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GAAP Lease Accounting

Your Guide to Adopting ASC 842

Johnson Lambert is dedicated to keeping you up to date on the impact of the Financial Accounting Standards Board's (FASB) Accounting Standard Codification (ASC) 842, Leases. This white paper presents the most significant changes to lease accounting that are likely to impact your financial statements.

Background

For many entities, leasing property is crucial to business - it is a simple way to access assets, ensure straightforward disposal and keep inherent risks associated with ownership at bay. As a result, most entities are parties to multiple leases, from copiers to office space to leasing automobiles and computer equipment. Prior to ASC 842, leases were classified as capital or operating. Capital lease assets and obligations were recognized by lessees and the assets were depreciated and obligations reduced by payments made. Operating leases, on the other hand, did not recognize lease assets or liabilities and instead the lease was charged over the lease term.

As a result, financial statement users struggled to identify which assets were leased and understand the cost of

assets or property that were essential for business operations. Further, analyzing and comparing the financial statements of entities using differing financing methods was not practical. Criticism from regulators and financial statement users prompted the FASB to undertake the lease accounting project.

In 2016, after a decade of work, the FASB issued Accounting Standards Update (ASU) 2016-02, Leases, the first of several ASUs that created and amended ASC 842.

The most significant change is the requirement to record a **right-of-use (ROU) asset and lease liability** for most leases on the balance sheet.

Under the new model, lessees will classify a lease as finance or operating; lessors will classify a lease as sales-type, direct financing or operating. ASC 842 is effective for non-public entities for periods beginning after December 15, 2021. Early adoption is permitted.

Summary

Lessee Model

Lessees will classify leases as finance or operating. The primary difference is how the lease is recognized on the income statement, which also impacts the ROU asset measurement. When accounting for a finance lease, a lessee utilizes a financing model whereby the associated expense decreases during the term of the lease. By comparison, operating leases are expensed on a straight-line basis. As a result, operating leases are generally amortized more slowly than financing leases.

Lessor Model

Leases classified as sales-type or direct financing are recognized by a lease receivable on the balance sheet with interest income that decreases during the term of the lease (like its counterpart, the finance lease recognized by a lessee). At the commencement of a sales-type lease, the lessee obtains control of the asset being leased and the lessor records sales revenue. If a sales-type lease does not transfer control of the asset being leased, a lessor is not permitted to recognize sales revenue at the commencement to ensure alignment with the revenue recognition guidance found in ASC 606, *Revenue From Contracts With Customers*. Profits are deferred in a direct financing lease.

Lessors can also be a party to an operating lease. Operating lease income is recognized on a straight-line basis. The leased asset remains on the lessor's balance sheet and the lessor is responsible for properly depreciating it.

Key Terms and Concepts

Lease Definition

A lease is "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 specified period of time in exchange for consideration." It is a right to use an asset that is legally owned by another party. A lease can be embedded in other contracts as more fully described in Appendix I - Embedded Leases, and commonly include leases for server rack space embedded with service contracts.

Lease Term

The lease term is comprised of several time periods, including:

Lease Term

- The noncancelable period
- Periods for which it is reasonably certain that renewal options will be exercised by the lessee
- Periods for which it is reasonably certain that termination options will not be exercised by the lessee
- Optional periods that the lessor is controlling

While there is no bright-line test for "reasonably certain", it is equatable to "reasonably assured" in the legacy guidance and interpreted as a high threshold. When determining whether lease terms are reasonably certain to be exercised, economic incentives at the lease commencement date that would prompt a lessee to renew, or not renew, should be considered (e.g., the lease renewal is below market rates, lease termination or relocation costs would be avoided, the importance of the underlying asset to the lessee's operations, etc.).

Lease Payments

Include:	Do NOT Include:
+ Fixed payments less any lease incentives paid or payable to or on behalf of the lessee + Variable lease payments based on an index or a rate (e.g. CPI). Index or rate changes are recognized in the period of change. Any triggering subsequent remeasurements require the use of the index or rate prevalent at the date of remeasurement. + Price of an option to purchase the underlying asset if the lessee is reasonably certain to exercise that option + Payments for lease termination penalties if the lease term reflects the lessee exercising a termination option + Fees paid by the lessee to the owners of a special-purpose entity for structuring the transaction + For lessees only, amounts probable of being owed under residual value guarantees + Amounts for nonlease components (if the practical expedient not to separate is elected) + Nonrefundable deposits	+ Variable lease payments (e.g. payments based on sale or profit) + Guarantees by the lessee of the lessor's debt + Amounts allocated to nonlease components (if the practical expedient to separate is not elected) + Refundable deposits

Short-Term Leases Option - for Lessees

A short-term lease is one with a term of 12 months or less (including options to extend that are reasonably certain to be exercised and options to terminate not reasonably certain to be exercised). The contract may not include an option to purchase the underlying asset that the lessee is reasonably certain to exercise. Accounting for short-term leases is functionally the same as the legacy accounting for operating leases. The lessee accounts for lease payments as an expense on a straight-line basis over the lease term and variable lease payments in the period in which the variable lease trigger becomes probable.

Short-term lease accounting is a policy election only available to lessees and has specific presentation and disclosure requirements. Calculation of the lease term is crucial when making the short-term lease election as it is important to consider more than the stated term when evaluating the overall term of an agreement.

Commencement Date

The commencement date is the date the lessor makes the lease asset available to use by the lessee and includes any rent-free periods provided to the lessee and periods the lease asset is available to the lessee (ex: for leasehold improvements) before the contract date.

Lessee Accounting

Leases that do not meet the short-term lease criteria or do not elect the short-term lease classification, are classified as finance or operating leases. A lease must meet one of the following criteria to be classified as a finance lease:

+ Ownership of the underlying asset is transferred to the lessee
+ Purchase option reasonably certain to be exercised
+ Lease term is a major part of the economic life of the asset (typically equal to or greater than 75%)
+ Present value of lease payments plus any guaranteed residual value is equal to or greater than substantially all of the fair value of the underlying asset (typically greater than 90%)
+ Underlying asset is specialized and is not expected to have an alternative use to the lessor at the end of the lease

Leases that do not meet the short-term lease or finance lease criteria are operating leases.

Although finance and operating leases have similarities, reporting and recognition requirements differ, as outlined below:

	Finance Leases	Operating Leases
Balance Sheet	Record an ROU asset and a lease liability	
Income Statement	Interest and amortization expense (not required to be presented separately but in a manner consistent with the presentation of other interest and amortization)	Lease expense
Impairment	ROU assets are tested for impairment	

The primary difference between finance and operating leases is how the lease is recognized on the income statement. Operating leases are expensed on a straight-line basis, without distinction between the interest and amortization components. Finance leases utilize a financing model, whereby the expense decreases during the lease term. Finance lease interest expense is calculated using the effective interest rate method, while amortization of the ROU asset is typically recorded using the straight-line basis.

Measuring the Lease Liability

At the commencement date, a lessee will record a lease liability equal to the present value of the remaining lease payments.

For any individual lease contract, the liability should be discounted using the rate implicit in the lease if readily determinable. If that rate is not readily determinable, the borrowing rate of the lessee may be use or an entity may elect, as an accounting policy, to use the risk free rate by class of underlying asset. The implicit rate is determined using the fair value of the underlying asset, the residual value estimated by the lessor and the initial direct costs incurred by the lessor. Such information may be difficult to obtain and not readily available. The borrowing rate is the rate of interest that would be paid to borrow on a collateralized basis over a similar term and for an amount equal to the lease payments. Similar to the implicit rate, this information can be difficult to obtain. Since determining the implicit or borrowing rate of the lessee can be challenging, non-public entities are permitted to use a risk-free rate, which is generally the rate of a US Treasury Bill for a term equivalent to the lease term, if the election is made consistently by class of underlying asset.

Amounts paid prior to the commencement of the lease are noted as prepaid rent rather than included in the liability. Once the lease commences, the prepaid amounts are reclassified to the ROU asset.

Subsequent to the commencement date, the lessee reduces the lease liability for the lease payments made.

Measuring the Right-of-Use (ROU) Asset

At the commencement date, the cost of the ROU asset includes:

+ 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

In an operating lease, the ROU asset is adjusted to achieve a straight-line expense recognition, by in essence recording a plug to ROU asset amortization to achieve total straight-line expense. For a finance lease, the ROU asset is depreciated over the term of the lease. The following is an example of the calculation for an operating and financing leases ROU asset and lease liability:

On January 1, 2022, the lessee enters into a five year lease. Lessee agrees to pay monthly payments at the beginning of each month totaling $828,845 (column B). Lessee received a $10,000 incentive from lessor and paid qualifying direct costs of $5,000. In this example the present value of future lease payments, discounted using a 5% rate, or the lease liability, at inception is $731,495, which is the same for both an operating and financing lease at the commencement of the lease. The lease liability continues to be the same at each valuation date. In contrast, the ROU asset is the same at lease commencement only, and represents the initial lease liability plus the qualifying direct costs less incentives ($731,495+ $5,000 - $10,000 = $726,495). The expenses will be the same each year for an operating lease (column E), but will decrease each year for a financing lease (column H), affecting the value of the ROU asset at each valuation date.

						Operating Lease			Financing Lease		
YR	Year-end (Valuation Date)	Lease Liability (PV of Remaining Cash Flows)	Payment	Principal	Interest	Straight Line Expense	Change in ROU Asset	ROU Asset	Amortization Expense	Total Lease Expense	ROU Asset
		A	B	C = PY A - CY A	D = B - C	E	F = E - D	G = PY - F	H	I = D + H	J = PY - H
0	1/1/2022	**731,495**						**726,495**			**726,495**
1	12/31/2022	614,795	150,000	116,701	33,299	164,769	131,470	595,026	145,299	178,599	581,196
2	12/31/2023	484,417	157,500	130,377	27,123	164,769	137,646	457,379	145,299	172,422	435,897
3	12/31/2024	339,281	165,375	145,136	20,239	164,769	144,530	312,849	145,299	165,538	290,598
4	12/31/2025	178,224	173,644	161,057	12,587	164,769	152,182	160,667	145,299	157,886	145,299
5	12/31/2026	0	182,326	178,224	4,102	164,769	160,667	0	145,299	149,401	0
		Total	**$828,845**	**$731,495**	**$97,350**	**$823,845**	**$726,495**		**$726,495**	**$823,845**	

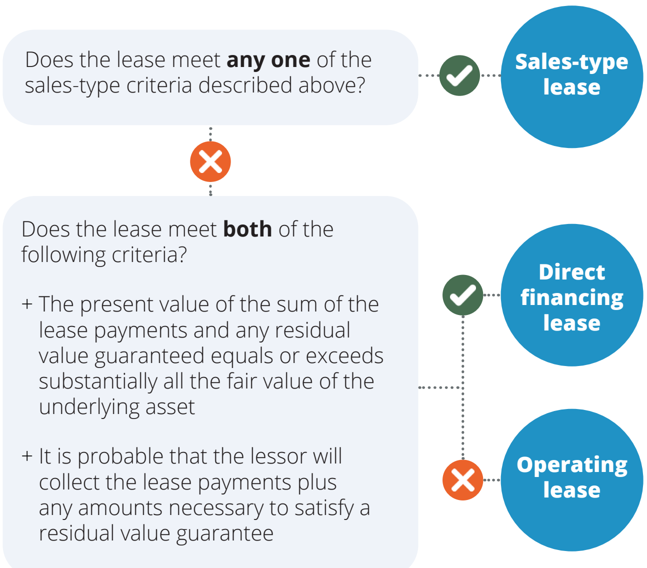
Lessor Accounting

Although some modifications to the lease classification criteria were made, lessor accounting is substantially unchanged. Lessors are required to classify leases as one of the following:

+ Sales-type: A sales-type lease is a lease where the lessor transfers control of the underlying asset to the lessee. To be classified as a sales-type lease, the lease must meet one of the following criteria:
    + Ownership transfers to the lessee at the end of the lease term
    + The lessee has a purchase option they are reasonably certain to exercise
    + The lease encompasses the majority of the leased asset's economic life
    + The present value of the leased asset and any residual value guarantee not reflected in those payments is equal to or greater than the fair value of the leased asset
    + The leased asset is expected to have no other use to the lessor at the end of the lease term due to its specialized nature
+ Direct financing: A lease that does not meet the definition of a sales-type lease, but meets the following criteria:
    + The present value of lease payments and any residual value guarantee equals or exceeds the fair value of the leased asset and
    + Collection of the payments and any amount needed for a residual value guarantee are probable
+ Operating: A lease that is neither a sales-type or a direct financing lease

However, leases with variable lease payments that do not depend on a rate or index must be classified as an operating lease provided the lease would have been classified as a sales-type or direct financing lease and the lessor would have recognized a selling loss at commencement. This prevents the recording of a day one loss when the lessor does not expect to incur a loss on the contract.

The following decision tree summarizes the evaluation of lease classification for lessors under ASC 842:



Under a sales-type lease, control of the asset transfers to the lessee. At the commencement of the lease, the lease asset is derecognized and a net investment in the lease is recognized on the lessor's balance sheet. The difference between that net investment and the derecognized asset is recognized as profit or loss on the income statement. The net investment in the lease equals the lease receivable (lease payments plus amounts guaranteed at the end of lease) plus the unguaranteed residual value, measured on a discounted basis. Subsequent to commencement, the net investment in the lease is decreased for the lease payments collected and increased to reflect the interest income. The interest income, variable lease payments and impairment is recognized through the income statement.

The initial recognition of a direct financing lease is similar to a sales-type lease, except that loss is recognized immediately and profit is deferred and recognized ratably over the lease term. Therefore, the net investment in the lease also includes any deferred profit.

For operating leases, as control of the lease asset does not transfer to the lessee, there is no balance sheet impact. Rental income is recognized straight-line over the term of the lease. This normally results in recording a deferred rent receivable for the difference between the lease payments and the straight-line rental income.

Lease Modifications

A lease modification occurs when a lease is renegotiated and results in a change to the:

+ Scope of the lease (e.g. adding or removing a ROU asset)
+ Consideration of a lease (e.g. increasing or decreasing the payment)
+ Lease term (e.g., extending or shortening) that was not part of the original contract

When a contract is renegotiated (modified), an entity must reassess whether the contract still contains a lease, and if so, whether the modified contract should be accounted for as a separate contract, as detailed below.

Separate Contract	**NOT a Separate Contract**
A lease modification is accounted for as a separate contract if both criteria are met: + Grants additional rights to use one or more underlying assets (e.g., adding more square footage in the building) **AND** + Increase in payments is equivalent to the stand alone price. The lease modification results in two separate contracts being recorded (the original contract and the separate contract)	Lease modifications that do not meet the criteria for a separate contract may include: + Extending or reducing the term of an existing lease (e.g. changes the lease term from 3 to 5 years or vice versa) + Fully or partially terminating a lease + Changes to contract price only + Granting additional ROU assets not included in the original contract and the increase in payments is NOT commensurate to a stand alone price These modifications require the following reassessments: **Lessee:** + Reassess the classification (operating or finance) + Remeasure and reallocate the consideration + Reassess the lease term and purchase options + Remeasure the lease liability using updated discount rate **Lessor:** + Modifications to financing or sales-type leases will apply different accounting models based on the facts and circumstances + Modifications to operating leases are considered a termination of the existing lease and the creation of a new lease

Entities need to develop ongoing controls to ensure new leases, lease modifications and renewal plans are detected and accounted for in a timely manner, due to the impact of lease modifications on the accounting treatment and measurement.

Lessee Reassessment (Lease Term + Purchase Options + Residual Value Guarantees)

A reassessment differs from a modification as there are no changes to or renegotiation of the original contract. A lessee reassessment is a change in or reassessment of the expected outcome of existing lease terms such as renewal options or purchase options. At each reporting period the lessee is required to assess the lease term and purchase options for significant changes, including residual value guarantees. A reassessment is triggered by the following activities, which results in a remeasurement of the ROU asset and lease liability:

Trigger	Description	Reassess Discount Rate	Reassess Classification (Operation/ Finance)	Remeasure & Allocation of Consideration of Lease Payments
Change in reasonable certainty	Significant change under the control of the lessee that affects the reasonable certainty of exercising an option to extend or terminate the lease or purchasing the underlying asset	✓	✓	✓
Contract obligation	Event is written into the contract that occurs and obliges the lessee to exercise (or not to exercise) an option to extend or terminate the lease	✓	✓	✓
Exercise an option	Lessee elects to exercise an option it originally was not reasonably certain execute	✓	✓	✓
Not exercise an option	Lessee elects not to exercise an option it originally was reasonably certain to execute	✓	✓	✓
Residual value guarantees	Change in amounts probable of being owed to the lessor by the lessee under the residual value guarantees	✓		
Variable lease payments becoming fixed	Event occurring resulting in variable lease payments (e.g. linked to the performance of the underlying asset) becoming fixed payments for the remainder of the lease term	✓		

For lessees, a lease reassessment is distinct from a lease modification as the impact of the changes are accounted for by remeasuring the lease liability using revised inputs (discount rate and allocation of contract consideration) and adjusting the ROU asset at the reassessment date. A lease modification may result in the extinguishment of the initial lease and creation of a new separate contract at the date of the modification.

Unless the lease is modified (renegotiated), a lessor shall not reassess the lease term or the lessee option to purchase the ROU asset. If the lessee exercised an option the lessor thought was not reasonably certain to be exercised, the lessor accounts for the change as a lease modification.

Initial Direct Costs

When a lease is executed, there are costs that would not have been incurred otherwise. Those costs, while not considered when measuring the liability carried, are recorded as a component of the ROU asset by the lessee. Only those costs directly related to the execution of the lease are allowable; costs related to the negotiation of the lease are excluded and expensed as incurred. Examples of included costs are:

+ Commissions
+ Legal fees incurred as part of the lease execution
+ Certain payments to existing tenants to relocate

Examples of excluded costs are:

+ Employee salaries
+ Legal fees incurred as part of the lease negotiation
+ Advertising

Initial direct costs incurred by a lessor are deferred (deferred asset) and expensed over the lease term for operating leases and included in net investment in lease for financing lease. For sale-type leases, these costs are expensed if the fair value of the underlying asset leased is different from its carrying value, or included in net investment in the lease if equal.

Lease Incentives & Improvements

A lessor may include incentives to entice a lessee to enter into a lease agreement, such as payment of lessee costs (e.g. moving expenses), reimbursement for leasehold improvements, up-front cash payments to a lessee or losses incurred by the lessor for assuming the lessee's pre-existing lease with a third party. Lease incentives reduce the total lease payments used to determine the lease classification and measurement of the ROU asset and lease liability.

Improvements and other expenses paid by the lessee are accrued when incurred regardless of whether they are reimbursed by the lessor.

Leasehold improvements are amortized over the shorter of the useful life of the leasehold improvements and the remaining lease term, subject to certain exceptions.

Impairment Considerations

At each reporting date, an entity needs to consider whether the ROU asset or lease receivable is impaired. A lessee's impairment consideration is subject to the same impairment guidance in ASC 360, *Property, Plant, and Equipment*. When a ROU asset is impaired under an operating lease, lease expense is no longer recognized on a straight-line basis. Entities will continue to amortize the lease liability using the same effective interest method used prior to the impairment charge. The ROU asset is then amortized on a straight-line basis.

When a ROU asset is impaired under a financing lease, an entity calculates a new straight-line amortization based on the revised asset value.

Lessors also consider the impairment guidance in ASC 360 for any assets leased under an operating lease. For sales-type and direct financing leases, lessors are required to consider the impairment guidance in ASC 310, *Receivables* to the resulting net investment in the lease, which includes the lease receivable, residual assets and deferred profits.

Sublease Accounting

A sublease is defined as "a transaction in which an underlying asset is re-leased by the lessee (or intermediate lessor) to a third party (the sublessee) and the original (or head) lease between the lessor and the lessee remains in effect." In such transactions, the original lease is generally referred to as the headlease.

Sublease Accounting - Original Lessor

When the lessee enters into a sublease arrangement, the lessor's accounting for the headlease does not change. However, if the headlease is replaced by a new agreement with a new lessee, or if the original lessee is relieved of the primary obligation under the headlease, the transaction is not a sublease. Such a transaction is considered a termination and the lessor accounts for the termination of the headlease and the execution of the new lease as separate transactions.

Sublease Accounting - Original Lessee

When the original lessee is not relieved of the primary obligation under the headlease, they become the sublessor in the sublease. The sublessor classifies the sublease as a sales-type, direct financing or operating lease in accordance with the Lessor Accounting section above. However, the sublease terms can impact the classification of the original lease. Additionally, the accounting treatment of the sublease is dependent on whether the headlease was initially classified as a finance or operating lease as summarized below:

	Sublease - Operating	Sublease - Sales-type or direct financing
Original lease - Operating or Financing	There is no change to the accounting for the headlease at the commencement of the sublease. If the lease cost for the sublease term exceeds the sublease income for the same period, the ROU asset associated with the headlease should be assessed for impairment.	Derecognize the original ROU asset at the sublease commencement. Account for headlease liability in accordance with the finance lease accounting guidance**. Recognize a net investment in the sublease and evaluate for impairment.

*** If the headlease was previously classified as an operating lease, the lease liability is treated as a finance lease subsequent to the sublease commencement.*

When a sublessor enters into a sublease it can cause a reassessment of the headlease. For example, the sublease term, including noncancelable terms and renewal options that are reasonably certain to be exercised by the sublessee, could exceed the initial term of the headlease, requiring the sublessor to reassess the headlease term. Similarly, a headlease may provide a purchase option the original lessee is unlikely to exercise. If the purchase option is included in a sublease and the sublessee is reasonably certain to exercise the purchase option, the sublessor is required to reassess the classification of the headlease to include the purchase option.

Sublessors should use the rate implicit in the sublease to determine the classification of the sublease and measure the net investment in the sublease classified as a sales -type or direct financing lease. If the rate implicit in the sublease cannot be readily determined, the sublessor may use the discount rate established for the headlease.

Sublessors generally present sublease income on a gross basis separate from the headlease expense. However, the guidance does not clearly address or prohibit net presentation. Regardless of the presentation in the statement of comprehensive income, sublease income is to be disclosed separately from finance or operating lease expenses in the notes to the financial statements.

Transition Elections

FASB provided several transition and practical expedient elections.

Entities can elect to utilize either of the following modified retrospective transition methods:

+ Comparative Presentation Method: Entities record a cumulative-effect adjustment to the beginning of the earliest period presented resulting in a restatement of periods prior to the period of adoption. This method results in all periods being presented comparatively.
+ Year of Adoption Method: The provisions of ASC 842 are applied at the beginning of the period of adoption. Entities record a cumulative-effect adjustment to the opening balance of retained earnings in the period of adoption. As the financial statements are not comparative, the prior lease disclosures are retained in the footnotes.

The FASB offers a package of practical expedients that allows entities to forego reassessing the following for existing or expired contracts, when transitioning to ASC 842:

+ Whether the contract contains a lease
+ Lease classification
+ Initial direct costs

The package of practical expedients needs to be adopted for all leases in process at the transition date. When the package of practical expedients is elected, the initial measurement of leases is as follows:

Lessee

Operating Lease under ASC 840 and ASC 842

+ Lease liability equals the discounted remaining minimum rental payments plus amounts probable to be paid under a residual value guarantee
+ ROU asset equals the lease liability plus prepaid or accrued lease payments, less the balance of incentive received, plus the unamortized initial direct costs

Capital Lease under ASC 840 and Financing Lease under ASC 842

+ Lease liability equals the carrying amount of the capital lease obligation under ASC 840
+ ROU asset equals the carrying amount of the capital lease asset plus any unamortized costs

Lessor

Operating Lease under ASC 840 and ASC 842

+ Continue to recognize the underlying asset and any related lease assets or liabilities

Capital Lease under ASC 840 and Direct Financing Lease under ASC 842

+ Continue to recognize the net investment in the lease including unamortized initial direct costs capitalized as part of the net investment in the lease under ASC 840, even if the entity did not elect the package of practical expedients

There is no adjustment to retained earnings when the package of practical expedients is elected. Entities not electing the package need to reassess if a contract is a lease, the lease classification, and the allowable capitalization of the direct costs.

A second practical expedient, referred to as the **hindsight practical expedient**, allows entities to consider hindsight when determining the lease term and assessing impairment for existing leases at the date of adoption. Entities electing this practical expedient may consider all facts and circumstances that changed, through the effective date. Events occurring after the effective date but prior to the issuance of financial statements cannot be considered. The hindsight practical expedient can be elected separately from the practical expedients package discussed above.

Tax Implications

ASC 842 does not change how leases are treated for tax purposes. However, since it changes the book recognition of leases, there are tax implications. Generally, tax follows cash so any difference in tax and book treatment results in a timing difference accounted for in the deferred tax inventory. Entities need to compare the difference in the ROU asset and lease liability and the respective tax basis. Generally, the tax basis will be zero, provided the lessee is not required to capitalize the lease for tax purposes.

Disclosures

Additional disclosures are required, which will require entities to develop controls to ensure lease data is collected, aggregated and validated timely.

Lessee Disclosures:

The following qualitative information must be disclosed:

+ A general description of those leases, the basis, terms and conditions on which variable lease payments are determined, options to extend or terminate the lease, residual value guarantees, and restrictions or covenants imposed by the leases
+ Information about leases that have not yet commenced but create significant rights and obligations for the lessee
+ Information about significant assumptions and judgments made as part of the lease measurement including the determination of whether a contract contains a lease, the allocation of the consideration in a contract between lease and nonlease components, the discount rate used, determination of embedded leases and the lease term utilized

Entities electing the practical expedient to use the risk free discount rate must disclose that election.

The following quantitative information, segregated between finance and operating leases, must be disclosed:

+ The components of lease costs separately by category for all finance leases, operating leases, short-term leases, variable lease costs and sublease income
+ Net gains or losses recognized from sale and leaseback transactions
+ Cash paid for amounts included in the measurement of the lease liability
+ Supplemental noncash information on lease liabilities arising from obtaining ROU assets
+ Weighted-average remaining lease term and weighted-average discount rate

A tabular disclosure of the above information is not required. However, the FASB provided the following illustrative example:

	Year Ending Dec. 31,	
	20X2	**20X1**
Lease cost		
Finance lease cost:	$ XXX	$ XXX
Amortization of right-of-use assets	XXX	XXX
Interest on lease liabilities	XXX	XXX
Operating lease cost	XXX	XXX
Short-term lease cost	XXX	XXX
Variable lease cost	XXX	XXX
Sublease income	(XXX)	(XXX)
Total lease cost	**$ XXX**	**$ XXX**
Other information		
(Gains) and losses on sale and leaseback transactions, net	$ (XXX)	$ XXX
Cash paid for amounts included in the measurement of lease liabilities	XXX	XXX
Operating cash flows from finance leases	XXX	XXX
Operating cash flows from operating leases	XXX	XXX
Financing cash flows from finance leases	XXX	XXX
Right-of-use assets obtained in exchange for new finance lease liabilities	XXX	XXX
Right-of-use assets obtained in exchange for new operating lease liabilities	XXX	XXX
Weighted-average remaining lease term - finance leases	XX years	XX years
Weighted-average remaining lease term - operating leases	XX years	XX years
Weighted-average discount rate - finance leases	X.X%	X.X%
Weighted-average discount rate - operating leases	X.X%	X.X%

+ Lease maturity analysis similar to existing lease disclosures, disclosing anticipated annual undiscounted cash flows for a minimum of five years and a total of the amounts for any remaining years, separately for financing and operating leases liabilities
+ A reconciliation of the undiscounted expected cash flow to the lease liabilities recorded
+ Practical expedient to not separate the lease and non-lease components, if elected

Lessor Disclosures:

The following qualitative information must be disclosed:

+ A general description of the leases, including the basis, and terms and conditions, including conditions on which variable lease payments are determined, options to extend or terminate the lease and terms and conditions that allow the lessee an option to purchase the underlying assets
+ Information about significant assumptions and judgments made such as whether the contract contains a lease, allocation of consideration and amount expected to derive from the asset at the end of lease
+ Information about how the entity manages risk associated with the residual value of its leased assets including the entity's risk management strategy and the carrying amount of residual assets covered by residual value guarantees
+ Practical expedient to not separate the lease and non-lease components if elected, including the nature of the lease and nonlease components combined and the nonlease components that do not qualify for the practical expedient

The following quantitative information segregated by lease classification:

+ A maturity analysis of the anticipated annual undiscounted cash flows to be received for a minimum of five years and a total of the amounts for any remaining years
+ A reconciliation of the maturity analysis to the lease receivable recognized for sales-type and direct financing leases
+ Lease income recognized for each period presented, in tabular format:
    + For sales-type and direct financing leases, the profit or loss recognized at the commencement date, interest income and lease income relating to variable lease payments
    + For operating leases, the lease income relating to lease payments, including variable lease payments
+ Information associated with the asset held:
    + For sales-type and direct financing leases, the carrying amount of lease receivables and the unguaranteed residual assets. For direct financing leases, any deferred selling profits
    + For operating leases, the property, plant and equipment disclosures required by ASC 360

Sublease

In addition to the lessor disclosures above, sublessors must disclose:

+ The existence, and terms and conditions, of residual value guarantees provided by the sublessee
+ Sublease income, on a gross basis, separate from financing or operating lease expense

Disclosures are required to be gross for the original and sublease. A net presentation is acceptable if the lease is not a significant business activity.

Transition Disclosures:

Lessees and lessors need to disclose the impact of adoption including:

+ For entities using the year of adoption method, the ROU assets and lease liabilities recorded at the beginning of the period of adoption
+ For entities using the comparative presentation method, the ROU assets and lease liabilities recorded at the beginning of the earliest period presented
+ Any transition methods or practical expedients elected as part of the adoption

Entities electing the year of adoption transition method are required to include prior period disclosures for all prior periods presented in accordance with ASC 840.

Conclusion

The new guidance is voluminous and complex for entities to navigate. To assist our clients, Johnson Lambert developed a practice aid to simplify implementation for entities with limited volume and complexity in their lease portfolio. The practice aid helps entities navigate the various options and considerations for lessees under the new guidance and provides a sample present value calculation template. The practice aid will be available to Johnson Lambert clients upon request from your engagement team, beginning in December of 2021. Entities should begin accumulating data as early as possible given the impact at the beginning of the year of implementation.

Entities with a high volume or complexity in their lease portfolios need to consider software solutions to help automate the data accumulation and accounting process. Manual accumulation and calculation will be difficult and subject to a heightened risk of error for entities with more than a few leases. As a result of public companies implementing ASC 842 in 2019, many lease management and accounting software solutions have emerged to assist in implementing the new standards. We also recommend entities with a high volume or complexity in their lease portfolio consider training relative to the specifics of their contracts and begin implementing the new lease standards as early as possible.

Embedded leases, sale-leaseback arrangements and built-to-suit leases can add further complexity to an entity's implementation. While these topics are beyond the scope of this white paper, we have provided further guidance in Appendix I.

ASC 842 is a revolutionary change in how entities account for leases. Entities need to fully understand the new standard when executing new leases before and after adoption of the new guidance. It is critical entities start as early as possible to ensure leases are properly captured and they have adequate time to consider the impact of the accounting changes for successful implementation.

Appendix I: Other Considerations

Embedded leases

An embedded lease is a lease included as a component of a larger contract. A contract is considered to contain a lease if a specified party has the right to control the use of an asset. This is common with service contracts, where a specified party is given the right to control an asset (e.g. copiers or computer equipment) over a specified period of time. Data center contracts that convey the use of rack space and equipment embedded with other services is another example of an embedded lease. Embedded leases should be bifurcated from the host contract and evaluated as a separate lease under ASC 842.

The improper identification of embedded leases can lead to misstated financial statements. In particular, unidentified embedded leases can result in the improper omission of related lease assets and liabilities on the balance sheet. Entities should review all significant contracts, including contracts that do not contain the word "lease", to identify embedded leases.

Entities should consider following these steps when reviewing contracts for embedded leases:

+ Identification of Embedded Lease: Entities must review all contracts for the existence of an embedded lease.
+ Component Separation and Allocation: Once an embedded lease is identified, the contract must be divided between lease and nonlease components. Any transfer of goods or services between contracted parties is considered a component. The contractual consideration is allocated between each identified lease and nonlease component, based on standalone prices.
+ Accounting Treatment: Each embedded lease component is evaluated to determine the proper classification and accounting treatment. See the Lessee Accounting and Lessor Accounting sections above for details.
+ Reassessment: Entity's should periodically reassess the treatment of embedded leases. This includes establishing new internal control processes to properly identify embedded leases moving forward, as well as reassessment of preexisting contracts. See the Lessee Reassessment section above for details.

Sale-leaseback accounting

A sale-leaseback transaction occurs when an entity sells an asset and immediately leases it back from the buyer. The transaction must meet two criteria.

The sale transaction must meet the definition of a sale under ASC 606, *Revenue from Contracts with Customers* and control of the asset must transfer to the lessor-buyer. Control is indicated by one or more of the following and entities should exercise judgment when determining whether control is transferred based on facts and circumstances:

+ The entity has a right to payment
+ The customer has legal title
+ The customer has physical possession
+ The customer has accepted the risk and rewards of ownership
+ The customer has accepted the asset (lease)

Additionally, the lessor must classify the lease as an operating lease for the provisions of a sale-leaseback accounting to apply. Leases meeting the classification of a sales-type or direct financing lease do not transfer control of the asset and thus do not qualify as a sale-leaseback transaction.

If both the sale and lease criteria are met, the lessor-buyer and lessee-seller recognize the following:

+ The lessor-buyer recognizes the asset when control is obtained. Subsequently the lessor recognizes the operating lease as described in the Lessor Accounting section above
+ The lessee-seller derecognizes the asset when control is transferred and immediately recognizes the profit or loss and recognizes the lease as described in the Lessee Accounting section above

This is a significant change to U.S. GAAP, as most situations previously, required profit on a sale-leaseback to be recognized over the term of the associated lease.

All sale-leaseback transactions are recorded at fair value. In situations where the sales price of the asset is not at fair value, the sales price may need to be adjusted to fair value for accounting purposes, which could result in additional profit or loss being recognized.

Build-to-suit leases

Build-to-suit leases are lease arrangements where the lessee is directly involved with the construction and design of the underlying asset prior to lease commencement. Asset ownership under such leases is determined by whether the lessee maintains control of the underlying asset during the construction period. The lessee is considered to maintain control under any of the following circumstances:

+ The lessee has the right to obtain the partially constructed underlying asset at any point during the construction period
+ The lessor has an enforceable right to payment for its performance to date, and the asset does not have an alternative use to the owner-lessor
+ The lessee legally owns either:
    + Both the land and the property improvements that are under construction
    + The non-real-estate asset that is under construction
+ The lessee controls the land that property improvements will be constructed upon and does not enter into a lease of the land before the beginning of that construction that, together with renewal options, permits the lessor or another unrelated third party to lease the land for substantially all of the economic life of the property improvements
+ The lessee is leasing the land that property improvements will be constructed upon, the term of which, together with lessee renewal options, is for substantially all of the economic life of the property improvements, and does not enter into a sublease of the land before the beginning of construction that, together with renewal options, permits the lessor or another unrelated third party to sublease the land for substantially all of the economic life of property improvements

Once the lessee is determined to own the asset, the lessee recognizes the cost of construction as an asset and a related liability for costs paid by the lessor. Upon completion of construction, the lessee must apply sale-leaseback guidance.

If the lessee is not determined to own the underlying asset during construction, the sale-leaseback guidance is not applicable. Instead, the costs are recorded in accordance with applicable accounting guidance such as Topic 360 on property, plant, and equipment.

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