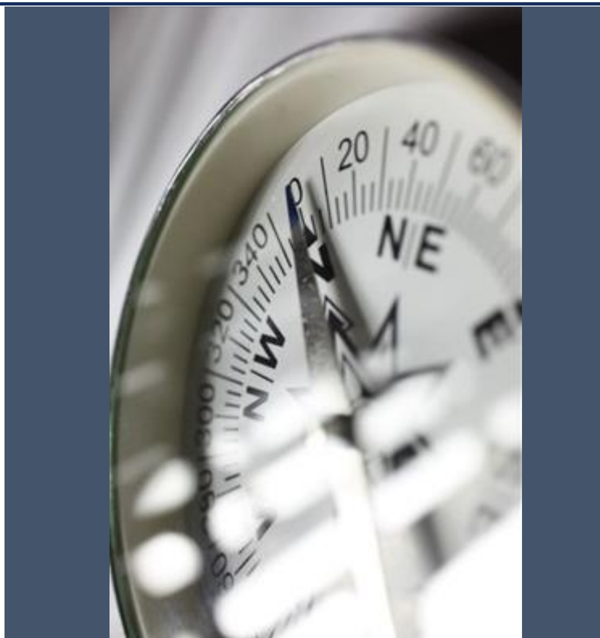

Acquirer accounting for acquired leases after adoption of ASC 842

Notification to reader

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Summary

This publication examines the relationship of Accounting Standards Codification 842, *Leases* ("ASC 842") to Accounting Standards Codification 805, *Business Combinations* ("ASC 805"). The discussion will not be an extensive analysis of ASC 842, but rather a discussion of key components relating to acquired leases, whether it be leases acquired in a transaction accounted for as a business combination or in a transaction accounted for as an asset acquisition.

Acquirers of any lease, regardless of whether the acquirer of the acquired lease is in a lessor or lessee position, must treat the acquired lease as if it were a new lease as of the acquisition date[1]. As such, acquirers must assess any differences between initial assessment of a lease under ASC 842, versus when a lease is acquired pursuant to a transaction accounted for under ASC 805. Specific differences are discussed in more depth within this publication.

Typically, under ASC 805 acquired assets and liabilities through business combinations are recognized at fair value on the acquisition date following the measurement provisions of Accounting Standards Codification 820, *Fair Value Measurement* ("ASC 820"). Leases under ASC 842 are an exception to the requirement to recognize assets and liabilities acquired at fair value. As previously mentioned and as analyzed further in this discussion, acquired leases are recognized and measured as new leases as of the acquisition date. Lease classification can be reassessed, but if the lease was previously recognized under ASC 842 and is not modified through the acquisition, the lease does not have to be reclassified.

Leases acquired through asset acquisitions are generally recognized and measured as they are under business combinations with the exception of carrying over the lease classification. Lessors must reassess lease classification and lessee requirements to reassess classification are subject to a higher threshold than under business combinations.

Adoption and effective dates

The effective dates for ASC 842 are as follows:

Issuer Type	Effective dates
Public business entities (PBEs)[2]	Fiscal years beginning after December 15, 2018, including interim periods within those fiscal years.
Other entities	Fiscal years beginning after December 15, 2021 (amended), interim periods with fiscal years beginning after December 15, 2022.

Scope

ASC 842 only covers contracts that do not fall under Accounting Standards Codification 606, *Revenue from Contracts with Customers*, or other applicable GAAP and that are considered leases as determined under ASC 842.

ASC 842 defines lease accounting relating to lessors and lessees. The various lease classifications under ASC 842 are as follows:

Lease holder type	Lease classification
Lessee	Finance or operating
Lessor	Operating, sales-type or direct finance

ASC 805 discusses treatment of acquired leases under both business combinations and asset acquisitions. Under ASC 805-20-25 and ASC 842, the acquirer recognizes assets and liabilities arising from leases of an acquiree in accordance

[1] FASB, February 2016, Accounting Standards Update No. 2016-02, Leases (Topic 842), BC415

[2] FASB, November 2019, Accounting Standards Update No. 2019-10, Financial Instruments – Credit Losses (Topic 326), Derivatives and Hedging (Topic 815), and Leases (Topic 842), Effective Dates

with ASC 842. The following discussion is limited to leases in relation to acquisitions (both business combinations and asset acquisitions as specifically noted) and acquisition date accounting.

Lease classification in relation to a business combination

In accordance with ASC 842-10-55-11, leases acquired in a business combination should retain the previous lease classification unless there is a lease modification, and that modification is not accounted for as a separate contract.

Lease modifications are considered separate contracts when they meet both of the following criterion[3]:

- Grants the lessee an additional right-of-use asset ("ROU") not included in the original contract, *and*
- Lease payments increase commensurate with the standalone price for the additional ROU, adjusted for circumstances of the particular contract (e.g., no cost incurred due to synergies of renting a new floor in the same building)

For instance, assume an acquirer acquired from the acquiree a lessee position for a floor of a building and negotiated to rent an additional floor in the same building at the same rate as the acquiree's lease. This additional floor lease and resulting modification would be treated as a separate contract from the acquired lessee contract as the terms create an additional ROU and the lease payments increase in line with the added ROU.

Any of the following lease modifications are not considered a separate contract and represent a need for reassessment of the lease classification[4], as long as in combination they do not meet the requirements to be a separate contract, as previously mentioned above:

- Grants the lessee an additional ROU not included in the original contract
- Extends or reduces the term of an existing lease, *other than* through the exercise of a contractual option to extend ("renewal option") or terminate the lease
- Fully or partially terminates an existing lease
- Changes the consideration of the contract only

In connection with the assumed situation above of an acquiree being a lessee of a floor in a building, assume instead that after discussions with the landlord the additional floor was contractually granted as an option to the acquirer, as the lessee, without any additional increase in the standalone price. If the potential option with its resulting modification was elected, the acquirer would have to reassess the classification of the lease.

Our observation

Acquirers and acquirees often have different business purposes for leases and other assets and liabilities, especially relating to the exercise of renewal options and purchase options. In practice, these differences in how the lease is intended to unfold are not considered to be a lease modification that would require a change in classification under ASC 842 in relation to ASC 805, as long as they represent rights that were present in the acquired lease. Rather, such rights are viewed as lessee elections for items already present in the lease contract and reflect more of the lessee's intention rather than a modification of the lease. This conclusion is in line with reassessment criteria above, especially when referring to the 'exercise of a contractual option to extend'.

Further, acquirers often are uncertain whether some lease modifications will be made at the time of the acquisition. For modifications that are contemplated at the acquisition date but not put into place at that date, no impact is reflected as of the acquisition date and no classification reassessment is considered. Any reassessment of classification should be assessed when the modification is effective.

[3] ASC 842-10-25-8
[4] ASC 842-10-25-11

If the acquiree has not yet adopted ASC 842, whether it has accounted for leases under Accounting Standards Codification 840, *Leases* ("ASC 840"), International Financial Reporting Standards ("IFRS") or other GAAP (non-US GAAP), reassessment of the classification of the acquired lease(s) must occur as of the acquisition date.

For leases where the acquiree is a lessee, the acquirer may elect an accounting policy election by class of underlying asset, which is applicable to all of the acquirer's acquisitions, not to recognize assets or liabilities at the acquisition date for leases that, at the acquisition date, have a remaining lease term of twelve months or less[5]. These acquired leases are considered short-term leases and the related lease expense is recognized on a straight-line basis over the remaining term.

For detailed classification guidance for lessees and lessors, refer to ASC 842-10-25-2 through 3A. As a note, the "bright-line" test of legacy lease guidance has been replaced by the criteria under ASC 842 and is no longer a bright-line but rather steps that indicate how the lease should be classified. Under ASC 840, the lease classification criteria were considered either met or not met through any of the following being true: ownership transfer, bargain purchase option, lease term greater than or equal to 75% of the useful life of the asset, and present value of the minimum lease payments being greater than or equal to 90% of the fair value of the leased property. Under ASC 842-10-55-2, the previously referenced percentages are not considered a set line, rather changing to a more judgmental "major part" or "at or near the end" for the economic/useful life, and "substantially all" for the fair value.

Lease recognition and measurement in relation to a business combination

Acquired leases are accounted for in accordance with ASC 842, but certain aspects that are related to those leases are accounted for under other GAAP as described in ASC 805 for fair value measurement[6]. The following table illustrates some of the key areas of recognition and measurement differences between assets and liabilities related to leases.

Acquiree as a:	**Directly associated to leases** *Recognized & measured under ASC 842*	**Lease-related but outside scope of ASC 842** *Recognized & measured under ASC 820*
Lessee *either finance or operating*	*Assets* ▪ Right-use-asset *Liabilities* ▪ Lease liability *Other considerations of note* ▪ Can designate an accounting policy election by class for leases with a remaining life of 12 months or less[7]	*Assets* ▪ Leasehold improvements ▪ In-place lease value[8] ▪ Other identifiable intangible assets associated to leases (i.e., building naming rights)
Lessor *operating*	None	*Assets* ▪ Favorable lease terms relative to market ▪ Leased asset (includes lessor-owned tenant improvements) ▪ In-place lease value ▪ Customer relationship intangible asset ▪ Other identifiable intangible assets ▪ Property, plant, and equipment

[5] ASC 805-20-25-28B. This accounting policy election includes not recognizing an intangible asset if the terms of an operating lease are favorable relative to the market terms or a liability if the terms are unfavorable relative to market terms.
[6] Accounting Standards Codification 820, *Fair Value Measurement*. Under ASC 805, fair value is measured in accordance with ASC 820 unless otherwise determined.
[7] Under ASC 842-20-25-2, lessees can have an accounting policy election for short-term (12 months or less) leases to be expensed as incurred rather than applying the typical guidance in ASC 842. The election must be applied by the class of underlying assets to which the right of use relates to, meaning once elected, all leases 12 months or less must apply this accounting policy.
[8] In-place leases represent the value of avoiding the costs needed to obtain the lease associated to the economic benefit of leasing a building and are considered intangible assets. See the 'In-place lease value' section below for further details.

		Liabilities ▪ Unfavorable lease terms relative to market
Lessor *sales-type or direct finance*	*Assets* ▪ Net investment in lease (sum of lease receivable & unguaranteed residual asset)	*Assets* ▪ In-place lease value ▪ Customer relationship intangible asset ▪ Other identifiable intangible assets

As a note for all lease types in an acquisition, ASC 805-20-25-10A states the following:

> *An identifiable asset may be associated with a lease, which may be evidence by market participants' willingness to pay a price for the lease even if it is at market terms. For example, a lease of gates at an airport or of retail space in a prime shopping area might provide entry into a market or other future economic benefits that qualify as identifiable intangible assets, such as a customer relationship. In that situation, the acquirer shall recognize the associated identifiable asset(s) in accordance with paragraph 805-20-25-10.*

This accounting is indicated in the table above with the various identifiable intangible assets that can be recognized related to acquired leases.

Lessee accounting

Under ASC 805-20-30 24, an acquirer must measure, or assess, any acquired lease as if the lease is a new lease as of the acquisition date, outside of its classification (see requirements above). If an acquirer acquires a lessee position that is either an operating or finance lease, the acquirer must first determine the lease's lease liability at present value of the remaining lease payments. Measuring the acquired lease requires reassessment of all of the following[9]:

- The lease term
- Any lessee options to purchase the underlying asset
- Lease payments (e.g., amounts probable of being owed by the lessee under a residual value guarantee)[10]
- The discount rate for the lease

Our observation

One of the most difficult aspects of determining the present value of the lease liability is the conclusion of the discount rate, which is frequently determined by the incremental borrowing rate ("IBR"). This determination can be a judgmental area due to approach and information available. In addition to understanding the term of the lease, understanding the historical borrowing rates for the acquiring entity, if any, the acquisition date credit rating of the acquiring entity (or a near-term evaluation of the credit rating), along with input from the acquiring entity's external auditors can greatly help this process. Additionally, performing sensitivity analyses around the selected rate can provide context for the selected rate and whether additional work is required for the rate to be more precise.

After the acquirer determines the present value of the lease liability at the acquisition date, it must determine the associated ROU, which is the lease liability adjusted for any off-market terms. Prepaid or accrued rent[11] associated to the leases should not be recognized separately on opening balance sheet as the accounts do not meet the definition of an asset or liability under Concepts Statement No. 6[12] in relation to ASC 842. The prepaid or accrued rent is instead

[9] ASU 2016-02, BC415

[10] Other associated assessments include fixed payments, variable lease payments that depend on an index or rate, purchase options that the lessee is reasonably certain to exercise, and penalties for early termination of a lease term.

[11] Prepaid rent represents advanced payment of contractual rent due. Accrued rent represents rent that is contractual past due and not yet paid. Accrued rent is not considered deferred rent under ASC 840 nor ASC 842.

[12] Concepts Statement No. 6 is part of the FASB Concept Statements that are intended to serve the public interest by setting the objectives, qualitative characteristics, and other concepts that guide selection of economic phenomena to be recognized and measured for financial reporting and their display in financial statements or related means of communicating information to those who are interested. Statement No. 6 specifically addresses the definition of an asset or liability.

included as a favorable or an unfavorable aspect, respectively, of the ROU calculation[13] and would impact the initial calculation of the present value of the lease liability, representing total payments due.

Calculation illustration

Lease liability	±	Favorable / unfavorable aspects	=	ROU asset

The market view and assessment of favorable or unfavorable aspects can be a difficult area to determine depending on availability of information relating to similar assets in the marketplace. Leveraging market reports from third-party sources can be helpful when looking at current market rates for the underlying asset and its associated area and/or use (e.g., commercial real estate market reports for a commercial building). Other favorable and unfavorable aspects could include lease incentives that are present and applicable at the date of acquisition that would be different than a market participant would expect for a similar underlying asset. Favorable and unfavorable aspects adjust the ROU and are amortized over the life of the ROU, which would directly impact the straight-line expense over the associated term.

A difference between lease accounting and lease accounting pursuant to ASC 805 comes from initial direct costs ("IDC" or "IDCs"). Typically, IDCs are included in the ROU calculation for the amounts incurred, but in relation to a business combination, the avoidance of direct costs that would be associated with obtaining a new lease (i.e., origination costs, lease commissions, legal, tenant improvements, etc.) are included as in-place lease intangible assets, which are discussed in more detail below.

A final observation is any originally (at lease inception) recorded adjustments to arrive at the initial ROU should be disregarded when considering the acquisition date measurement unless those adjustments are currently applicable when assessing the new lease. This treatment is in line with ASC 805-20-30-24 – acquired leases are treated as new leases at the acquisition date – and additionally with only using applicable inputs as of the acquisition date as historical inputs would no longer be relevant if already expired. An example of this would be rent abatement for the first three months of the lease term, which would adjust the ROU at inception, but a lease acquired one year into the lease term would not have any remaining impacts from the abatement as it would not be relevant to the go-forward term.

Lessor accounting

Acquired lessor operating leases

Similar to operating leases for lessees, the acquirer determines if the terms of the leases as a lessor have favorable or unfavorable market terms when compared to the same or similar items at the acquisition date. The acquirer recognizes an intangible asset if the terms are favorable or a liability if the terms are unfavorable relative to market terms and both are recognized under ASC 820 fair value guidance as indicated by ASC 805. Further, any intangible asset or liability that arises is generally amortized as additional rental income over the term of the lease.

Customer relationship intangible assets, leased assets (which includes lessor-owned tenant improvements), and other identifiable intangible assets can be recognized in relation to the acquired lease and are recognized under ASC 805 fair value guidance.

Acquired lessor sales-type or direct finance leases

Both lessor sales-type and direct finance leases are measured in the same manner for acquirers of lessor positions. According to ASC 805-20-30-25, the acquirer measures its net investment in the lease as the sum of both of the following, which equal the fair value of the underlying asset at the acquisition date:

[13] ASU 2016-02, BC415

a) The lease receivable at the present value as if the acquired lease were a new lease at the acquisition date, discounted using the rate implicit in the lease, by using the following:
   1) The remaining lease payments
   2) The amount the lessor expects to derive from the underlying asset following the end of the lease term that is guaranteed by the lessee or any other third party unrelated to the lessor
b) The unguaranteed residual asset as the difference between the fair value of the underlying asset at the acquisition date and the carrying amount of the lease receivable, as determined in accordance with (a) above, at that date

Calculation illustration

Acquisition date fair value	**−**	**Present value of the lease receivable**	**=**	**Unguaranteed residual asset**

The acquirer also takes into account the terms and conditions (off-market terms, options, residual value guarantees, termination penalties, etc.) of the lease in calculating the acquisition-date fair value of an underlying asset that is subject to a sales-type or direct financing lease by the acquiree-lessor. Any off-market terms are not recognized separately as an intangible asset, however, are separately recognized as identifiable assets associated with the inherent value of the lease by the acquirer, which could be related to the economic benefit of acquiring an asset with an in-place lease (as discussed below) as compared to the cost and effort required to acquire an asset that does not.

Other matters

Acquired leasehold improvements (for lessees)

Leasehold improvements are customizations to a leased asset made for the benefit or use of a lessee that are capitalizable lessee assets. These improvements, which must be either improvements that the lessee paid for directly or that the landlord paid for as an incentive with the lessee maintaining ownership of the improvements, could be customizations for laboratory space, separating office spaces, among many other reasons. These capitalized amounts are presented separately from the related ROU asset and are recognized the same as other plant and equipment assets acquired.

Leasehold improvements under business combinations are amortized over the shorter of the useful life of the assets and the remaining lease term at the acquisition date[14]. It should be noted however, if the lease transfers ownership of the underlying asset to the lessee at any point in time, or the lessee is reasonably certain to exercise an option to purchase the underlying asset, the lessee amortizes the leasehold improvements to the end of their useful life[15].

In-place lease value

In-place lease value for a lessor is derived from the value of avoided direct costs associated with obtaining a new lease. These costs are usually associated with avoided origination costs, marketing costs, leasing commissions, legal costs, tenant improvements, among others. It could also be associated with the opportunity cost related to lost rentals for a lessor, meaning avoided vacancy costs after acquiring the underlying asset and its associated rental income by already having a lessee present.

For lessees, having in-place lease value can be infrequent due to most of the value typically being included in the right-of-use asset (e.g., favorable aspects as noted above) and depending on the specific market or industry, but when present, the value is related to additional economic benefits beyond the leased asset. ASC 805-20-25-10A gives an example of a lease of gates at an airport which could represent an intangible asset. In conjunction with the gate leasing, the opportunity costs related to lost business, or revenues, from no longer having contractual access to the gates could be substantial, indicating inherent value to market participants having an in-place lease asset. Additionally, market participants may be willing to pay for the lease even if it is at market terms/rates as a way to

[14] ASC 842-20-35-13
[15] ASC 805-20-35-6

expand market opportunities which would not be available without having access to the leased gates, further indicating inherent value. While certain at-market lease contracts may have inherent value to market participants, we observe that this can be very industry dependent and may be less frequent in certain industries.

Overall, these avoided and opportunity costs represent an intangible asset to the acquirer at the acquisition date and should be amortized over a period less than the life of the underlying asset, which is in line with rental income for lessors or associated lessee term of the lease. These intangibles are valued under principles of ASC 820 typically by valuation experts based on lost rents discounted to present value.

Lease accounting in relation to an asset acquisition

At a summary level, the primary difference between business combinations and asset acquisitions is that no goodwill can be recognized as part of an asset acquisition, and as such, the entire purchase price is assigned to all identifiable assets and liabilities in the acquisition, including the lease assets and liabilities. For acquirers with leases acquired, asset acquisitions share many of the same attributes for lease accounting as business combinations, though some differences arise as considered below.

Lessor considerations

Acquirers that become lessors still follow guidance to recognize lease-related intangibles under ASC 350-30-25 and then in accordance with ASC 805-50, allocate the cost of the acquisition based on those intangible assets' relative fair values. Contrastingly, acquirers in an asset acquisition, that become lessors must reassess the classification to determine if the lease is operating, sales-type or direct finance in accordance with ASC 842-10-25.

Lessee considerations

For acquirers that are lessees under an asset acquisition, reassessment of the lease classification might not be necessary, similar to business combination, but the reassessment requirements are broadened to include more factors that would trigger reassessment when compared to the associated requirements under business combinations. The following are indications, any of which require reassessment of classification in relation to lease modifications:

- Lease modification not accounted for as a separate contract under ASC 842-10-25-8
- Change in the lease term, which includes renewal options
- Change in the assessment by the acquirer that the lessee is reasonably certain to exercise a purchase option

Our observation

In cases where questions relating to the classification of a lease arise, discussing the matter early on with the external auditors can be very beneficial. Additionally, even if a company was not required but desires to reassess the lease classification (e.g., it is unclear if the lease classification should be reassessed or unclear on the acquiree's classification under ASC 842), it would be generally acceptable to reassess the classification.

Another factor should be considered when assessing the classification and measurement of leases with an asset acquisition is the economic reason for the asset acquisition. The economic reason may indicate a sale and leaseback situation – meaning the acquirer obtains an asset and then leases the asset back to the seller – which could indicate the acquisition is a purchase or a financing of the asset and would require the determination of the lease classification.

Illustrative Examples

For all of the examples, the lessee position has been assumed for clarity. Many of the lessor additional considerations fall under intangible asset guidance under ASC 805 and the following examples are focused on the opening balance sheet recording for items directly under ASC 842. Any specific implementation should be considered based on your specific facts and circumstances relating to lease accounting, including discussing with your external auditors the positions taken.

Overview of facts

General background

Company Alpha is a publicly traded company and has previously adopted ASC 842. Alpha acquired company Beta on July 1, 20X1. Alpha has determined that the discount rate (IBR) for the acquired leases is 10.00%, which represents a common rate at the date of this publication and is used consistently through the examples for simplicity, as of the acquisition date[16].

Building

At the time of acquisition, Beta had one lease for a building floor of 12,000 square feet that was the headquarters of Beta's operations. This lease was included in the acquisition by Alpha. Beta began renting the building in 20X0 and has a lease agreement in place until 20X6 and has an annual escalation of three percent. Additionally, the Beta lease has a renewal option for two additional years which must be elected six months before the end of the current lease term.

Term and annual payment details		
January 1, 20X0	December 31, 20X0	$10,000
January 1, 20X1	December 31, 20X1	10,300
January 1, 20X2	December 31, 20X2	10,609
January 1, 20X3	December 31, 20X3	10,927
January 1, 20X4	December 31, 20X4	11,255
January 1, 20X5	December 31, 20X5	11,593
January 1, 20X6	December 31, 20X6	11,941
Total rent over initial lease term		$76,625
Renewal option term and annual payment details		
January 1, 20X7	December 31, 20X7	$12,500
January 1, 20X8	December 31, 20X8	12,875
Total rent over renewal period		$25,375
Total rent over lease period (including renewal period)		$102,000

Equipment

At the time of acquisition, Beta had one equipment lease for network server purposes. This lease was included in the acquisition by Alpha. Beta began leasing the equipment at the same time it entered the building in 20X0 and has a lease agreement in place until 20X4 and does not have a lease escalation. The lease has no renewal option.

Term and annual payment details		
January 1, 20X0	December 31, 20X0	$2,000
January 1, 20X1	December 31, 20X1	2,000
January 1, 20X2	December 31, 20X2	2,000
January 1, 20X3	December 31, 20X3	2,000
January 1, 20X4	December 31, 20X4	2,000
Total rent over lease period		$10,000

Example 1 – Business combination, the acquirer assumes lessee position, acquiree previously adopted ASC 842 + acquiree prepayment

This example takes all the facts and circumstances as stated above in the overview.

Company Alpha determined that the acquisition would be considered a business combination. Alpha notes that Beta had an operational accounting policy to pay three months in advance, fifteen days before the beginning of each

[16] For these examples the IBR has been simplified, but the term of the lease, location (domestic versus international), and other factors should be considered, along with discussion with external auditors as previously mentioned.

quarter. Beta had previously adopted ASC 842 and had classified the lease as an operating lease. The prepayment was recorded by Beta as an outflow of cash and a prepaid expense on its books at the time of payment.

Alpha determined that it should record a lease under the lease's previous classification determined by the acquiree, and that the lease terms were in line with the overall market for similar leases. No lease modifications, purchase options, incentives or avoided costs were noted. Further, Alpha determined for business and economic reasons, including uncertainty of future interest rates and the potential of needing less office space due to more remote workers, that it was too early to assess that the renewal option would be taken and will assess the option again in a future period. No intangible assets were noted in relation to the lease. Alpha recorded a lease liability of $45,131 and an associated right-of-use asset of $47,706 on its opening balance sheet. Additionally, Alpha eliminated the associated prepaid rent expense from its opening balance sheet in accordance with ASC 842 and ASC 805.

Acquired term and annual payment details			
July 1, 20X1	December 31, 20X1		$5,150
January 1, 20X2	December 31, 20X2		10,609
January 1, 20X3	December 31, 20X3		10,927
January 1, 20X4	December 31, 20X4		11,255
January 1, 20X5	December 31, 20X5		11,593
January 1, 20X6	December 31, 20X6		11,941
Total rent over initial lease term as stated in the agreement			$61,475
Total remaining payments, net of prepayments			$58,900
Favorable / (unfavorable) aspect(s)		**(i)**	$2,575
Opening balance sheet			
Lease liability		**(ii)**	$45,131
Right-of-use asset		**(iii)**	47,706
Impact to goodwill — increase / (decrease)		**(iv)**	$(2,575)

Notes

(i) Represents the favorable aspect derived from the rent prepayment by the acquiree in June 20X1 for following three months.
(ii) Calculated as the present value of the remaining lease payments using the associated discount rate.
(iii) Calculated as the lease liability ± favorable / (unfavorable) aspects.
(iv) Goodwill is where the difference between the lease liability and ROU is ultimately recorded.

<u>Example 2 – Business combination acquires lessee position, acquiree had not previously adopted ASC 842 + unfavorable market terms</u>

This example takes all the facts and circumstances as stated above in the overview.

Alpha determined that the acquisition would be considered a business combination. Beta had not previously adopted ASC 842, had classified the lease as an operating lease, and had paid its lease payments on the first of each month.

Alpha determined that it should record a lease as an operating lease, and that the lease terms were not in line with the overall market for similar leases. Alpha considered whether there were any modifications to the lease term, however, no lease modifications, purchase options, incentives or avoided costs were noted. Further, Alpha determined for business and economic reasons, including uncertainty of future interest rates and the potential of needing less office space due to more remote workers, that it was too early to assess that the renewal option would be taken and will assess the option again in a future period. No intangible assets were noted in relation to the lease. Alpha recorded a lease liability of $47,685 and an associated right-of-use asset of $55,408 on its opening balance sheet.

Acquired term and annual payment details			
July 1, 20X1	December 31, 20X1		$5,150
January 1, 20X2	December 31, 20X2		10,609
January 1, 20X3	December 31, 20X3		10,927
January 1, 20X4	December 31, 20X4		11,255
January 1, 20X5	December 31, 20X5		11,593
January 1, 20X6	December 31, 20X6		11,941
Total rent over initial lease term / total remaining payments			$61,475
Present value of remaining lease payments			$47,685
Lease classification (operating versus finance)			
Do any of the following factors indicate a finance lease? (ASC 842-10-25-2 to 3)			
Does ownership transfer?			No
Is there a Bargain Purchase clause?			No
Is the lease term a major part of the useful life (~ >=75%)?		**(i)**	No
Is the net present value substantially all of the fair market value (~ >=90%)?		**(ii)**	No
Is the underlying asset a specialized asset with no alternative use to the lessor?			No
Lease classification			Operating
Favorable / (unfavorable) aspect(s)		**(iii)**	$7,723
Opening balance sheet			
Lease liability		**(iv)**	$47,685
Right-of-use asset		**(v)**	55,408
Impact to goodwill — increase / (decrease)		**(vi)**	$(7,723)

Notes

(i) The building life is 45 years from the acquisition date.

(ii) Calculated as follows:
Present value of remaining lease payments / (Annual market rate/square foot × leased square footage × remaining term in years)
The market rate per square foot (for the entire building per market research) is determined to be $1.00.

(iii) Represents the favorable aspect of the lease rent terms when compared to the market rate for similar assets in the area. This was calculated by comparing the market rent per square foot per year of $1.00 and associated discounted cash flow difference from the lease rent per the lessee agreement, including the considerations for rent escalation, the IBR used as the discount rate and the remaining lease term.

(iv) Calculated as the present value of the remaining lease payments using the associated discount rate.

(v) Calculated as the lease liability ± favorable / (unfavorable) aspects.

(vi) Goodwill is where the difference between the lease liability and ROU is ultimately recorded.

<u>Example 3 – Asset acquisition, acquiree previously adopted ASC 842 + renewal option</u>

This example takes all the facts and circumstances as stated above in the overview.

Company Alpha determined that the acquisition would be considered an asset acquisition. Beta had previously adopted ASC 842 and had classified the lease as an operating lease.

Alpha determined for business and economic reasons, which is due to the rental extension aligning with the long-term operational synergies of the location for the company, it would exercise the renewal option as it considered its operational development plans[17]. As the renewal option differed from Beta's assessment, Alpha assessed the lease's classification and determined that it should record a lease as an operating lease and that the lease terms were in line

[17] From our observations and interactions with external auditors, a renewal determination this early in the lease term would be considered earlier than commonly accepted but was used for purposes of this illustration. Consult with your audit advisor for specific determinations.

with the overall market for similar leases. No lease modifications, purchase options, incentives or avoided costs were noted. No intangible assets were noted in relation to the lease. Alpha recorded a lease liability of $61,401 and an associated right-of-use asset of $61,401 on its opening balance sheet.

Acquired term and annual payment details, including the renewal period			
July 1, 20X1	December 31, 20X1		$5,150
January 1, 20X2	December 31, 20X2		10,609
January 1, 20X3	December 31, 20X3		10,927
January 1, 20X4	December 31, 20X4		11,255
January 1, 20X5	December 31, 20X5		11,593
January 1, 20X6	December 31, 20X6		11,941
January 1, 20X7	December 31, 20X7		12,500
January 1, 20X8	December 31, 20X8		12,875
Total rent over initial lease term			$86,850
Present value of remaining lease payments			$61,401
Lease classification (operating versus finance)			
Do any of the following factors indicate a finance lease? (ASC 842-10-25-2 to 3)			
Does ownership transfer?			No
Is there a Bargain Purchase clause?			No
Is the lease term a major part of the useful life (~ >=75%)?		**(i)**	No
Is the net present value substantially all of the fair market value (~ >=90%)?		**(ii)**	No
Is the underlying asset a specialized asset with no alternative use to the lessor?			No
Lease classification		**(iii)**	Operating
Favorable / (unfavorable) aspect(s)		**(iv)**	–
Opening balance sheet			
Lease liability		**(v)**	$61,401
Right-of-use asset		**(vi)**	61,401

Notes

(i) The building life is 45 years from the acquisition date.

(ii) Calculated as follows:
Present value of remaining lease payments / (Annual market rate/square foot × leased square footage × remaining term in years)
The market rate per square foot (for the entire building per market research) is determined to be $1.00.

(iii) Classification is reassessed due to the renewal option being elected for the lease.

(iv) None noted.

(v) Calculated as the present value of the remaining lease payments using the associated discount rate.

(vi) Calculated as the lease liability ± favorable / unfavorable aspects.

Example 4 – Business combination acquires lessee position, acquiree had not previously adopted ASC 842, equipment lease

This example takes all the facts and circumstances as stated above in the overview related to the equipment lease.

Alpha determined that the acquisition would be considered a business combination. Beta had not previously adopted ASC 842, had classified the lease as an operating lease, and had paid its lease payments on the first of each month.

Alpha determined that it should record a lease as a finance lease, and that the lease terms were in line with the overall market for similar equipment leases. Alpha considered whether there were any modifications to the lease term, however, no lease modifications, purchase options, incentives or avoided costs were noted. No intangible assets

were noted in relation to the lease. Alpha recorded a lease liability of $5,975 and an associated right-of-use asset of $5,975 on its opening balance sheet.

Acquired term and annual payment details, including the renewal period			
July 1, 20X1	December 31, 20X1		$1,000
January 1, 20X2	December 31, 20X2		2,000
January 1, 20X3	December 31, 20X3		2,000
January 1, 20X4	December 31, 20X4		2,000
Total rent over initial lease term			$7,000
Present value of remaining lease payments			$5,975
Lease classification (operating versus finance)			
Do any of the following factors indicate a finance lease? (ASC 842-10-25-2 to 3)			
Does ownership transfer?			No
Is there a Bargain Purchase clause?			No
Is the lease term a major part of the useful life (~ >=75%)?		**(i)**	Yes
Is the net present value substantially all of the fair market value (~ >=90%)?		**(ii)**	No
Is the underlying asset a specialized asset with no alternative use to the lessor?			No
Lease classification			Finance
Favorable / (unfavorable) aspect(s)		**(iii)**	–
Opening balance sheet			
Lease liability		**(iv)**	$5,975
Right-of-use asset		**(v)**	5,975

Notes

(i) The equipment life is 5 years from the acquisition date.

(ii) Calculated as follows:
Present value of remaining lease payments / market price of similar equipment
The market price for a similar piece of equipment was determined to be $7,500.

(iii) None noted.

(iv) Calculated as the present value of the remaining lease payments using the associated discount rate.

(v) Calculated as the lease liability ± favorable / unfavorable aspects.