fiscal funding clause will be exercised, the lease term should include only those periods for which funding is reasonably certain.

3. *Reassessing the lease term after the initial determination*

As discussed in the following chart, after the initial lease term is determined, the lease term will be updated if the lessee elects to exercise an option or not to exercise an option **contrary** to the initial determination of the lease term.

	When should the lease term be reassessed? Under FASB ASC 842, lessees will reassess the lease term (or a lessee option to purchase the underlying asset) **only** if one or more of the following **occur**: [1] there is a significant event or a significant change in circumstances that is within the control of the lessee that directly affects whether the lessee is reasonably certain to exercise or not to exercise an option to extend or terminate the lease or to purchase the underlying asset; [2] there is an event that is written into the contract that obliges the lessee to exercise (or not to exercise) an option to extend or terminate the lease; [3] the lessee elects to exercise an option even though the entity had previously determined that the lessee was not reasonably certain to do so; or [4] the lessee elects not to exercise an option even though the entity had previously determined that the lessee was reasonably certain to do so.

A lessor will not reassess the lease term (or a lessee option to purchase the underlying asset) unless the lease is modified and that modification is not accounted for as a separate contract in accordance with FASB ASC 842-10-25-8 (**Note.** FASB ASC 842-10-25-8 discusses lease modifications).

D. The definition of a *short-term lease*

In an effort to reduce the costs of applying FASB ASC 842, the FASB included an accounting policy election related to short-term leases. However, to begin, we need to understand the definition of a short-term lease. The following chart discusses the formal FASB ASC 842 definition of a short-term lease.

	FASB ASC 842 defines a *short-term lease* as being… A lease that, at the commencement date, has a lease term of 12 months or less and does not include an option to purchase the underlying asset that the lessee is reasonably certain to exercise.

The following chart discusses the accounting policy election related to short-term leases allowed in FASB ASC 842. The benefit to lessees choosing this policy will be more fully appreciated by the end of this chapter. However, it centers on easier accounting as illustrated in the following chart.

The accounting policy election related to short-term leases allowed in FASB ASC 842	
	A lessee **may elect** to **not** recognize right-of-use assets and lease liabilities for short-term leases. Instead, the lessee would recognize the lease payments as lease cost on a straight-line basis over the lease term and variable lease payments in the period in which the obligation for those payments is incurred. The accounting policy election for short-term leases will be made by class of underlying asset to which the right of use relates.
	A lessee that elects the above accounting policy is required to disclose that fact. If the short-term lease expense for the period does not reasonably reflect the lessee's short-term lease commitments, FASB ASC 842 requires a lessee to disclose that fact and the amount of its short-term lease commitments [e.g., at year end, an NFP enters into a significant number of leases (which qualify as short-term leases) and which will result in a significant increase in lease expense in the following year].

(**Note.** The above simplified approach is consistent with how operating leases have historically been accounted for.)

An illustration of the short-term lease policy election

Private School Z has adopted the accounting policy election of not recognizing right-of-use assets and lease liabilities arising from short-term leases for any class of underlying asset. Private School Z enters into a 12-month lease of a van, with a lessee option to extend for another 12 months. Private School Z has determined at the lease commencement that it is not reasonably certain to exercise the option to extend. The lease does not have an option to purchase the underlying asset that Private School Z is reasonably certain to exercise.

Since Private School Z is not reasonably certain to exercise the option to extend the lease at the lease commencement the lease term is 12 months. Thus, the van lease meets the definition of a short-term lease because the lease term is 12 months or less. Consistent with Private School Z's accounting election, it would not recognize the right-of-use asset and the lease liability arising from the van lease.

FASB ASC 842 does provide guidance related to whether leases continue to meet the short-term lease definition when situations change. FASB ASC 842-20-25-3 provides that if the lease term or the assessment of a lessee option to purchase the underlying asset changes such that, after the change, the remaining lease term extends more than 12 months from the end of the previously determined lease term or the lessee is reasonably certain to exercise its option to purchase the underlying asset, the lease no longer meets the definition of a short-term lease and the lessee will apply the remainder of the guidance in FASB ASC 842 as if the date of the change in circumstances is the commencement date.

1. Exercise 2-9

Please indicate whether the following statement is true or false.

		True or False
1	The possible short-term lease exemption in FASB ASC 842 applies to lessees but not lessors.	

E. Contracts with multiple components and contract combinations

If applicable, an NFP generally will account for the lease component (e.g., the right to use a building) and nonlease component (e.g., maintenance services for the building) of a lease as separate contracts. Only the lease components are required to be accounted for in accordance with FASB ASC 842. The consideration in the contract is allocated to the lease and nonlease components on a relative standalone price basis (for lessees) or in accordance with the allocation guidance in FASB ASC 606 (for lessors). If a lease involves multiple assets, those components may need to be separated as well (see discussion and illustrations at FASB ASC 842-10-55-131).

In an effort to save some lessees time and to some degree ease the accounting, the FASB provided an accounting policy election related to not separating lease and nonlease components as discussed in the following chart.

The accounting policy election related to not separating lease and nonlease components allowed in FASB ASC 842	
	A lessee **may elect** to **not** separate nonlease components from lease components and instead to account for each separate lease component and the nonlease components associated with that lease component as a single lease component. The accounting policy election will be made by class of underlying asset. A lessee that elects this accounting policy is required to disclose its accounting policy election and which class or classes of underlying assets it has elected to apply it to.

Contracts that are entered into at or near the same time with the same counterparty will be considered part of the same contract if any of the following criteria are met: (1) the contracts are negotiated as a package with the same commercial objective; (2) the amount of consideration to be paid in one contract depends on the price or performance of the other contract; or (3) the rights to use underlying assets conveyed in the contracts are a single lease component in accordance with paragraph 842-10-15-28. For more guidance in this area see FASB ASC 842-10-25-19.

1. Exercise 2-10

Please indicate whether the following statement is true or false.

		True or False
1	FASB ASC 842 provides an accounting policy election for lessees related to not separating lease and nonlease components. Lessors may make the same accounting policy election.	

F. Distinguishing finance leases from operating leases

As we discussed earlier, FASB ASC 842 retains a distinction between **finance leases** (previously called capital leases) and **operating leases**.

1. Distinguishing leases from the lessee perspective

Under FASB ASC 842, whether a lease is classified as an **operating lease** or a **finance lease** affects the accounting and disclosures regarding the agreement. FASB ASC 842-10-25-2 provides criteria for distinguishing an operating lease from a finance lease.

How lessees distinguish an *operating lease* from a *finance lease* A lessee will classify a lease as an **operating lease** <u>**unless**</u> the lease meets **any** of the following criteria at lease commencement in which case the lease will be deemed a **finance lease:**	
a	The lease transfers ownership of the underlying asset to the lessee by the end of the lease term.
b	The lease grants the lessee an option to purchase the underlying asset that the lessee is reasonably certain to exercise.
c	The lease term is for the major part of the remaining economic life of the underlying asset (FASB ASC 842 suggests that 75 percent or more of the remaining economic life of the asset is a major part). If the commencement date falls at or near the end of the economic life of the underlying asset, this criterion is **not** used for purposes of classifying the lease (FASB ASC 842 suggests that this refers to a commencement date that falls within the last 25 percent of the total economic life of the asset).
d	The present value of the sum of the lease payments and any residual value guaranteed by the lessee that is not already reflected in the lease payments [in accordance with FASB ASC 842-10-30-5(f)] equals or exceeds substantially all of the fair value of the underlying asset. (**Note.** FASB ASC 842 suggests that 90 percent or more of the fair value of the underlying asset amounts to substantially all the fair value of the underlying asset.)
e	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.

In looking at the above, it is important to remember that if just one of the **a-e** criteria is met, the lessee will classify the agreement as a finance lease. Some of the above criteria are more concrete and easy to determine [e.g., the transfer of ownership criterion (**a**)] than others [e.g., the major part of the remaining economic life criterion (**c**)].

2. Exercise 2-11

Please indicate whether the following statement is true or false.

		True or False
1	NFP A has chosen the accounting policy election related to short-term leases allowed in FASB ASC 842 to not recognize right-of-use assets and lease liabilities for short-term leases. NFP A must still distinguish whether its short-term leases are operating leases or finance leases.	

3. Distinguishing leases from the lessor perspective

As we have discussed, under FASB ASC 842, a **lessee** will classify a lease as being either an **operating lease** or a **finance lease**. FASB ASC 842 also requires lessors to categorize lease agreements as well for accounting and disclosure purposes. **Lessors** will classify a lease as being either an **operating lease**, **direct financing lease**, or **sales-type lease**.

How lessors distinguish leases as being either operating, direct financing, or sales-type	
	Lessors use the same five criteria that lessees use to determine finance leases (i.e., the **a** to **e** criteria in FASB ASC 842-10-25-2). If **any** of those criteria are met, the lessor would classify the lease as a **sales-type lease**.
	If **none** of the **a** to **e** criteria in FASB ASC 842-10-25-2 are met, a lessor will classify the lease as either a **direct financing lease** or an **operating lease**. A lessor will classify the lease as an **operating lease** **<u>unless both</u>** of the following criteria are met, in which case the lessor will classify the lease as a **direct financing lease**: [1] the present value of the sum of the lease payments and any residual value guaranteed by the lessee that is not already reflected in the lease payments [in accordance with FASB ASC 842-10-30-5(f)] and/or any other third party unrelated to the lessor equals or exceeds substantially all of the fair value of the underlying asset; **and** [2] it is probable that the lessor will collect the lease payments plus any amount necessary to satisfy a residual value guarantee. **Note.** Criteria [1] and [2] come from FASB ASC 842-10-25-3(b).

G. The elephant in the room (i.e., materiality)

Section BC421 of ASU No. 2016-02 discusses that FASB ASC 842 does not include any recognition and measurement exemption for leases of small assets. Section BC122 of ASU No. 2016-02 discusses that entities will likely be able to adopt reasonable capitalization thresholds below which lease assets and lease liabilities are not recognized, which should reduce the costs of applying the guidance and that an entity's practice in this regard may be consistent with many entities' accounting policies in other areas of GAAP (e.g., in capitalizing purchases of property, plant, and equipment). In applying FASB ASC 842, NFP lessees will need to consider separately the effects of not recognizing the lease liability and the right-of-use asset (both individually and in the aggregate) and the effects on the disclosures when studying the appropriateness of using a capitalization threshold for leases.

III. Lessee recognition, measurement, and disclosure

Conceptually, in a lease transaction, a lessee receives the legal right to use an underlying asset (e.g., some equipment, a vehicle, or a building) at the commencement of the lease term. In exchange, the lessee promises to make payments over time for the right to use that underlying asset. Thus, the lessee has financed the acquisition of that legal right.

A. An overview of lessee accounting

A lessee will recognize a **lease liability** and a **right-of-use asset** at the **commencement** of the lease (**unless** the lease is a short-term lease where the lessee has adopted the accounting policy of not recognizing right-of-use assets and lease liabilities). The **lease liability** will be measured at the present value of the lease payments not yet paid, discounted using the discount rate for the lease at lease commencement. The **right-of-use asset** will be measured at the amount of the initial measurement of the lease liability, plus any lease payments made to the lessor at or before the commencement date (less any lease incentives received), plus any initial direct costs incurred by the lessee. The subsequent accounting for the lease liability and right-of-use asset will be dependent upon whether the lease is classified as an operating lease or a finance lease.

B. Calculating the lessee's initial lease liability

Conceptually, the lessee's initial **lease liability** will be measured at the present value of the lease payments not yet paid, discounted using the discount rate for the lease at lease commencement. Since there are several different types of payments that may be required under a lease contract, the calculation of the lease liability can become somewhat complex depending upon the terms of the lease.

<table>
<tr><td colspan="2">Calculating the lessee's initial lease liability
At the commencement date, a lessee will measure the lease liability at the present value of the lease payments not yet paid, discounted using the discount rate for the lease at lease commencement. At the commencement date, the lease payments will consist of the following payments relating to the use of the underlying asset during the lease term:</td></tr>
<tr><td></td><td>Fixed payments, including in substance fixed payments, less any lease incentives paid or payable to the lessee;</td></tr>
<tr><td></td><td>Variable lease payments that depend on an index or a rate (e.g., the Consumer Price Index or a market interest rate), initially measured using the index or rate at the commencement date;</td></tr>
<tr><td></td><td>Fees paid by the lessee to the owners of a special-purpose entity for structuring the transaction;</td></tr>
<tr><td></td><td>Amounts probable of being owed by the lessee under residual value guarantees;</td></tr>
<tr><td></td><td>The exercise price of a purchase option if it is reasonably certain that the lessee will exercise that option; and</td></tr>
<tr><td></td><td>Payments for penalties for terminating the lease (if the lease term reflects the lessee exercising an option to terminate the lease).</td></tr>
</table>

For a lessee, the discount rate for the lease is the rate implicit in the lease unless that rate cannot be readily determined (in which case the lessee uses its incremental borrowing rate). However, FASB ASC 842-20-30-3 does allow nonpublic business entities to use a risk-free discount rate, determined using a period comparable with that of the lease term, as an accounting policy election (see Appendix 2A).

1. Exercise 2-12

Please answer the following question related to lease payments.

Lease payments
Food Bank X leases warehouse space for four years. The initial base rent is $5,000 per month. The contract states that rents will increase by the greater of .5 percent of Food Bank X's contribution revenue for the year **or** 2 percent of the previous rental rate on each anniversary of the lease commencement. **What would the lease payments be for measuring the initial lease liability?**

C. Calculating the lessee's initial right-of-use asset

Conceptually, the lessee's initial **right-of-use asset** will be measured at the amount of the initial measurement of the lease liability, plus any payments made to the lessor at or before the commencement of the lease term and certain direct costs.

Calculating the lessee's initial right-of-use asset At the **commencement date**, a lessee will measure the **right-of-use asset** as the sum of the following:	
	The amount of **the initial measurement of the lease liability**;
	Any lease payments made to the lessor at or before the commencement date, minus any lease incentives received; and
	Any initial direct costs incurred by the lessee as described in FASB ASC 842-10-30-9 through 30-10 (e.g., commissions, certain payments to existing tenants to move out).

1. Exercise 2-13

Please indicate whether the following statements are true or false.

		True or False
1	For **both operating** and **finance** leases, an NFP lessee will initially recognize a right-of-use asset and a lease liability using the same methodology (i.e., the NFP lessee will record exactly the same initial journal entry for either an operating or finance lease).	
2	In its statement of financial position, an NFP lessee may present: (1) finance lease right-of-use assets in the same line item as operating lease right-of-use assets; and (2) finance lease liabilities in the same line item as operating lease liabilities.	

D. Subsequent accounting for the lessee's lease liability and right-of-use asset

While the initial measurement of a lessee's lease liability and right-of-use asset is the same for both operating leases and finance leases, the subsequent accounting differs.

Subsequent accounting for the lessee's lease liability and right-of-use asset	
The accounting for a lessee's lease liability and right-of-use asset subsequent to the initial recognition is dependent upon whether the lease is classified as an **operating lease** or a **finance lease**.	
For an **operating lease** the lessee will:	For a **finance lease** the lessee will:
Recognize **lease expense** [**Tip**: Although it is not presented this way in the financial statements, conceptually think of this amount as consisting of two components: (1) interest on the lease liability; and (2) an amortization of the right-of-use asset]	Recognize **interest expense** on the lease liability Recognize **amortization expense** on the right-of-use asset
Reduce the lease liability to reflect payments made	Reduce the lease liability to reflect payments made
Reduce the right-of-use asset	Reduce the right-of-use asset

FASB ASC 842-20-35-4 to 35-6 discuss conditions that require the lease liability to be remeasured at subsequent reporting dates. Those paragraphs also discuss certain circumstances that trigger reassessment of the discount rate used to measure the lease liability. FASB ASC 842-20-35-9 to 35-11 discuss situations in which the right-of-use asset is impaired. We will soon look at some illustrative lessee journal entries; however, before we do, the following chart explores some additional concepts related to the subsequent accounting for leases.

	Additional concepts related to the subsequent lessee accounting for leases
	For a **finance lease**, a lessee will generally amortize the right-of-use asset on a straight-line basis (see FASB ASC 842-20-35-7 through 35-8).
	The statement of activities presentation for **operating leases** displays a single **lease expense** calculated so that the cost of the lease is generally allocated on a **straight-line basis over the lease term**.
	The statement of activities presentation for **finance leases** displays the separate components of **interest expense** and **amortization expense** in a manner consistent with how the NFP presents other interest expense and depreciation or amortization of similar assets, respectively.
	For both **operating** and **finance leases**, most variable lease payments are accounted for as period expenses (exceptions would include things like variable lease payments that depend on an index or a rate or in substance fixed payments).
	For **operating leases**, lessees will classify payments within operating activities in the statement of cash flows.
	For **finance leases**, lessees will classify repayments of the principal portion of the lease liability within financing activities and payments of interest on the lease liability and variable lease payments within operating activities in the statement of cash flows.

E. An illustration of lessee accounting for an operating lease

On 1/1/X1, Private University leases office space under a three-year noncancellable agreement. Private University has determined that the lease is an operating lease. Fixed payments are due at 12/31 each year in the following amounts: 12/31/X1 = $10,000; 12/31/X2 = $11,000; and 12/31/X3 = $12,000. Private University has determined that the discount rate is 4 percent and the present value of the lease liability at the commencement of the lease is $30,453 (it has also determined that the right-of-use asset at commencement is $30,453). Private University has prepared the following amortization table for the lease liability:

Payment date:	Payment amount:	Liability amortization component:	Interest component:
12/31/X1	10,000	8,782	1,218
12/31/X2	11,000	10,133	867
12/31/X3	12,000	11,538	462
Totals	33,000	**30,453**	2,547

Private University understands that since this is an operating lease, the **lease expense** will consist of the total payment amount of $33,000 recognized on a **straight-line basis over the lease term**. Private University has prepared the following table calculating the lease expense (to be recognized each period on a straight-line basis) and the right-of-use asset amortization (which essentially will be based on the lease expense recognized less the interest component from the lease liability schedule above):

Period:	Lease expense amount:	Interest component (from lease liability amortization schedule):	Right-of-use asset amortization:
Year X1	11,000	1,218	9,782
Year X2	11,000	867	10,133
Year X3	11,000	462	10,538
Totals	33,000	2,547	**30,453**

In looking at the above, to ensure that the total lease payment amount is recognized on a straight-line basis over the lease term, the right-of-use asset is amortized at a higher amount later in the lease. The following table reflects the first year's journal entries:

X1 journal entries for Private University's operating lease:			
1/1/X1	Right-of-use asset	30,453	
	Lease liability		30,453
12/31/X1	Lease expense	11,000	
	Lease liability	8,782	
	Right-of-use asset		9,782
	Cash		10,000

1. Exercise 2-14

Please indicate whether the following statement is true or false.

		True or False
1	For a lessee accounting for an operating lease, the reduction in the lease liability each year will never be the same number as the reduction in the right-of-use asset.	

F. An illustration of lessee accounting for a finance lease

On 1/1/X1, Private University leases equipment under a three-year noncancellable agreement. Private University has determined that the lease is a finance lease. Fixed payments are due at 12/31 each year in the following amounts: 12/31/X1 = $10,000; 12/31/X2 = $11,000; and 12/31/X3 = $12,000. Private University has determined that the discount rate is 4 percent and the present value of the lease liability at the commencement of the lease is $30,453. Private University has prepared the following amortization table for the lease liability:

Payment date:	Payment amount:	Liability amortization component:	Interest component:
12/31/X1	10,000	8,782	1,218
12/31/X2	11,000	10,133	867
12/31/X3	12,000	11,538	462
Totals	33,000	**30,453**	2,547

Private University has also determined that the lease asset at the commencement of the lease (i.e., $30,453) should be amortized in a straight-line manner over the lease term. Private University has prepared the following amortization table for the lease asset:

Period:	Lease asset amortization amount:
Year X1	10,151
Year X2	10,151
Year X3	10,151
Totals	30,453

The following table reflects the first year's journal entries.

X1 journal entries for Private University's finance lease:			
1/1/X1	Right-of-use asset	30,453	
	Lease liability		30,453
12/31/X1	Lease liability	8,782	
	Interest expense	1,218	
	Cash		10,000
12/31/X1	Amortization expense - right-of-use asset	10,151	
	Accumulated amortization - right-of-use asset		10,151

G. Lessee disclosure requirements

FASB ASC 842-20-50 contains disclosure requirements for lessees. The disclosures tend to emphasize the amount, timing, and uncertainty of cash flows related to leasing activities.

Under FASB ASC 842, a lessee is required to disclose…
Information about the nature of its leases, including: [1] a general description of those leases; [2] the basis and terms and conditions on which variable lease payments are determined; [3] the existence and terms and conditions of options to extend or terminate the lease (including narrative information about the options that are/are not recognized as part of its right-of-use assets and lease liabilities); [4] the existence and terms and conditions of residual value guarantees provided by the lessee; and [5] the restrictions or covenants imposed by leases.
Information about leases that have not yet commenced but that create significant rights and obligations for the lessee (including the nature of any involvement with the construction or design of the underlying asset).
Information about significant assumptions and judgments made in applying FASB ASC 842 (e.g., the determination of whether a contract contains a lease, the allocation of the consideration in a contract between lease/nonlease components, and the determination of the discount rate).
For each period presented, a lessee will disclose the following amounts relating to a lessee's total lease cost and the cash flows arising from lease transactions: [1] finance lease cost (segregated between the amortization of the right-of-use assets and interest on the lease liabilities); [2] operating lease cost; [3] short-term lease cost (excluding expenses relating to leases with a lease term of one month or less); [4] variable lease cost; [5] amounts segregated between those for finance and operating leases for: (a) cash paid for amounts included in the measurement of lease liabilities, segregated between operating and financing cash flows; (b) supplemental noncash information on lease liabilities arising from obtaining right-of-use assets; (c) weighted-average remaining lease term; and (d) weighted-average discount rate.
A maturity analysis of the lessee's finance lease liabilities and its operating lease liabilities separately, showing the undiscounted cash flows on an annual basis for a minimum of each of the first five years and a total of the amounts for the remaining years. A lessee will disclose a reconciliation of the undiscounted cash flows to the finance lease liabilities and operating lease liabilities recognized in the statement of financial position.
A lessee that elects to not recognize right-of-use assets and lease liabilities for short-term leases (as discussed earlier) will disclose that fact. If the short-term lease expense for the period does not reasonably reflect the lessee's short-term lease commitments, the lessee will disclose that fact and the amount of its short-term lease commitments.
A lessee that elects the practical expedient to not separate lease components from nonlease components (as discussed earlier) will disclose its accounting policy election and which class or classes of underlying assets it has elected to apply the practical expedient.

Note. If applicable, a lessee also will provide relevant disclosures for: (1) sublease transactions; (2) sale-leaseback transactions; and (3) lease transactions between related parties.

IV. Lessor accounting

As we discussed earlier, the lessor accounting model in FASB ASC 842 distinguishes between **sales-type**, **direct financing**, and **operating leases**. The lease classification for lessors is primarily based on the same lease classification approach as that for lessees. Under FASB ASC 842, the accounting applied by a **lessor** is largely unchanged from previous GAAP. However, some changes have been made to lessor accounting to conform and align that guidance with the lessee guidance and other areas within GAAP (e.g., FASB ASC 606, *Revenue from Contracts with Customers*). Since NFPs tend to be lessees instead of lessors, in this section we will briefly highlight aspects of lessor accounting under FASB ASC 842 for the three types of leases.

A. Sales-type leases

As we observed earlier, a lease that meets any of the criteria in FASB ASC 842-10-25-2 is a **sales-type lease** since the lessor, in effect, transfers control of the underlying asset to the lessee.

Lessors – Sales-type leases

A **sales-type lease** is economically similar to a sale. Thus, the lessor: (1) recognizes any selling profit or loss at lease commencement; (2) derecognizes the underlying asset; and (3) recognizes a net investment in the lease. For a sales-type lease, the lessor initially measures the **net investment in the lease** as the sum of the **lease receivable** and the **unguaranteed residual asset**. Both the lease receivable and the unguaranteed residual asset will be measured at present value (discounted using the rate implicit in the lease).

FASB ASC 842-30-25-3 through 25-6 describes how a lessor will recognize and measure a sales-type lease when collectability of the lease receivable is not probable at the commencement date.

1. Exercise 2-15

Please indicate whether the following statements are true or false.

		True or False
1	For both sales-type and direct financing leases, the **lease receivable** is initially measured as the sum of the present value of the lease payments not yet received by the lessor **and** the present value of any portion of the estimated residual value at the end of the lease term that is guaranteed.	
2	In calculating the **net investment in the lease** for a sales-type lease, the lessor will always need to calculate the **unguaranteed residual asset**.	

B. Direct financing leases

As we observed earlier, a lessor will report a lease that meets none of the criteria in FASB ASC 842-10-25-2 as either a **direct financing lease** or an **operating lease**. The lessor's classification of the lease as a direct financing lease or an operating lease hinges on the criteria in FASB ASC 842-10-25-3(b).

	Lessors – Direct financing leases
	In a **direct financing lease**, the lease transaction effectively converts the lessor's risk arising from ownership of the underlying asset (i.e., asset risk) into credit risk. Thus, the lessor: (1) recognizes any selling loss at lease commencement; (2) derecognizes the underlying asset; and (3) recognizes a net investment in the lease. For a direct financing lease, the lessor initially measures the **net investment in the lease** as the sum of the **lease receivable** and the **unguaranteed residual asset**, adjusted for **selling profit and initial direct costs**. Both the lease receivable and the unguaranteed residual asset will be measured at present value (discounted using the rate implicit in the lease).

1. Exercise 2-16

Please indicate whether the following statement is true or false.

		True or False
1	For a direct financing lease, any selling profit and initial direct costs should be deferred and included in the net investment in the lease. These amounts should be recognized over the lease term in a manner that will produce, when combined with the interest income on the remainder of the net investment, a constant periodic rate of return on the lease.	

C. Operating leases

As we observed earlier, a lessor will report a lease that meets none of the criteria in FASB ASC 842-10-25-2 as either a **direct financing lease** or an **operating lease**. The lessor's classification of the lease as a direct financing lease or an operating lease hinges on the criteria in FASB ASC 842-10-25-3(b).

	Lessors – Operating leases
	An **operating lease** is neither a sale nor financing of an asset. Thus, the lessor will keep the asset underlying the lease on its statement of financial position and continue to depreciate the asset based on its estimated useful life. Rental revenue will be recognized on a straight-line basis (or another systematic and rational basis if that basis is more representative of the pattern in which income is earned from the underlying asset over the term of the lease).

D. Exercise 2-17

Please indicate whether the following statement is true or false.

		True or False
1	Like lessees, lessors will account for nonlease maintenance services components separate from the lease components.	

V. Other more specialized guidance

Since there is such variety in the population of leases that occur, it is difficult to have a standard that addresses all the potential leasing scenarios out there. While FASB ASC 842 is general in nature, the FASB did try to address certain specialized scenarios that may arise in a limited way. FASB ASC 842 contains specialized guidance related to lease modifications, lease terminations, lease incentives, subleases, sale and leaseback transactions, leases between related parties, and more.

VI. Effective date and implementation

As we mentioned earlier, the requirements of FASB ASC 842 are effective for most NFPs for fiscal years beginning after December 15, 2021 (due to ASU No. 2020-05). The implementation of FASB ASC 842 may pose a significant challenge to many NFPs. FASB ASC 842 contains several accounting policy elections related to the implementation of the standard which we will briefly highlight. See FASB ASC 842 for additional details.

A. An accounting policy election related to prior periods at implementation

In transition, lessees and lessors are required to recognize and measure leases using a modified retrospective approach. Entities are allowed to choose one of two methods to recognize and measure leases within the scope of FASB ASC 842: **[1] Adjusting comparative periods** – Under this method, an entity initially applies FASB ASC 842 at the beginning of the earliest period presented in the financial statements and recognizes a cumulative effect adjustment to the opening balance of equity in that period; or **[2] Not adjusting comparative periods** – Under this accounting policy election, an entity initially applies FASB ASC 842 at the effective date and recognizes a cumulative effect adjustment to the opening balance of equity in the period of adoption. If an entity elects this option, the reporting for comparative periods presented in the financial statements will continue to be in accordance with FASB ASC 840.

B. Additional accounting policy elections at implementation

FASB ASC 842 contains additional accounting policy elections for the implementation of the new leasing standard. These accounting policy elections include: [1] a package of practical expedients to not reassess: (a) whether a contract is or contains a lease; (b) lease classification; and (c) initial direct costs; [2] a practical expedient to use hindsight when determining lease term; and [3] a practical expedient to not reassess certain land easements.

VII. Exercise 2-18

Please answer the following question related to the new FASB and GASB lease standards.

So what's the difference?

In this chapter, we have discussed the implementation of FASB ASC 842, which will apply to NFPs and other FASB entities. While the FASB was developing FASB ASC 842, the GASB was developing a new lease standard for state and local governments (i.e., GASB No. 87, *Leases*). **Since the FASB and GASB lease standards were developed at the same time, is there any meaningful difference between the two standards?**

VIII. Suggested solutions to exercises

This section contains the suggested solutions to the exercises presented in this chapter.

A. Suggested solution to Exercise 2-1

		True or False
1	Ann Auditor works with both governmental and NFP clients. She has successfully guided her governmental clients through implementation issues involving GASB No. 87, *Leases*. Ann expects to be able to apply the same knowledge she attained related to GASB No. 87 to her NFP clients in their implementation of FASB ASC 842.	**False**. Although FASB ASC 842 and GASB No. 87 were developed almost simultaneously, the FASB and GASB came to very different conclusions in several key areas related to leases. This will make the adoption of FASB ASC 842 difficult for auditors like Ann.

B. Suggested solution to Exercise 2-2

As part of its mission, NFP X distributes medical supplies to impoverished countries. NFP X enters into an agreement with Company Z for the use of a cargo plane for a three-year period in exchange for consideration. The plane is specifically identified in the agreement and Company Z does not have the right to substitute the plane. NFP X determines what cargo will be sent and whether, when, and to which airports the plane will fly, during the three-year period, subject to restrictions specified in the agreement. Those restrictions prevent NFP X from flying to certain unsafe regions or tranporting hazardous cargo. Company Z maintains and operates the plane and is responsible for the safe passage of the cargo on the plane. NFP X is required to use Company Z for maintaining and operating the plane during the three-year period. **Does this agreement meet the definition of a lease?**

The agreement contains a lease as it conveys the right to control the use of an identified asset for a period of time in exchange for consideration. NFP X has the exclusive right to use the plane during the three-year period and the restrictions preventing flights to unsafe regions or transporting hazardous cargo merely define the scope of NFP X's use of the plane. NFP X makes the determinations of whether, when and where the plane will fly and what will be transported. While Company Z maintains and operates the plane, it does not have the right to direct how or for what purpose the plane is used.

C. Suggested solution to Exercise 2-3

How do I know if the NFP is in control?

We have seen that an important determination under FASB ASC 842 is whether the contract, or part of a contract, conveys the right to control the use of identified property, plant, or equipment (an identified asset). **Is there a simple way to think through whether an NFP lessee controls the use of an asset?**

Control over the use of an identified asset depends on whether, over the period of use, the lessee has: (1) the right to substantially all of the economic benefits from use of the asset; and (2) the right to direct the use of the asset. Section BC123 of ASU No. 2016-02 discusses that the customer controls the use of an identified asset for a period of time if the customer can make the important decisions about the use of the asset in a similar way to that in which it makes decisions about owned assets that it uses. In such cases, the customer (the lessee) has obtained the right to use an asset (the right-of-use asset) that it should recognize on its balance sheet (subject to the recognition and measurement exemption for short-term leases we will discuss shortly). In contrast, in a service contract, the supplier controls the use of any assets used to deliver the service.

Note. FASB ASC 842 clarifies that if a supplier has a substantive right to substitute the asset throughout the period of use, there is not an identified asset and the contract does not contain a lease. That is because the supplier (and not the customer) controls the use of the asset if it can substitute that asset throughout the period of use, thereby deciding for what purpose the asset is used. FASB ASC 842 includes guidance to help determine the situations in which substitution rights are substantive. If a substitution clause is not substantive because it does not change the substance of the contract, that substitution clause should not affect an entity's assessment of whether a contract contains a lease.

D. Suggested solution to Exercise 2-4

Is this a lease?

Private School A enters into an agreement with Church B to use Church B's classroom facilities. In exchange for consideration, the three-year agreement allows Private School A the exclusive use of Church B's classroom facilities for five days a week for 32 weeks a year. **Does this agreement appear to meet the FASB ASC 842 definition of a lease?**

Yes. Private School A has an agreement that conveys the right to control the use of an identified asset for a period of time in exchange for consideration. **Note.** FASB ASC 842 defines a period of use as being the total period of time that an asset is used to fulfill a contract with a customer (**including the sum of any nonconsecutive periods of time**). So, an agreement does not have to be for a consecutive period of time. In this case, Private School A would likely determine that this lease would be for 480 days (i.e., three years X five days a week X 32 weeks a year).

E. Suggested solution to Exercise 2-5

		True or False
1	An NFP zoo leases two turtledoves and a partridge in a pear tree for a specific period of time in exchange for consideration. This contract would be excluded from FASB ASC 842 as a lease of biological assets.	**True.** Leases of biological assets (including plants and living animals) are exempt from FASB ASC 842. The FASB wanted to ensure that requirements relating to biological assets are found solely in FASB ASC 905, *Agriculture*.

F. Suggested solution to Exercise 2-6

Reasonably certain
Under FASB ASC 842, at the commencement date, an entity assesses whether the lessee is **reasonably certain** to exercise or not to exercise an option by considering all economic factors relevant to that assessment. **What are some examples of economic factors that should be considered as part of this assessment?** Examples of economic factors to consider include: [1] contractual terms and conditions for the optional periods compared with current market rates; [2] significant leasehold improvements that are expected to have significant economic value for the lessee when the option to extend or terminate the lease or to purchase the underlying asset becomes exercisable; [3] costs relating to the termination of the lease and the signing of a new lease (e.g., negotiation costs, relocation costs); and [4] the importance of that underlying asset to the lessee's operations.

G. Suggested solution to Exercise 2-7

Are you reasonably certain?
Below are two scenarios for lessee options to extend a lease. Please indicate whether you would consider the reasonably certain threshold to be met.
NFP A signs a ten-year lease for office space. At the end of ten years, NFP A has an option to renew the lease for five years based on the current market rates at that date. In the past, NFP A has been reluctant to relocate even though office space is rather abundant in the area. **Do you believe the reasonably certain threshold has been met?** **Probably not**. While NFP A's reluctance to relocate in the past may indicate an intention to renew the lease, this ten-year lease does not appear to have a compelling economic reason for doing so (i.e., the renewal option will be at market rates, office space is abundant in the area, etc.)
NFP B signs a five-year lease for office space. At the end of five years, NFP B has an option to renew the lease for five years at the original lease rate. NFP B made some significant leasehold improvements that it will not be able to recover if it relocates to another location. Office space is somewhat sparse in the area. **Do you believe the reasonably certain threshold has been met?** **Probably so**. NFP B has compelling economic reasons for renewing the lease (e.g., to fully benefit from the leasehold improvements it made, a likely discounted renewal rate, limited office space in the area). N**ote.** This lease is also shorter than NFP A's, which allows for more certainty in weighing the economic factors.

H. Suggested solution to Exercise 2-8

When will this lease term ever end?
Trade Association Z (the lessee) enters into a lease agreement for 48 months. Trade Association Z has an option to extend the lease for an additional 12 months. Trade Association Z is uncertain as to whether it will exercise the option to extend the lease. After the end of the 48 months (if Trade Association Z does not extend the lease) or 60 months (if Trade Association Z does extend the lease), the lease may be continued on a month-to-month basis, which either Trade Association Z or the lessor can cancel without penalty. **Based on these facts alone, what is the initial lease term under FASB ASC 842?** In this case, the initial lease term under FASB ASC 842 would be the noncancellable period of 48 months. Since Trade Association Z is not reasonably certain that it will exercise the option to extend the lease for an additional 12 months, it would not include those months in the lease term. The potential month-to-month extensions also would not be included in the lease term as both Trade Association Z and the lessor have an option to terminate the lease without permission from the other party without penalty.

I. Suggested solution to Exercise 2-9

		True or False
1	The possible short-term lease exemption in FASB ASC 842 applies to lessees but not lessors.	**True.** Section BC380 of ASU No. 2016-02 explains that because the FASB decided to substantially retain the lessor accounting model in previous GAAP, which accounts for nearly all short-term leases as operating leases, the FASB concluded that it was not necessary to include a short-term lease exemption in FASB ASC 842 for lessors.

J. Suggested solution to Exercise 2-10

		True or False
1	FASB ASC 842 provides an accounting policy election for lessees related to not separating lease and nonlease components. Lessors may make the same accounting policy election.	**False.** FASB ASC 842 requires that lessors separate lease from nonlease components in a contract. The FASB felt that for lessors, most nonlease goods or services that are included in a contract with a lease will be subject to the revenue recognition guidance in FASB ASC 606.

K. Suggested solution to Exercise 2-11

		True or False
1	NFP A has chosen the accounting policy election related to short-term leases allowed in FASB ASC 842 to not recognize right-of-use assets and lease liabilities for short-term leases. NFP A must still distinguish whether its short-term leases are operating leases or finance leases.	**False.** As we will soon see, the distinction between operating and finance leases is important as it drives the amounts/timing/classification of items appearing on an NFP's statement of financial position and statement of activities. However, NFP A would not recognize right-of-use assets and lease liabilities for short-term leases and would simply recognize the lease payments as lease cost on a straight-line basis over the lease term and variable lease payments in the period in which the obligation for those payments is incurred.

L. Suggested solution to Exercise 2-12

Lease payments
Food Bank X leases warehouse space for four years. The initial base rent is $5,000 per month. The contract states that rents will increase by the greater of .5 percent of Food Bank X's contribution revenue for the year **or** 2 percent of the previous rental rate on each anniversary of the lease commencement. **What would the lease payments be for measuring the initial lease liability?**
The lease payments for Food Bank X would include the fixed monthly payments of $5,000 plus the 2 percent minimum annual increase. The 2 percent would be included in the calculation as it is an in substance fixed payment. The .5 percent of Food Bank X's contribution revenue would not be considered as it is a variable lease payment not dependent on an index or a rate. Variable lease payments (other than those that depend on an index or a rate) would not be included in lease payments for purposes of measuring the initial lease liability, unless those payments are in substance fixed payments. **Note.** FASB ASC 842-10-55-225 to 55-234 contain illustrations of lessee accounting for variable lease payments.

M. Suggested solution to Exercise 2-13

		True or False
1	For **both operating** and **finance** leases, an NFP lessee will initially recognize a right-of-use asset and a lease liability using the same methodology (i.e., the NFP lessee will record exactly the same initial journal entry for either an operating or finance lease).	**True.** Whether the lease is classified as being either an operating or finance lease does not impact the initial recognition of the right-of-use asset or the lease liability.
2	In its statement of financial position, an NFP lessee may present: (1) finance lease right-of-use assets in the same line item as operating lease right-of-use assets; and (2) finance lease liabilities in the same line item as operating lease liabilities.	**False.** FASB ASC 842-20-45-3 specifically prohibits both (1) and (2) to the left. **Note.** FASB ASC 842-20-45-1 and 45-2 provide guidance and options related to presenting right-of-use assets

		and lease liabilities in the statement of financial position.

N. Suggested solution to Exercise 2-14

		True or False
1	For a lessee accounting for an operating lease, the reduction in the lease liability each year will never be the same number as the reduction in the right-of-use asset.	**False.** The reduction in the lease liability and the right-of-use asset can indeed be the same if the lease payments required each year are the same (see below calculation).

On 1/1/X1, Private University leases office space under a three-year noncancellable agreement. Private University has determined that the lease is an operating lease. **Fixed payments of $11,000 are due at 12/31 each year.** Private University has determined that the discount rate is 4 percent and the present value of the lease liability at the commencement of the lease is $30,526 (it has also determined that the right-of-use asset at commencement is $30,526). Private University has prepared the following amortization table for the lease liability:

Payment date:	Payment amount:	Liability amortization component:	Interest component:
12/31/X1	11,000	**9,779**	1,221
12/31/X2	11,000	**10,170**	830
12/31/X3	11,000	**10,577**	423
Totals	33,000	**30,526**	2,474

Private University understands that since this is an operating lease, the **lease expense** will consist of the total payment amount of $33,000 recognized on a **straight-line basis over the lease term**. Private University has prepared the following table calculating the lease expense (to be recognized each period on a straight-line basis) and the right-of-use asset amortization (which essentially will be based on the lease expense recognized less the interest component from the lease liability schedule above):

Period:	Lease expense amount:	Interest component (from lease liability amortization schedule):	Right-of-use asset amortization:
Year X1	11,000	1,221	**9,779**
Year X2	11,000	830	**10,170**
Year X3	11,000	423	**10,577**
Totals	33,000	2,474	**30,526**

The following table reflects the first year's journal entries:

X1 journal entries for Private University's operating lease:			
1/1/X1	Right-of-use asset	30,526	
	Lease liability		30,526
12/31/X1	Lease expense	11,000	
	Lease liability	**9,779**	
	Right-of-use asset		**9,779**
	Cash		11,000

O. Suggested solution to Exercise 2-15

		True or False
1	For both sales-type and direct financing leases, the **lease receivable** is initially measured as the sum of the present value of the lease payments not yet received by the lessor **and** the present value of any portion of the estimated residual value at the end of the lease term that is guaranteed.	**True.**
2	In calculating the **net investment in the lease** for a sales-type lease, the lessor will always need to calculate the **unguaranteed residual asset**.	**False.** While the unguaranteed residual asset (i.e., the present value of the amount the lessor expects to derive from the underlying asset following the end of the lease term that is not guaranteed) is a component of the net investment in lease, there is not always an unguaranteed residual asset. For example, a lease may transfer ownership of the underlying asset to the lessee by the end of the lease term.

P. Suggested solution to Exercise 2-16

		True or False
1	For a direct financing lease, any selling profit and initial direct costs should be deferred and included in the net investment in the lease. These amounts should be recognized over the lease term in a manner that will produce, when combined with the interest income on the remainder of the net investment, a constant periodic rate of return on the lease.	**True.** While any selling losses are recognized at commencement, any selling profits are deferred and recognized over the lease term.

Q. Suggested solution to Exercise 2-17

		True or False
1	Like lessees, lessors will account for nonlease maintenance services components separate from the lease components.	**True.** However, as a reminder, FASB ASC 842 contains an accounting policy election for **lessees** (see FASB ASC 842-10-15-37) related to not separating lease and nonlease components. **Lessors** have a similar but more limited accounting policy election at FASB ASC 842-10-15-42A.

R. Suggested solution to Exercise 2-18

So what's the difference?

In this chapter, we have discussed the implementation of FASB ASC 842 which will apply to NFPs and other FASB entities. While the FASB was developing FASB ASC 842, the GASB was developing a new lease standard for state and local governments (i.e., GASB No. 87, *Leases*). **Since the FASB and GASB lease standards were developed at the same time, is there any meaningful difference between the two standards?**

While there is some comparability between the FASB and GASB leasing models, the two standard setters came to some significant differences in certain areas. Examples of significant differences include: [1] the GASB model makes no distinction between operating or finance leases; [2] the GASB model contains stricter rules for leases to qualify as short-term leases; [3] in determining the lease term under the two models, there are differences in how lessor options to extend or terminate the lease are considered; [4] under the FASB model entities have a choice regarding the capitalization of short-term leases and the GASB model simply does not capitalize them; [5] the FASB model contains accounting policy elections to slightly simplify lease accounting that are not found in the GASB model (e.g., elections related to the discount rate used and not separating nonlease components); and [6] the transitional provisions between the two models differ.

Appendix 2A: Implementation Tips

Appendix 2A

I. Implementation tips

This appendix contains additional tips the author believes are helpful in implementing FASB ASC 842.

A. Making an inventory of existing lease agreements

The first step in applying FASB ASC 842 is to make an inventory of existing lease agreements at implementation. This will involve reviewing: (1) agreements related to office space/facility rentals, vehicles, copiers, computers, and equipment; (2) recurring expenses to look for potential lease payments; and (3) general ledger expense accounts for keywords that could indicate a lease. While conducting the inventory of lease agreements, learn from the experience and establish processes and controls so that the accounting function readily has access to all leasing information and documentation of key FASB ASC 842 determinations in future periods.

B. Gathering key information from the lease agreements

Key information to gather in reviewing lease agreements includes: (1) the lease commencement and termination dates; (2) the lease term and information regarding options to extend or terminate; (3) details regarding the type, description, and location of the leased asset; (4) payment terms, termination penalties, bargain purchase options, renewal term payments, and residual value guarantees; (5) information regarding any lease incentives and initial direct costs; and (6) information regarding any variable lease payments.

C. CPE for leases under FASB ASC 842

Based on the FASB ASC 842 definition of a lease, **CPE** describes the elements required for a recordable lease: **conveyance** of control, **period** of time, and **exchange** transaction. If an agreement does not have all three "CPE" elements, it is not a recordable lease under FASB ASC 842.

D. Understanding "reasonably certain"

When applying the reasonably certain threshold, think of "reasonably certain" as around 90 percent certainty. It is easier to add right-of-use assets and lease liabilities in future years (if an option is exercised that was initially uncertain) than to incorrectly include periods or amounts that need to be corrected down the road by large financial statement adjustments to remove those assets and liabilities.

E. Three types of time periods you may encounter

When measuring time under FASB ASC 842, there are three types of possible time periods that you may encounter. These can be remembered using the acronym **CON**: (1) **cancelable** periods of time – periods in which **both** the lessee **and** the lessor have the right to terminate the lease without permission from the other party with no more than an insignificant penalty; (2) **optional** periods of time – periods in which **either** the lessee **or** the lessor (but not both) have the option to extend or terminate a lease; and (3) **noncancelable** periods of time – periods in which **both** the lessee **and** the lessor have enforceable rights and obligations.

F. A time-saving choice

Elect not to recognize right-of-use assets and lease liabilities for short-term leases! There is no reason to go through this if you do not have to.

G. Combining saves time

The accounting policy election to treat lease and nonlease components as a single combined lease component makes sense for most NFPs because it saves time and simplifies the accounting. Electing to treat the nonlease components as lease components will cause the lessee to record larger assets and liabilities. If an NFP has classes of leases (e.g., property leases with meaningful common area maintenance or parking), it can consider not combining components for that class of underlying asset.

H. Materiality is always a factor

Materiality is always a factor when determining what is reflected in the financial statements, and this mindset should be applied to leases as well. If an organization has a reasonable capitalization threshold for fixed assets, that threshold (with temperance) likely makes sense for leases as well. When thinking about the materiality of a potential asset and liability, keep in mind that the drivers are the payments and **time period involved**.

I. When the rate implicit in the lease cannot be readily determined…

When the rate implicit in a lease cannot be readily determined, a nonpublic business entity has an expediency option if it does not want to use its incremental borrowing rate. FASB ASC 842-20-30-3 (as amended by ASU No. 2021-09 in November 2021) allows the use of a risk-free discount rate (determined using a period comparable to that of the lease term) as an accounting policy election made by class of underlying asset. Use of this option requires additional disclosure.

When the rate implicit in the lease is not present, use of the risk-free discount rate makes the most sense (regarding time and consistency) for the majority of leases. An NFP may want to consider using the incremental borrowing rate for classes of larger dollar assets (e.g., a building lease), particularly in low-interest-rate environments, as a risk-free rate will result in larger assets and liabilities being booked (perhaps even pushing some leases from operating into financing leases).

J. Donated rent

Earlier, when we discussed the FASB ASC 842 definition of a lease, we discussed that donated rent is recorded as a contribution. We also discussed that when an NFP lessee is calculating its lease liability and lease asset, it should exclude the market value of donated rent. Now that we have reviewed the basics of calculating a lessee’s lease liability and lease asset, let’s look at how an NFP would account for a lease that is **part contribution** (recorded using contribution accounting) and **part exchange transaction** (recorded using FASB ASC 842 accounting).

On 1/1/X1, Bedford Falls Food Bank leases warehouse space under a three-year operating lease that is part contribution. Bedford Falls Food Bank is required to pay a below-market rate of $20,000 on 12/31 each year. The undiscounted fair value of the total space included in the agreement is determined to be worth the following amounts: $100,000 for the year X1; $105,000 for the year X2; and $110,000 for the year X3.

The following table breaks down the undiscounted fair value of the rental between the contribution element and the FASB ASC 842 operating lease element.

Payment date:	Contribution element:	FASB ASC 842 operating lease element:	Undiscounted fair value of the rental:
12/31/X1	80,000	20,000	100,000
12/31/X2	85,000	20,000	105,000
12/31/X3	90,000	20,000	110,000
Totals:	255,000	60,000	315,000

Bedford Falls Food Bank has determined that a 5 percent discount rate should be used; therefore, the present value of the contribution element is $231,033 and the present value of the FASB ASC 842 operating lease element is $54,465. The following entries reflect the first year's journal entries for the contributed rent.

X1 journal entries for the contribution element:			
1/1/X1	Contribution receivable	255,000	
	Discount on contributions receivable		23,967
	Contribution revenue – nonfinancial assets – restricted		231,033
12/31/X1	Rent expense	80,000	
	Discount on contributions receivable	11,552	
	Contribution revenue – nonfinancial assets – restricted		11,552
	Contribution receivable		80,000
12/31/X1	Net assets with donor restrictions	80,000	
	Net assets without donor restrictions		80,000

The following entries reflect the first year's journal entries for the FASB ASC 842 operating lease element.

X1 journal entries for the FASB ASC 842 operating lease element:			
1/1/X1	Right-of-use asset	54,465	
	Lease liability		54,465
12/31/X1	Rent expense	20,000	
	Lease liability	17,277	
	Right-of-use asset		17,277
	Cash		20,000

The following tables show support for the calculations in the contribution journal entries.

Contribution receivable:	Year X1	Year X2	Year X3
Contribution receivable, net of discount, 1/1	231,033	162,585	85,714
Amortization of discount	11,552	8,129	4,286
Less fair value of donated lease	(80,000)	(85,000)	(90,000)
Contribution receivable, net of discount, 12/31	162,585	85,714	–

Net assets with donor restriction:	Year X1	Year X2	Year X3
Net assets with donor restriction, 1/1	231,033	162,585	85,714
Amortization of discount	11,552	8,129	4,286
Release from restriction	(80,000)	(85,000)	(90,000)
Net assets with donor restriction, 12/31	162,585	85,714	–

The following tables show support for the calculations in the operating lease journal entries.

Lease liability:	Year X1	Year X2	Year X3
Lease liability, 1/1	54,465	37,188	19,048
Payment	(20,000)	(20,000)	(20,000)
Interest component of annual payment	2,723	1,860	952
Lease liability, 12/31	37,188	19,048	–

Right-of-use asset:	Year X1	Year X2	Year X3
Right-of-use asset, 1/1	54,465	37,188	19,048
Lease expense	(20,000)	(20,000)	(20,000)
Interest component of annual payment	2,723	1,860	952
Right-of-use asset, 12/31	37,188	19,048	–

K. Plan for additional time and work related to the note disclosures

The note disclosures in FASB ASC 842 are extensive and will take some additional time and effort. For example, the new requirement to disclose the **weighted-average remaining lease term** and **weighted-average discount rate** (calculated separately for operating and financing leases) for each period presented will take some time and calculation.

1. Calculating the weighted-average remaining lease term

The **weighted-average remaining lease term** is calculated based on the lease liability balance and the remaining lease term for each lease as of the reporting date. As illustrated in the following charts, the operating and financing lease terms are calculated separately.

The following reflects NFP Z's operating lease balances at year-end.

Weighted-Average Remaining Lease Term Calculation – Operating Leases				
	Lease liability at 12/31/X1	(A): % of total lease liability	(B): Months remaining on the lease	(A) x (B): Weighted average
Operating lease 1	71,987	13%	23	2.99
Operating lease 2	161,963	29%	37	10.73
Operating lease 3	50,780	9%	15	1.35
Operating lease 4	278,912	49%	60	29.40
Total:	563,642	100%		44.47

The following reflects NFP Z's finance lease balances at year-end.

Weighted-Average Remaining Lease Term Calculation – Finance Leases				
	Lease liability at 12/31/X1	(A): % of total lease liability	(B): Months remaining on the lease	(A) x (B): Weighted average
Finance lease 1	305,221	34%	28	9.52
Finance lease 2	78,914	9%	14	1.26
Finance lease 3	512,903	57%	41	23.37
Total:	897,038	100%		34.15

Note. NFP Z would not need to include the above calculations in the notes; rather, it would simply need to disclose that the **weighted-average remaining lease term for operating leases was 3.7 years (or 44.47 months)** and the **weighted-average remaining lease term for finance leases was 2.9 years (or 34.15 months)**.

2. Calculating the weighted-average discount rate

The **weighted-average discount rate** is calculated based on the remaining balance of the lease payments and the discount rate that was used to calculate the lease liability for each lease as of the reporting date. As illustrated in the following charts, the operating and financing lease rates are calculated separately.

The following reflects NFP X's operating leases at year-end (20X2).

Weighted-Average Discount Rate Calculation – Operating Leases				
	Lease A (remaining payments)	**Lease B (remaining payments)**	**Lease C (remaining payments)**	**Total**
20X3	15,000	110,000	42,220	167,220
20X4	15,500	110,000	42,220	167,720
20X5	16,000	110,000	42,220	168,220
20X6	16,500	115,000	42,220	173,720
20X7		115,000	21,110	136,110
20X8		115,000		115,000
Total:	63,000	675,000	189,990	927,990
% of lease's remaining payments to total remaining payments (A)	7%	73%	20%	100%
Discount rate at commencement (B)	3.75%	4.15%	4.05%	
Weighted-average discount rate (A) x (B)	.26%	3.03%	.81%	4.1%

The following reflects NFP X's finance leases at year-end (20X2).

Weighted-Average Discount Rate Calculation – Finance Leases				
	Lease D (remaining payments)	**Lease E (remaining payments)**	**Lease F (remaining payments)**	**Total**
20X3	25,000	140,300	172,030	337,330
20X4	25,000	140,300	174,151	339,451
20X5		140,300	177,860	318,160
20X6		140,300	181,111	321,411
Total:	50,000	561,200	705,152	1,316,352
% of lease's remaining payments to total remaining payments (A)	4%	43%	53%	100%
Discount rate at commencement (B)	4.7%	4.4%	3.99%	
Weighted-average discount rate (A) x (B)	.19%	1.89%	2.12%	4.2%

Note. NFP X would not need to include the above calculations in the notes; rather, it would simply need to disclose that the **weighted-average discount rate for operating leases was 4.1 percent** and the **weighted-average discount rate for finance leases was 4.2 percent**.

L. Elect not to adjust comparative periods at implementation

For NFPs providing comparative financial statements, the decision not to adjust comparative periods definitely makes the most sense barring unusual circumstances.

M. Don't forget about debt covenants

Depending on the NFP involved, FASB ASC 842 may add meaningful assets and liabilities to an entity's financial statements. Subject to the particulars of certain debt covenants, some NFPs could find themselves in violation of existing debt covenants due to these changes. It is critical for NFPs in this situation to reach out to their lenders as soon as possible to avoid difficulties.

FASB ASC 842:
Glancing Back and Looking Forward

FASB ASC 842: Glancing Back and Looking Forward

Learning objectives

In this chapter, we will review aspects of how FASB ASC 842 impacted reporting at two NFP lessees and also examine issues to watch out for in year two of implementation.

I. Glancing back

For many NFPs, 2023 is the year of the lease. However, for calendar year-end NFPs, 2022 was. The implementation of FASB ASC 842 ushered in a new reporting model for lease accounting based on the foundational principle that even operating leases result in the recognition of lease assets and liabilities. This new reporting model came at a cost to NFP lessees in terms of the time spent on: [1] locating and analyzing leasing arrangements; [2] calculating lease terms; [3] distinguishing operating leases from finance leases; [4] determining the lease payments to be included in lease liabilities; [5] developing incremental borrowing rates or risk-free rates; [6] calculating lease liabilities/lease assets and related lease expense or interest expense/amortization expense; [7] considering the existence of lessor lease receivables (i.e., from perhaps being a lessor in a sales-type or direct financing lease); and [8] developing disclosures.

A. A tale of two NFPs

To look at how FASB ASC 842 changed financial reporting, we reviewed two NFPs' audited financial statements and aspects of how FASB ASC 842 impacted their reporting. The following table contains information about the two NFPs we selected.

A Tale of Two NFPs

	NFP 1	**NFP 2**
A little background on the NFP	Small NFP providing Head Start/Pre-K and assistance to violent crime victims	Large NFP professional association with approximately 275,000 members
Fiscal year end selected	12/31/2022	12/31/2022
Were comparative f/s prepared in the year FASB ASC 842 was implemented?	No	NFP 2 first applied the standard for its 2018 f/s and did not adjust the 2017 comparative period
Total **lease liabilities** at 12/31/22	$1,076,796	$65,300,000
% of lease liability to total liabilites on 12/31/22 f/s	45.2%	21.2%
Total **lease assets** at 12/31/22	$1,076,796	$39,100,000
% of lease assets to total assets on 12/31/22 f/s	22.2%	3.3%

A Tale of Two NFPs	NFP 1	NFP 2
Types of assets leased as lessee	Operating leases for office and classroom space	Operating leases for office space, copiers, and printers
Interest rate methodology used	Risk-free rate	Incremental borrowing rate
Weighted-average discount rate	1.28%	5%
Weighted-average remaining lease term at 12/31/22	5 years	6.3 years
Was the NFP also a lessor?	No	No

1. FASB ASC 842 and lessee disclosures

In Chapter 2 of the course, we summarized the lessee disclosure requirements. In this section, we will review selected excerpts from our two NFP implementers related to their **lessee disclosures**.

Selected excerpts from NFP 1's lessee disclosures

Note 1 - Summary of Significant Accounting Policies (continued)

Leases

The Agency determines if an arrangement is or contains a lease at inception. Leases are included in right-of-use (ROU) assets and lease liabilities in the statement of financial position. ROU assets and lease liabilities reflect the present value of the future minimum lease payments over the lease term. Operating lease expense is recognized on a straight-line basis over the lease term. The Agency does not report ROU assets and lease liabilities for its short-term leases (leases with a term of 12 months or less). Instead, the lease payments of those leases are reported as lease expense on a straight-line basis over the lease term.

Recent Accounting Guidance (continued)

The Agency adopted Accounting Standards Update (ASU) No. 2016-02, *Leases*, which requires lessees to recognize leases on the statement of financial position and disclose key information about leasing arrangements. The Agency elected not to reassess at adoption (i) expired or existing contracts to determine whether they are or contain a lease, (ii) the lease classification of any existing leases, or (iii) initial direct costs for existing leases. As a result of implementing ASU No. 2016-02, the Agency recognized ROU assets of $1,286,815 and lease liabilities totaling $1,286,815 in its statement of financial position as of January 1, 2022. The adoption did not result in a significant effect on amounts reported in the statement of activities for the year ended December 31, 2022.

Note 7 – Leases

The Agency evaluated current contracts to determine which met the criteria of a lease. The ROU assets represent the Agency's right to use underlying assets for the lease term, and the lease liabilities represent the Agency's obligation to make lease payments arising from these leases. The ROU assets and lease liabilities, all of which arise from operating leases, were calculated based on the present value of future lease payments over the lease terms. The Agency has made an accounting policy election to use a risk-free rate in lieu of its incremental borrowing rate to discount future lease payments. The weighted average discount rate applied to calculate lease liabilities as of December 31, 2022, was 1.28%.

The Agency's operating leases consist of real estate leases for office and classroom space. For the year ended December 31, 2022, total operating lease cost was $374,329, and total short-term lease cost was approximately $148,849. As of December 31, 2022, the weighted-average remaining lease term for the Agency's operating leases was approximately 5 years.

Selected excerpts from NFP 1's lessee disclosures

Note 7 – Leases (continued)

Cash paid for operating leases for the year ended December 31, 2022 was $225,480. There were no noncash investing and financing transactions related to leasing.

Future maturities of lease liabilities are presented in the following table, for the fiscal years ended December 31:

2023	$	225,480
2024		225,480
2025		220,680
2026		165,576
2027		94,968
Thereafter		189,936
Total lease payments		1,122,120
Less present value discount		(45,324)
Total lease obligations	$	1,076,796

The next excerpts are from NFP 2. Keep in mind that NFP 2 implemented several years ago. Also note that NFP 2 had a lease remeasurement.

Selected excerpts from NFP 2's lessee disclosures

10. Leases

AMA leases office space at a number of locations and the initial terms of the office leases range from five years to 15 years. Most leases have options to renew at then prevailing market rates, or, in one circumstance, early terminate with appropriate notice and termination payments. As any extension, renewal, or termination is at the sole discretion of AMA, and at this date is not certain, renewal and termination options are not included in the right-of-use (ROU) asset or lease liability.

AMA leases do not provide an implicit interest rate and as such, AMA calculates the lease liability at lease commencement or remeasurement date as the present value of unpaid lease payments using an estimated incremental borrowing rate. The incremental borrowing rate represents the rate of interest that AMA estimates it would have to pay to borrow an amount equal to the lease payments on a collateralized basis over a similar term, based on information available at the time of commencement or remeasurement.

AMA exercised a contraction option during 2022 reducing the square footage at the main headquarters by approximately 10%, with a contraction penalty. The ROU asset and lease liability were remeasured as of the lease modification date and the impact of the contraction is reflected in the ROU asset and lease liability as of December 31, 2022. ROU assets decreased $1.3 million, lease liabilities decreased $2.3 million, with the resulting net gain of $1 million included as a reduction to other operating expense. AMA also leases copiers and printers in several locations. The lease agreements do not contain variable lease payments, residual value guarantees or material restrictive covenants. All office and equipment leases are classified as operating leases.

Operating lease costs totaled $9.7 million in 2022 and $10.1 million in 2021. Cash paid for amounts included in the measurement of lease liabilities totaled $13.2 million in 2022 and $13.1 million in 2021.

Selected excerpts from NFP 2's lessee disclosures

The remaining weighted-average lease term is 6.3 years and 7.1 years as of December 31, 2022 and 2021, respectively. The weighted-average discount rate used for operating leases is 5% for both 2022 and 2021.

Notes to Consolidated Financial Statements
For the Years Ended December 31, 2022 and 2021
(Columnar amounts in millions)

The maturity of lease liabilities as of December 31, 2022:

2023	$ 15.3
2024	11.4
2025	11.4
2026	11.6
2027	11.8
2028 and beyond	14.5
Total lease payments	76.0
Less imputed interest	(10.7)
Present value of lease obligations	$ 65.3

II. Looking forward (although perhaps not forward to it!)

There are some accounting standards which are difficult to apply in the first year but are really not much of an issue in subsequent years. FASB ASC 842 does not exactly fit into that category. Due to FASB ASC 842, each year NFPs will have to watch out for things like: (1) new leasing agreements being entered into; (2) the disclosure of short-term and variable lease costs; (3) the annual updating of the lease asset and liability schedules; (4) lease options being exercised/not exercised contrary to initial expectations that require remeasurements; and (5) leases being modified or terminated.

A. Remeasurements

As we learned during the implementation of FASB ASC 842, multiple assumptions/assessments were made in calculating the lease amounts reported. We also know that we are not always going to be perfect in all of our assumptions/assessments.

FASB ASC 842 specifies several conditions under which the lease payment amounts likely have changed because of changes to the estimates used in determining the liability. Thus, at each reporting period, an NFP lessee will need to look for significant changes to things like the lease term, purchase options, and residual value guarantees. If the criteria in FASB ASC 842-10-35-4 are met, the NFP lessee essentially remeasures the lease liability at the reassessment date and adjusts the lease asset by the change in the lease liability.

	When do lessees have to remeasure? Under FASB ASC 842-10-35-4, a **lessee** remeasures the lease payments if any of the following occur:
	There is a change in the lease term. FASB ASC 842-10-35-1 provides qualifying events in this area (e.g., the lessee elects to exercise an option even though the entity had previously determined that it was not reasonably certain to do so or vice versa);
	There is a change in the assessment of whether the lessee is reasonably certain to exercise/not exercise an option to purchase the underlying asset (FASB ASC 842-10-35-1 provides qualifying events);
	There is a change in the amounts probable of being owed by the lessee under residual value guarantees;
	The lease is modified, and that modification is not accounted for as a separate contract in accordance with FASB ASC 842-10-25-8 (see related discussion in next section of course);
	A contingency upon which some or all of the variable lease payments that will be paid over the remainder of the lease term are based is resolved such that those payments now meet the definition of lease payments (see FASB ASC 842-10-35-4)

We should also note that FASB ASC 842-10-35-6 discusses that a **lessor** does not remeasure the lease payments unless the lease is modified and that modification is not accounted for as a separate contract as discussed in the fourth box in the above chart.

B. Lease modifications and terminations

We just discussed certain conditions that may trigger the need to remeasure a lease under FASB ASC 842 (e.g., a lessee elects to exercise an existing option contrary to the initial determination of the lease term). Another complication in lease accounting occurs when a **lease contract is actually modified (i.e., the terms and conditions of the contract are changed) or terminated** during the lease term. Examples of modifications or terminations include: (1) the parties agree to extend or reduce a lease when there is no option to extend or reduce; (2) payment amounts are revised; (3) another underlying asset is added or an asset is removed; or (4) the parties simply agree to terminate a lease prior to its scheduled end date when such a provision was not included in the contract. When a contract is modified, an NFP lessee needs to first reassess whether the modified contract still contains a lease. If so, the NFP needs to consult FASB ASC 842-10-25-8 and 25-9 to assess whether the modified contract should be accounted for as a separate contract (i.e., separate from the original contract) or if both contracts should be accounted for together. If the modified contract does not contain a lease, the NFP will look to the lease termination guidance in FASB ASC 842-20-40-1. We should also note that lessors generally work through somewhat similar reassessment issues.

1. Exercise 3-1

Please complete the following exercise.

When it's over

NFP Alpha has a ten-year noncancellable lease for office space with lessor Beta. In year five, Alpha asks Beta if the lease can be terminated as it no longer needs the space. Beta is happy to terminate the lease as rent has gone up in the area and it can readily find a new lessee. Thus, Alpha and Beta mutually agree to terminate the existing lease immediately. **How do you believe that NFP Alpha should account for the termination?**

III. Suggested solution to exercise

This section contains the suggested solution to the exercise presented in the chapter.

A. Suggested solution to Exercise 3-1

When it's over

NFP Alpha has a ten-year noncancellable lease for office space with lessor Beta. In year five, Alpha asks Beta if the lease can be terminated as it no longer needs the space. Beta is happy to terminate the lease as rent has gone up in the area and it can readily find a new lessee. Thus, Alpha and Beta mutually agree to terminate the existing lease immediately. **How do you believe that NFP Alpha should account for the termination?**

FASB ASC 842-20-40-1 provides that a termination of a lease before the expiration of the lease term shall be accounted for by the lessee by removing the right-of-use asset and the lease liability, with profit or loss recognized for the difference.

Latest Developments

This chapter is reserved for additional materials to be added throughout the year as appropriate. As this course went to press there were no latest developments to include.

