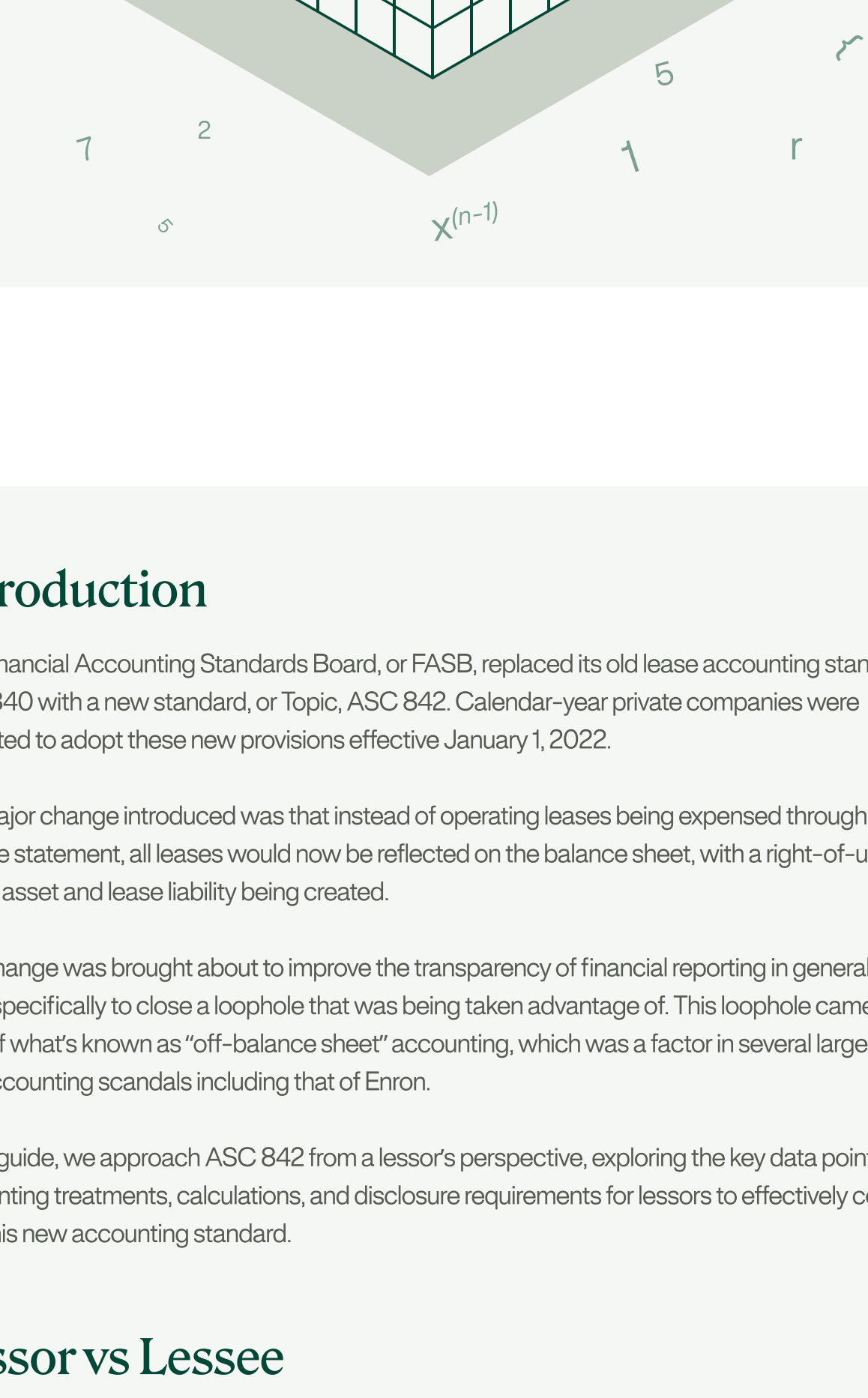


Guide to Lessor Accounting under ASC 842



Introduction

The Financial Accounting Standards Board, or FASB, replaced its old lease accounting standard ASC 840 with a new standard, or Topic, ASC 842. Calendar-year private companies were expected to adopt these new provisions effective January 1, 2022.

The major change introduced was that instead of operating leases being expensed through the income statement, all leases would now be reflected on the balance sheet, with a right-of-use (ROU) asset and lease liability being created.

This change was brought about to improve the transparency of financial reporting in general, and more specifically to close a loophole that was being taken advantage of. This loophole came in the form of what's known as "off-balance sheet" accounting, which was a factor in several large financial and accounting scandals including that of Enron.

In this guide, we approach ASC 842 from a lessor's perspective, exploring the key data points, accounting treatments, calculations, and disclosure requirements for lessors to effectively comply with this new accounting standard.

Lessor vs Lessee

While the changes introduced by ASC 842 for lessees are significant, the changes for ASC 842 lessor accounting are less wide-ranging.

FASB notes (BC90)

The Board decided that the lessor accounting model in previous GAAP did not need comprehensive improvements and, therefore, changing that model in a significant way would not produce benefits (and would perhaps reduce the usefulness of lessors' financial reporting) significant enough to justify the costs of doing so.

With regards to complying with ASC 842, lessors should take a systematic approach which can be based on the following outline:

01. Assess whether a contract or agreement contains a lease as defined by ASC 842 (bearing in mind that it does not have to explicitly be called a lease to fall under the standard, and could be what's known as an "embedded lease")

A. This is defined by the standard as "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."

02. Identify lease and non-lease components

03. Determine the key data points that will be needed for calculations

04. Classify the lease and apply the correct accounting treatment

05. Ensure presentation and disclosure are consistent with the requirements of the standard

ASC 842 and Lessors

Lead Inputs

The following lead inputs are specifically defined by ASC 842:

Commencement date

The date on which a lessor makes an underlying asset available for use by a lessee

Rate implicit in the lease

The rate of interest that, at a given date, causes the aggregate present value of:

- A. The lease payments
- B. The amount that a lessor expects to derive from the underlying asset following the end of the lease term

To equal the sum of:

- 01. The fair value of the underlying asset less any related investment tax credit retained and expected to be realized by the lessor and
- 02. Any deferred initial direct costs of the lessor

If the rate determined in accordance with the preceding sentence is less than zero, a rate implicit in the lease of zero shall be used

Lease term

The noncancellable period for which a lessee has the right to use an underlying asset – this is further qualified by periods covered by an option to extend or terminate the lease

Initial direct costs

Incremental costs of a lease that would not have been incurred if the lease had not been obtained

Variable lease payments

Payments made by a lessee to a lessor for the right to use an underlying asset that vary because of changes in facts or circumstances occurring after the commencement date, other than the passage of time.

Recognizing the lease

There are three main types of leases defined in the standard for lessors: a Sales-Type lease, a Direct Financing lease, and an Operating lease. In terms of a high-level overview, the differences are as follows (842-30-25):

For a Sales-Type lease

At the commencement date, a lessor recognizes the following while derecognizing the underlying asset:

- A net investment in the lease
- A profit or loss arising from the lease
- Initial direct costs as an expense

For a Direct Financing lease

At the commencement date, a lessor recognizes the following while derecognizing the underlying asset:

- A net investment in the lease
- Selling loss arising from the lease, if relevant

For an Operating lease

At the commencement date, initial direct costs are deferred. Then:

- Lease payments are recognized as income in profit or loss
- Initial direct costs are recognized over the lease term as lease income is recognized

Initial measurement

For a Sales-Type lease

The net investment in the lease, which includes:

- 01. The lease receivable, measured at present value, and discounted using the rate implicit in the lease. This comprises:
 - A. The lease payments still to be received by the lessor
 - B. Any amounts, after the end of the lease term, that are guaranteed by the lessee or another 3rd party
- 02. The unguaranteed residual asset at 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 by the lessee or any other third party unrelated to the lessor, discounted using the rate implicit in the lease

For a Direct Financing lease

The net investment in the lease, less any selling profit.

For an Operating lease

The lessor should continue to account for the underlying asset as usual and according to the relevant standard.

Recognizing the lease

For a Sales-Type lease or a Direct Financing lease

The net investment in the lease is measured by:

- 01. **Increasing the carrying amount:** to reflect interest income on the net investment in the lease
- 02. **Decreasing the carrying amount:** to reflect lease payments received during the period

After the commencement date, the only reasons to remeasure the net investments in the lease are if the lease is modified and this is not considered a separate contract (per 842-10-25-8).

Disclosure

While ASC 842 presents detailed guidelines (842-30-50) in terms of disclosure requirements, we'll summarize the main points here:

01. Overall, the standard requires lessors to provide qualitative and quantitative information about their leases, including lease descriptions, terms, variable payments, and purchase options (842-30-50-3). The disclosure also includes significant assumptions and judgments, such as the determination of lease contracts and allocation of consideration (842-30-50-3b).

02. Lessors must consider the level of detail and aggregation to ensure clarity without overwhelming users with irrelevant data (842-30-50-2). Related party lease transactions must be disclosed (842-30-50-4).

03. The disclosure format for lease income varies by lease type (842-30-50-5), and the components of aggregate net investment in sales-type and direct financing leases should be included (842-30-50-6). There's also a requirement to disclose risk management strategies regarding residual asset value (842-30-50-7).

04. Sales-Type and Direct Financing Leases (842-30-50-8) demand explanations for changes in unguaranteed residual assets and deferred selling profit (842-30-50-9), as well as a maturity analysis of lease receivables (842-30-50-10).

05. Operating Leases (842-30-50-11) have their own set of requirements, including a maturity analysis of lease payments (842-30-50-12) and separate disclosures for underlying assets under operating leases from owned assets (842-30-50-13).

ASC 842 Lessor Account Example

The following is a summarized example from ASC 842:

There is an agreement between a Lessor and a Lessee for equipment with a 6-year term. The annual lease payments are \$9,500, payable at the end of each year, and the Lessee provides a residual value guarantee of \$13,000. The equipment has an estimated remaining economic life of 9 years, a carrying amount of \$54,000, and a fair value of \$62,000 at the start of the lease. The Lessor expects the residual value of the equipment to be \$20,000 at the end of the lease term, and the lease does not transfer ownership or contain a purchase option for the Lessee.

The lease is classified as a sales-type lease because the present value of the lease payments and the residual value guaranteed by the Lessee together represent a substantial portion of the equipment's fair value, even though other criteria for classification are not met. The discount rate used to assess this classification is 5.4839%.

At lease commencement, the Lessor's net investment in the lease is \$62,000, equal to the fair value of the equipment. This net investment comprises the lease receivable (discounted annual payments and the guaranteed residual value) and the present value of the unguaranteed residual value. The selling profit on the lease is \$8,000.

The Lessor derecognizes the equipment's carrying amount, recognizes the net investment in the lease of \$62,000, and the selling profit of \$8,000 at the lease commencement. The Lessor also expenses the initial direct costs of \$2,000.

At the end of Year 1, the Lessor recognizes a lease payment of \$9,500, interest on the net investment, and calculates the separate components of the net investment in the lease: the lease receivable and the unguaranteed residual asset.

At the end of Year 6, the Lessor reclassifies the net investment in the lease, equal to the estimated residual value of \$20,000, as equipment. (842-30-55)

Conclusion

While the ASC 842 requirements for lessors vs lessees are less onerous, there is still much complexity and many moving parts. What's more, these standards are constantly being updated to reflect the changing realities of a fast-paced business environment.

For many companies, dealing with ASC 842 manually – that is, using spreadsheets or similar solid yet legacy tools – is a nightmare, not to mention incredibly risky when it comes to accuracy and compliance.

These companies have discovered that incorporating a purpose-built AI-powered automated accounting platform like Trullion is the most effective way to manage their leases.

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