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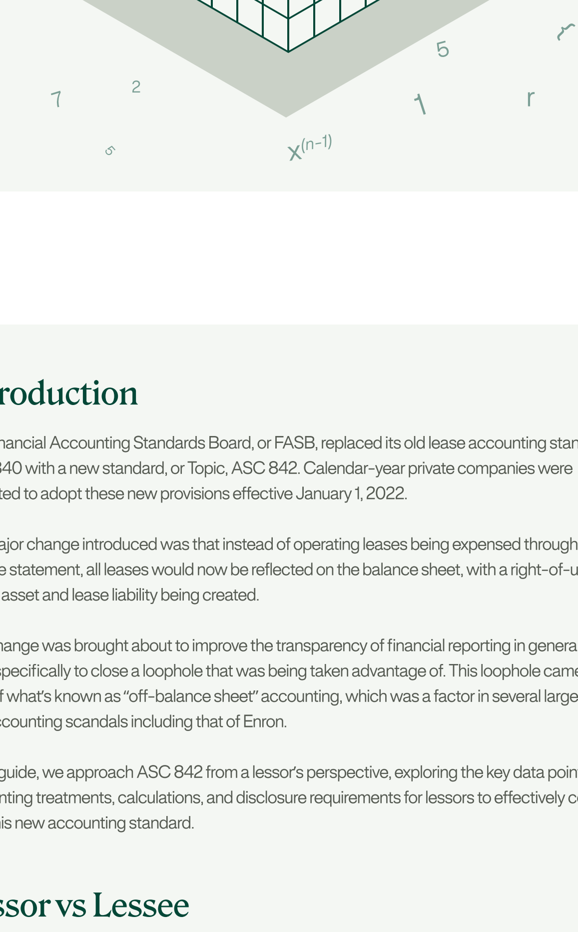
# Guide to Lessor Accounting under ASC 842



## Introduction

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## Lessor vs Lessee

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### FASB notes

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01. Assess whether a contract is or contains a lease as defined by ASC 842

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 disclosures 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:

C. The fair value of the underlying asset

D. Any deferred initial direct costs of the lessor

**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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