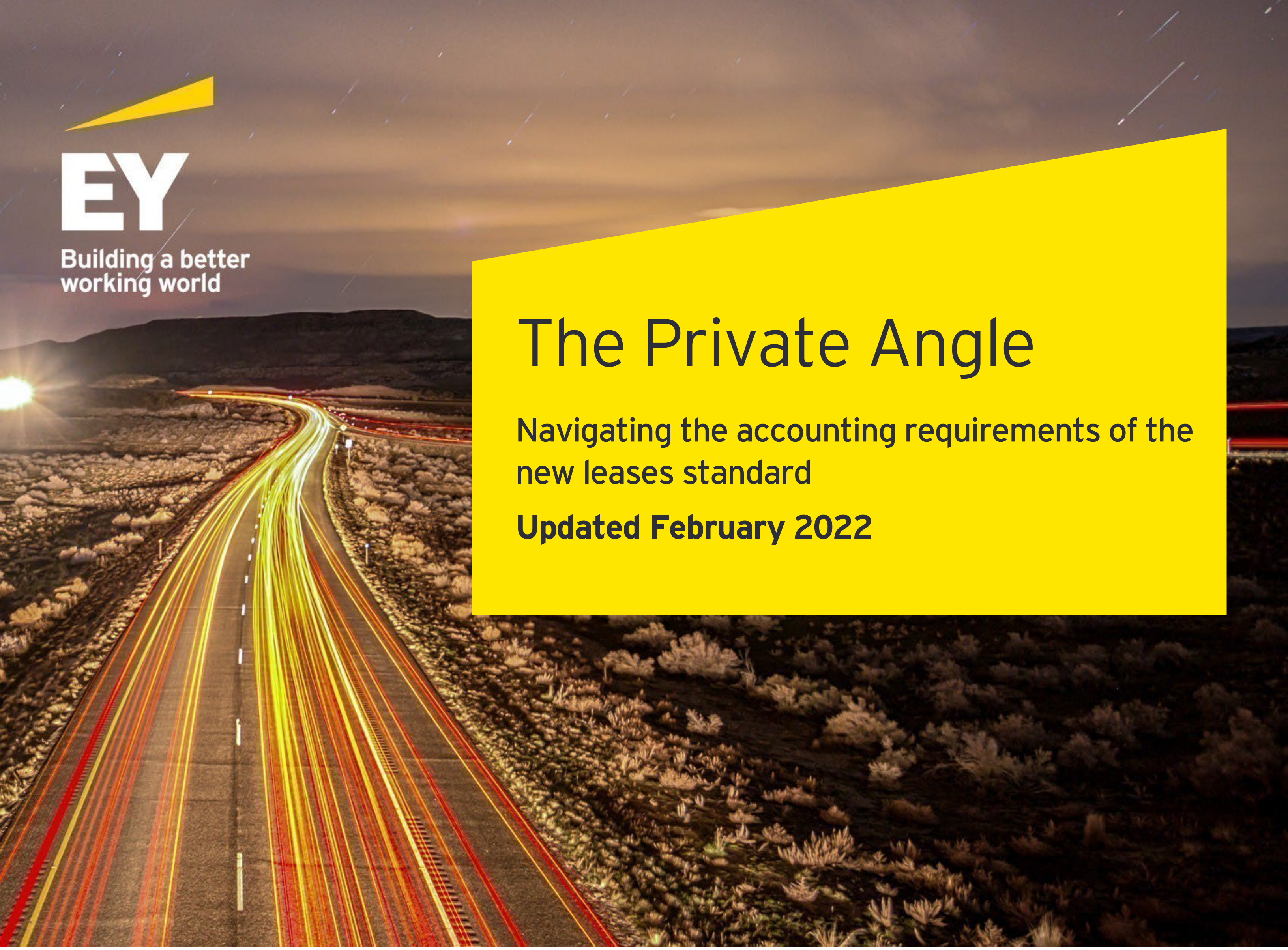

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The Private Angle

Navigating the accounting requirements of the new leases standard

Updated February 2022

Contents:

What you need to know

- Under ASC 842, lessees will have to recognize a right-of-use asset and a lease liability for most leases. This will be a significant change in practice.
- While ASC 842 does not make substantial changes to lessor accounting, it modifies the lease classification criteria and the accounting for operating, direct-financing and sales-type leases.
- The standard provides several practical expedients and policy elections to assist private companies with applying the guidance in transition and after the effective date.
- Both lessees and lessors will need to gather and track more information to comply with the expanded disclosure requirements of ASC 842, even if applying the standard does not have a significant effect on their financial statements.

Overview

Implementing the new leases standard requires a significant investment of time and resources to understand its requirements and determine the effect on a private company's financial statements.

One of the biggest changes is that Accounting Standards Codification (ASC) 842, *Leases*, requires lessees to record most leases on the balance sheet. While ASC 842 does not make substantial changes to lessor accounting, it modifies the lease classification criteria and the accounting for operating, direct-financing and sales-type leases.

To implement ASC 842, lessees and lessors will have to make changes to their accounting policies, processes and controls, and possibly to their information technology (IT) systems. As such, it is important that private companies focus on understanding the new requirements and the effects on their financial statements and disclosures. This publication provides a high-level overview of the key accounting provisions of the standard. The Appendix provides a summary of the major differences between ASC 842 and ASC 840, *Leases*. For a comprehensive look at the standard, refer to our Financial reporting developments (FRD) publication, ***Lease accounting: Accounting Standards Codification 842, Leases,*** which we refer to as our ASC 842 FRD.

This is the second in a series of publications aimed at helping private companies plan for their transition to the new leases standard. The first was The Private Angle: ***Starting the journey to implement the new leases standard*.**

Additional resources are available on our AccountingLink website at **ey.com/en_us/assurance/accountinglink**.

What do you need to know?

Under ASC 842, lessees record a right-of-use (ROU) asset and lease liability for most leases, but their overall pattern of expense recognition isn't likely to change significantly.

Lessee accounting

To apply the new standard, you need to first understand how to determine whether an arrangement is a lease or contains a lease. Just because a contract is labeled a lease does not mean it is a lease, or vice versa. You may need to apply judgment to make the determination because you will have to evaluate whether a contract includes an identified asset and whether the customer has the right to control that identified asset for a period of time in exchange for consideration.[1]

The determination of whether a contract is a lease is more important under the new standard than under ASC 840 because a company that fails to identify a complete population of leases could materially misstate its financial statements (e.g., a lessee might understate its ROU assets and lease liabilities).

Once an arrangement is determined to be or contain a lease, you will need to determine the commencement date, lease term, lease payments and the discount rate because you will need this information to determine lease classification and calculate the amounts you initially recognize on the balance sheet.

Correctly classifying a lease is important because the pattern of expense recognition is different for each lease type. A lessee classifies leases as either operating leases or finance leases, which are similar to capital leases under ASC 840. While the criteria to determine whether a lease is a finance lease are similar to those for capital leases under ASC 840, there are two changes lessees need to be aware of: (1) the addition of a fifth criterion related to the specialized nature of the underlying asset and (2) the removal of ASC 840's bright lines and the introduction of judgment in determining whether a lease meets the economic life (the 75% test under ASC 840) or fair value (the 90% test under ASC 840) criterion.[2]

The former bright lines were replaced with the terms "major part," "at or near the end" and "substantially all." However, the implementation guidance in ASC 842 states that one reasonable approach to lease classification is to use the bright lines in ASC 840 when defining these terms. For example, you may conclude that 75% or greater is a "major part" of the remaining economic life or that 90% or greater is "substantially all" of the fair value of an underlying asset.[3]

Initial recognition of a lease

While the determination of whether a contract is or contains a lease is at the **inception** of the lease, the lease liability and ROU asset are recognized on the **commencement date** of a lease, which is the date the lessor makes the underlying asset available for the lessee to use.[4]

The initial calculation of the lease liability and the ROU asset on the commencement date is the same for both operating and finance leases.

The graphic below displays the inputs you will need to initially calculate the lease liability:

* Lease incentives that are payable to the lessee on the commencement date are deducted from lease payments (i.e., they reduce the lease liability).

To determine the lease payments that will be discounted for each lease, you will need to identify the lease and non-lease components, determine the consideration in the contract over the lease term, and allocate the consideration to the separate lease and non-lease components. The amount you will discount is the consideration in the contract that is allocated to each lease component.[5] However, if you elect the expedient to combine the lease and the associated non-lease components (as an accounting policy election applied by class of underlying asset), you will allocate all of the consideration in the contract to the lease component.

Therefore, it's important to understand what's included in the consideration in the contract. For example, variable payments that depend on an index or rate are included in the consideration in the contract using the prevailing index or rate at the commencement date, but variable payments that do not depend on an index or rate are not. You also need to be aware that determining the lease term and the consideration in the contract will require judgment if your contracts contain options to extend or terminate the lease, or options that allow you to purchase the underlying asset.[6]

You will likely use your company's incremental borrowing rate (IBR) or a risk-free rate to discount the lease payments because most lessees are not expected to have access to the information necessary to determine the rate implicit in the lease. The IBR is the rate of interest you would be charged to borrow, on a collateralized basis over a term similar to the lease term, an amount equal to the lease payments in a similar economic environment. To estimate this rate, you start with the general credit of the entity and consider adjustments for collateral, differences between existing debt and lease terms, and any differences in the underlying currency.[6] If you choose to make a policy election, by class of underlying asset, to use the risk-free rate (e.g., in the US, the rate of a zero-coupon US Treasury instrument), you must include disclosures on the class or classes of underlying assets for which the risk-free rate was applied.

The *Practical expedients and available policy elections* section below discusses the practical expedient to combine the lease and non-lease components and the private company risk-free rate election. The ROU asset is recognized at the commencement date at the amount of the lease liability, adjusted for the items shown in the graphic below. Initial direct costs are incremental costs a lessee would not have incurred if it hadn't obtained the lease (e.g., commissions).

Subsequent measurement of a lease liability and ROU asset

For both operating and finance leases, the lease liability is calculated as of each reporting date at the present value of the remaining lease payments using the discount rate determined at lease commencement (or, if applicable, the updated rate as of the most recent modification date or reassessment event).[8]

The pattern of expense recognition depends on whether a lease is classified as an operating lease or a finance lease. That is, a lessee generally recognizes higher periodic lease expense in the earlier periods of a finance lease than it does for an operating lease, which is consistent with ASC 840. The difference results from the subsequent measurement of the ROU asset. For operating leases, the ROU asset is effectively a "plug" necessary to achieve the straight-line expense recognition over the lease term. For finance leases, the ROU asset is generally amortized on a straight-line basis.[9]

If a lease calls for variable payments that do not depend on an index or rate, a lessee will record these lease payments in the period in which the achievement of the specified target becomes probable.

For all leases, lessees need to have processes in place to identify modifications and reassessment or remeasurement events. Reassessment and remeasurement events are new concepts that can materially affect the measurement of the lease liability and ROU asset.[8]

ROU assets for both operating and finance leases are subject to impairment testing under ASC 360, *Property, Plant, and Equipment*.[10]

Lessor accounting

While ASC 842 does not make fundamental changes to today's lessor accounting, it modifies the lease classification criteria and the accounting for operating, sales-type and direct financing leases. The guidance also requires lessors to classify leases as operating leases if they have variable lease payments that do not depend on an index or rate and would have selling losses if they were classified as sales-type or direct financing leases and eliminates ASC 840's real estate-specific provisions for lessees and lessors. Lastly, ASC 842 leverages certain guidance in ASC 606, *Revenue from Contracts with Customers*, such as the guidance related to estimating the relative standalone selling price for each component.[11]

One important change under the new leases standard relates to the accounting for lease and non-lease components. Lessors that did not identify and separately allocate consideration to lease and non-lease components because the effect on the income statement was immaterial will need to revisit that conclusion during transition. That's because the amounts recorded, presented and disclosed for the lease and non-lease components in a contract under ASC 842 and ASC 606, respectively, could lead to material differences from ASC 840.

To ease the burden of accounting for lease and non-lease components, ASC 842 provides a practical expedient that gives lessors the option (by class of underlying asset) to combine the lease and related non-lease components, if certain criteria are met (refer to the discussion of this expedient in the *Practical expedients and available policy elections* section).

Transition considerations

For private companies (i.e., entities other than public business entities; not-for-profit entities that have issued, or are conduit bond obligors for, securities that are traded, listed or quoted on an exchange or an over-the-counter market; and employee benefit plans that file or furnish financial statements with or to the Securities and Exchange Commission), the new leases standard is effective for annual periods beginning after 15 December 2021 and interim periods within annual periods beginning after 15 December 2022. Early adoption (i.e., for interim periods) is still permitted.

Lessees and lessors are required to adopt ASC 842 using a modified retrospective approach and are prohibited from using a full retrospective transition approach. You can choose one of the following options to determine when to apply ASC 842's transition accounting (i.e., when to record the transition adjustments):

- The later of (1) the beginning of the earliest comparative period presented and (2) the commencement date of the lease
- The beginning of the period of adoption (i.e., the effective date)

How we see it

We expect most private companies to apply the transition provisions as of the effective date to reduce the cost and complexity of applying ASC 842. However, private companies need to keep in mind that this election will result in the financial statements being less comparable in the year of adoption since private companies will continue to apply ASC 840 in the prior period.

The modified retrospective transition method generally results in an entity applying concepts from both ASC 840 and ASC 842 to certain leases that existed before the effective date. Many lessees and lessors will need to make transition adjustments when they apply the transition guidance in ASC 842, but a lessor that elects the package of practical expedients and does not elect the hindsight practical expedient may not have transition adjustments.

For lessees, the transition adjustments will include the recognition of an ROU asset and lease liability for all existing leases that are not short-term leases (assuming the short-term lease policy election is applied).[12]

Lessors and lessees should keep in mind that the amount of each entity's cumulative effect adjustment to retained earnings will depend on whether the entity elects to apply the transition provisions.

Disclosures

ASC 842 expands the disclosure requirements for both lessees and lessors. The objective of these expanded disclosures is to enable financial statement users to assess the amount, timing and uncertainty of cash flows arising from leases. ASC 842 requires both lessees and lessors to disclose quantitative and qualitative information about their leases, the significant judgments and assumptions made in applying ASC 842 and the amounts recognized in the financial statements related to those leases. For example, under ASC 842 lessees will be required to disclose the amount of lease expense by lease type (i.e., operating and finance leases), and lessors will be required to disclose lease income recognized in each reporting period by lease type (i.e., operating, sales-type and direct financing leases) and for variable lease payments.

Transition practical expedients and available accounting policy elections

ASC 842 provides you with several practical expedients and policy elections to make it easier to apply the new guidance. It is important to distinguish between elections available to account for new, modified, remeasured or reassessed leases after the effective date of ASC 842 and those available under the transition provisions of ASC 842 to account for leases that existed before the effective date.

Election	Description	Considerations
Package of practical expedients (lessee and lessor)[13]	Allows a company not to reassess: ▸ Whether any expired or existing contracts are or contain leases ▸ Lease classification for any expired or existing leases ▸ Initial direct costs for any expired or existing leases This expedient is available for transition only. Entities must apply all of the expedients in the package to all leases.	Most private companies are expected to elect this package of expedients because doing so reduces the cost and complexity of transitioning to ASC 842. It is important to keep in mind that this election does not grandfather incorrect conclusions under ASC 840.
Hindsight practical expedient (lessee and lessor)[13]	Permits companies to revisit the determination of the lease term for existing leases by considering the effect of changes in facts and circumstances through the effective date. This expedient is available for transition only, must be applied to all leases, and may be elected separately or in conjunction with the package of practical expedients (described above).	Lessees are more likely to elect this expedient if the facts and circumstances indicate that lease terms may be shorter than originally anticipated, resulting in a lower ROU asset and lease liability. Electing this practical expedient is generally expected to make implementation more complex.
Easements practical expedient (lessee only)[13]	Permits lessees to continue applying their legacy policy for accounting for land easements that existed as of, or expired before, the effective date. This expedient is available for transition only.	Lessees will still need to evaluate whether land easements they enter into or modify on or after the effective date meet the definition of a lease under ASC 842.
Short-term lease policy election (by class of underlying asset to which the right of use relates) (lessee only)[14]	Permits lessees to apply an accounting policy to not recognize an ROU asset and a lease liability for leases with a term of 12 months or less at lease commencement and to recognize expense related to lease payments on a straight-line basis over the lease term as they do for operating leases under ASC 840. Leases do not qualify for this election if they include an option to purchase the underlying asset that the lessee is reasonably certain to exercise. If this accounting policy election is made, it must be applied to existing qualifying leases by class of underlying asset. For new or modified leases after the effective date, lessees need to determine whether the lease qualifies as short-term at the commencement date.	Using this accounting policy election is expected to reduce the cost of applying ASC 842. However, lessees still need to appropriately evaluate the lease term, including the likelihood that they will exercise extension and/or termination options, and provide certain disclosures.

Election	Description	Considerations
Lessee practical expedient to not separate lease and non-lease components (by class of underlying asset)[15]	Permits lessees to apply an accounting policy (by class of underlying asset) to account for each separate lease component of a contract and its associated non-lease components as a single lease component (i.e., all of the contract consideration is allocated to the lease component). Multiple lease components cannot be combined into a single lease component. This accounting policy election is available for new or modified leases beginning on or after the effective date, but we believe a lessee can apply this accounting policy to existing leases when it initially measures its leases during transition.	Using this accounting policy will reduce the cost and complexity of applying ASC 842, but it will increase the likelihood that a lease will be classified as a finance lease (i.e., it's more likely that the lease would meet the fair value criterion because all consideration is allocated to the lease component) and it will increase the initial measurement of the lease liability and ROU asset.
Lessor practical expedient to not separate lease and non-lease components (by class of underlying asset)[14]	Allows lessors to apply an accounting policy (by class of underlying asset) to not separate lease components from the associated non-lease components if the non-lease components otherwise would be accounted for in accordance with ASC 606 and both of the following criteria are met: ▸ The timing and pattern of transfer of the lease component and the associated non-lease component(s) are the same. ▸ The lease component, if accounted for separately, would be classified as an operating lease. If both of the criteria are met and a lessor elects to apply this accounting policy, the lessor is required to account for the combined component as a single performance obligation in accordance with ASC 606 if the non-lease component is the predominant component. If the non-lease component is not the predominant component, the lessor is required to account for the combined component as an operating lease in accordance with ASC 842. Multiple lease components cannot be combined. A lessor that chooses to apply this accounting policy to new or modified leases beginning on or after the effective date is required to apply it to existing leases as of the effective date when it transitions to ASC 842.	Many lessors are expected to use this accounting policy election because it will reduce the cost and complexity of applying ASC 842. However, a lessor that wants to continue to recognize separate revenue streams for lease-related revenue and other revenue would choose not to elect this accounting policy.
Risk-free-rate policy election by class of underlying asset (private company lessee only) [16]	Permits private company lessees to make an accounting policy election to use a risk-free rate as the discount rate by class of underlying asset for classifying and measuring leases. Private company lessees will need to obtain the rate for risk-free borrowings for a term comparable to each lease. The risk-free rate should not be less than zero. A lessee that makes this accounting policy election is required to disclose the class or classes of underlying assets to which it applied the risk-free rate.	Using a risk-free rate will reduce complexity, but it will increase the likelihood that a lease will be classified as a finance lease, and it will increase the initial measurement of the lease liability and ROU asset. Private companies may elect to use their incremental borrowing rate for big-ticket leases they enter into infrequently (e.g., real estate) and the risk-free rate for leases of lower-priced assets or leases they enter into more frequently (e.g., office equipment) so they do not have to incur the cost of calculating their incremental borrowing rate for them. Private companies considering going public may not want to make this election because they will have to retrospectively apply the public entity accounting and reporting requirements to all prior periods presented if they go public.
Sales taxes and other similar taxes collected from lessees (lessor only)[17]	Allows lessors to make an accounting policy election not to evaluate whether sales taxes and other similar taxes imposed by a governmental authority on a specific lease revenue-producing transaction that are collected by the lessor from the lessee are the primary obligation of the lessor as owner of the underlying leased asset.	A lessor that makes this accounting policy election will exclude sales taxes and other similar taxes from the measurement of lease revenue and the associated expense. However, taxes assessed on a lessor's total gross receipts or on the lessor as owner of the underlying asset (e.g., property taxes) are excluded from the scope of the policy election.

Endnotes:

[1] Refer to section 1.2 of our ASC 842 FRD.
[2] Refer to section 3 of our ASC 842 FRD.
[3] Refer to section 3.4.3 of our ASC 842 FRD.
[4] Refer to section 2.2 of our ASC 842 FRD.
[5] Refer to section 1.4 of our ASC 842 FRD.
[6] Refer to section 2.3 of our ASC 842 FRD.
[7] Refer to section 2.5 of our ASC 842 FRD.
[8] Refer to sections 3.5.1, 4.5 and 4.6 of our ASC 842 FRD.
[9] Refer to sections 4.2.2 and 4.3.2 of our ASC 842 FRD.
[10] Refer to sections 4.2.5 and 4.3.4 of our ASC 842 FRD.
[11] Refer to sections 1.4.4 and 3.2 of our ASC 842 FRD.
[12] Refer to section 11.3 of our ASC 842 FRD.
[13] Refer to section 11.2.2 of our ASC 842 FRD.
[14] Refer to section 4.1.1 of our ASC 842 FRD.
[15] Refer to sections 1.4.2.3 and 1.4.2.4 of our ASC 842 FRD.
[16] Refer to section 2.5.2 of our ASC 842 FRD.
[17] Refer to section 1.4.4 of our ASC 842 FRD.

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Appendix — key differences between ASC 842 and ASC 840

The following table discusses key differences between the guidance in ASC 842 and ASC 840.

Topic	ASC 842	ASC 840
Definition of a lease — the customer's right to control the use of the identified asset	The assessment is focused on control of an identified asset for a period of time in exchange for consideration. To have control, a customer must have the right to obtain substantially all the economic benefit from the use of the identified asset and the right to direct the use of the identified asset.	The assessment is focused on whether a lease transfers substantially all of the benefits and risks incident to ownership.
Identifying lease components — contracts with both land and other assets	Companies are required to classify and account for the right to use land as a separate lease component from the right to use other assets (e.g., a building), unless the accounting effect of not separately accounting for the land is insignificant.	Companies evaluate certain criteria that consider transfer of ownership, bargain purchase options and consideration of the fair value of the land and property when determining whether a lease of land and building are accounted for separately.
Related party leasing transactions	Companies are required to classify and account for leases between related parties on the basis of the legally enforceable terms and conditions of the lease (i.e., in the same manner as leases between unrelated parties).	The classification and accounting for a related party lease is the same as for a similar lease between unrelated parties, except in circumstances in which it is clear that the terms of the transaction have been significantly affected by the fact that the lessee and lessor are related. In such circumstances, the classification and accounting are modified as necessary to recognize economic substance rather than legal form.
Lease classification — lessees	Leases are classified as finance, which are similar to capital leases under ASC 840, or operating.	Leases are classified as capital or operating.
Leveraged lease classification — lessor	Leveraged lease classification is eliminated for new and modified leases.	Special accounting rules are provided for leases that meet the criteria to be classified as leveraged leases.
Timing of the initial lease classification assessment	Lease classification is determined at the lease commencement date.	Lease classification is determined at lease inception.
Lease classification criteria (non-real estate)	At lease commencement, a lessee classifies a lease as a finance lease if any of the following five criteria are met or an operating lease if none are met: ▸ The lease transfers ownership of the property to the lessee by the end of the lease term. ▸ The lease grants the lessee an option to purchase the underlying asset that the lessee is reasonably certain to exercise. ▸ The lease term is for a major part of the remaining economic life of the underlying asset. This criterion does not apply to leases that commence at or near the end of the underlying asset's economic life.* ▸ The present value of the sum of the lease payments and any residual value guaranteed by the lessee that is not already included in the lease payments equals or exceeds substantially all of the fair value of the underlying asset.* ▸ The underlying asset is of such a specialized nature that it is expected to have no alternative use to the lessor at the end of the lease term.	At lease inception, if any of the following criteria are met, a lessee classifies a lease as a capital lease: ▸ The lease transfers ownership of the property to the lessee by the end of the lease term. ▸ The lease contains a bargain purchase option. ▸ The lease term is equal to 75% or more of the estimated economic life of the property. ▸ The present value at the beginning of the lease term of the minimum lease payments, excluding the portion related to executory costs, equals or exceeds 90% of the excess of the fair value of the leased property to the lessor at lease inception. If the beginning of the lease term falls within the last 25% of the total estimated economic life of the leased property, the economic life and fair value criterion shall not be used. If none of the above criteria are met, the lease is classified as an operating lease by the lessee.

Topic	ASC 842	ASC 840
	A lessor classifies a lease as a sales-type lease if any of these five criteria is met, unless the lease has variable lease payments that are not based on an index or rate and would have a selling loss (in which case the lease is classified as an operating lease): If none of the five criteria is met but both of the following additional criteria are met, the lessor classifies the lease as a direct financing lease, unless the lease has variable lease payments that are not based on an index or rate and would have a selling loss (in which case the lease is classified as an operating lease): ▸ The present value of the sum of lease payments and any residual value guaranteed by the lessee and any other third party unrelated to the lessor equals or exceeds substantially all the fair value of the underlying asset. ▸ It is probable that the lessor will collect the lease payments plus any amount necessary to satisfy a residual value guarantee. If none of the five criteria above is met and the two additional criteria are not met, the lessor classifies the lease as an operating lease.	In addition to the criteria above, lessors consider additional criteria (including collectibility of minimum lease payments, existence of important uncertainties, existence of manufacturer's or dealer's profit) to determine whether the lease is classified as a sales-type, direct financing lease, leveraged lease or operating lease.
Lease classification — real estate leases	There are no real estate-specific classification criteria.	ASC 840 includes additional real estate-specific considerations to determine lease classification.
Sale and leaseback transactions	When one entity transfers an asset to another entity and then leases the asset back from that entity, both the seller-lessee and the buyer-lessor are required to apply ASC 842 and certain provisions in ASC 606 to determine whether the transaction should be accounted for as a sale, and if so, how to account for the leaseback. There is no real estate-specific guidance on sale and leaseback transactions.	Sale and leaseback accounting applies only to the seller-lessee. ASC 840 includes specific guidance on sale and leaseback transactions involving real estate.
Build-to-suit lease arrangements	ASC 842 focuses on whether the lessee controls the identified asset being constructed. ASC 842 provides examples of circumstances that demonstrate when the lessee controls an underlying asset that is under construction. The guidance applies to both the lessee and lessor.	ASC 840 focuses on whether the lessee has substantially all of the construction risks during the construction period. ASC 840 also contains a maximum guarantee test and other special conditions that, if met, result in the lessee being considered the owner of the asset during the construction period. The guidance applies to lessees only.
Initial direct costs	Definition of initial direct costs is narrower than the guidance in ASC 840 and includes only incremental costs of a lease that would not have been incurred if the lease had not been obtained (e.g., commissions, payments made to an existing tenant as an incentive to terminate its lease).	Guidance for initial direct costs is broader than ASC 842 and does not require the costs to be incremental.
Incremental borrowing rate (lessee)	Defined as the rate of interest that a lessee would have to pay to borrow on a collateralized basis over a similar term an amount equal to the lease payments in a similar economic environment. This rate is determined at the commencement date of the lease.	Defined as the rate that, at lease inception, the lessee would have incurred to borrow over a similar term the funds necessary to purchase the leased asset.

Topic	ASC 842	ASC 840
Recognition of lease liabilities for operating leases (lessee)	Lessees are required to recognize an ROU asset and a lease liability for most leases, including operating leases.	For leases classified as operating leases, lessees do not recognize either a liability for the obligation to make future payments or an ROU asset.
Accounting for reassessment or remeasurement of a lease, not involving a modification to the lease (lessee)	Lessees are required to monitor and identify certain events (e.g., change in lease term) that may require a reassessment or remeasurement of the lease.	No requirement for lessees to monitor and identify certain events that may require a reassessment or remeasurement of the lease.
Disclosures	Lessees and lessors are required to disclose significantly more quantitative and qualitative information, including the significant judgments and assumptions made in applying ASC 842.	Lessees and lessors must disclose a general description of their leasing arrangements and certain other qualitative and quantitative information.

* ASC 842 includes implementation guidance (ASC 842-10-55-2) that states that one reasonable approach to lease classification is to conclude that 75% or greater is a "major part" of the remaining economic life of an underlying asset, a commencement date that falls within the last 25% of the total economic life of the underlying asset is "at or near the end" of the total economic life of the underlying asset, and 90% or greater is "substantially all" the fair value of the underlying asset.