



**LEVITZACKS**

CERTIFIED PUBLIC ACCOUNTANTS

# **ASC 842 - LEASES**

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# Today's Speakers



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## ***The Legal Stuff.....***

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The general information provided in this presentation is not intended to be, nor should it be, treated as tax, legal, investment, accounting, or other professional advice. Before making any decision or taking any action, you should consult a qualified professional advisor who has been provided with all pertinent facts relevant to your situation.

# GENERAL

ASC Topic 842, Leases, issued February 25, 2016.

- Effective date for public business entities fiscal years beginning after 12/15/2018 and interim periods within those fiscal years.
- Non-public companies apply the standard to financial statements issued for fiscal years beginning after December 15, 2021, and interim periods within fiscal years beginning after December 15, 2022. Earlier application is permitted.
- ***All leases longer than 12 months will be capitalized by lessees.***

# GENERAL

- Applies to all leases, including subleases, except:
  - Leases of intangible assets (e.g. licensing)
  - Leases to explore for or use minerals, oil, natural gas and similar non regenerative resources
  - Leases of biological assets, including timber
  - Leases of inventory
  - Leases of assets under construction

# IDENTIFYING A LEASE

To meet the definition of a lease:

- A contract, **or part of a contract**, that conveys the right to control the use of an **identified asset**;
- the customer has the right to obtain substantially all of the economic benefits from use of the asset; and
- the customer has the right to direct the use of the asset (e.g. decision-making rights: what, how much, when, where and whether)



# LEASE AND NON-LEASE COMPONENTS

- After determining that a contract is or contains a lease, identify the separate lease and nonlease components within the contract.
- “Components” include only those items that transfer a good or service to the lessee.

# ALLOCATE CONSIDERATION

- The lessee allocates consideration to the separate lease components and the non-lease components in the contract on the basis of their observable standalone prices.

# CLASSIFICATION

- A lessee classifies a lease as a finance lease if any of five criteria are met at lease commencement
- “Finance Lease” under 842 is the equivalent of “Capital Lease” under 840

# CLASSIFICATION

- The lease transfers ownership of the asset to the lessee by the end of the lease term
- The lease grants a purchase option that the lessee is reasonably certain to exercise
- The lease is for the major part of the remaining economic life of the asset
- The present value of the lease payments equals or exceeds substantially all of the asset's fair value
- The asset is of a specialized nature and is not expected to have an alternative use to the lessor at the end of the lease term

# CLASSIFICATION

- If none of the criteria are met, the lease is classified as an operating lease
- The first four criteria are similar to ASC 840, however they eliminate the 75% and 90% bright lines.
- The specialized nature criterion is new

# LESSEE ACCOUNTING-LEASE LIABILITY

- The lessee records a lease liability equal to the present value of the lease payments



# **LESSEE ACCOUNTING-LEASE LIABILITY**

- Lease payments include:
  - Fixed payments, including in-substance fixed payments
  - Variable lease payments that depend on an index rate or a rate at lease commencement

# VARIABLE LEASE PAYMENTS

- Variable lease payments that depend on an index or a rate should be included in lease payments based on the index or rate at lease commencement - no increase or decrease to future lease payments during the lease term should be assumed.



# LESSEE ACCOUNTING-DISCOUNT RATE

- A lessee should use the rate implicit in the lease whenever that rate is readily determinable.
- If the rate implicit in the lease is not readily determinable, a lessee uses its incremental borrowing rate.

# LESSEE ACCOUNTING-DISCOUNT RATE

- Under ASC 842, the incremental borrowing rate is the rate at which the lessee could obtain funds to borrow on a collateralized basis over a similar term for this specific asset.
- ASC 840 did not require companies to use a secured borrowing rate.

# LEASE TERM

- Noncancellable period for which a lessee has the right to use an underlying asset
- Plus, any periods covered by an option to
  - Extend the lease (if the lessee is reasonably certain to exercise)
  - Terminate the lease (if the lessee is reasonably certain they will not exercise)



## LEASE TERM

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- When the lease term changes, the lessee must remeasure the lease payments and reassess the lease classification.

# LESSEE ACCOUNTING-RIGHT OF USE

- The lessee records an offsetting right of use asset (ROU)
- The ROU represents the lessee's right to obtain the economic benefit from the usage of an asset over the duration of an agreed-upon lease term

# RELATED PARTY LEASES

- Under ASC 842, an entity should classify a lease with a related party on the basis of the legally enforceable terms and conditions of the contract.

# RELATED PARTY LEASES

- So, a lease between related parties should be accounted for in a manner similar to a lease between unrelated parties.
- Judgment is necessary in determining the lease term in a related party lease.
- Consider asset-specific, contractual, market, and entity-specific factors in making this judgment.

# LEASE INCENTIVES

- Lease incentives include rent-free periods, or cash allowances to help fund tenant improvements.
  - Rent-free periods are captured as part of the initial and subsequent measurements of the lease liability and ROU asset
  - Tenant improvement allowances and similar cash incentive payments to, or on behalf of, a lessee are credited directly against the ROU asset upon receipt.



# MODIFICATIONS

- A modification is a change to the contractual terms and conditions of a contract that results in a change in the scope of or the consideration for the lease.

# MODIFICATIONS

- Lease modifications are accounted for as a separate contract if both of the following conditions are met:
  - The modification provides the lessee with an additional right of use not included in the original lease (e.g. use of an additional asset)
  - The lease payments increase commensurate with the standalone price for the additional right of use, adjusted for the circumstances of the particular contract.

# MODIFICATIONS

- If both conditions are met, the modification is accounted for as a separate contract from the original lease
- The accounting for the original lease is not changed and the new lease is accounted for as any other new lease
- If modification does not result in a separate contract, subsequent accounting depends on details of modification

# SUBLEASES

- The sublessee accounts for the sublease consistent with other leases in which it is a lessee
- Sublessor accounting depends on whether it's been relieved of the primary obligation under the original lease:
  - If relieved of PO, derecognize ROU and LL with any difference in P&L
  - If not relieved of PO, account for original lease as before (operating leases)

# TRANSITION

- Effective date option:
  - An entity can elect to apply the new lease standard at the effective date and recognize a cumulative effect adjustment to the opening balance of equity in the period of adoption

# TRANSITION

- For leases previously classified as operating leases under ASC 840 recognize an ROU asset and lease liability at the later of the date of initial application or lease commencement
- The lease liability equals the present value of
  - the remaining “minimum lease payments” as defined in ASC 840,
  - any amounts that are probable of being owed by the lessee under a residual value guarantee
- Present value calculation uses a discount rate established under ASC 842



# TRANSITION

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- The initial ROU asset for operating leases should equal the lease liability, adjusted for any prepaid or accrued rent, lease incentives, impairments (if applicable), or unamortized initial direct costs

# TRANSITION

- For capital leases classified as finance leases:
  - Recognize an ROU asset and a lease liability based on the carrying amount of the capital lease asset and capital lease obligation, respectively, as measured under ASC 840
  - From the initial application date onward, measure the ROU asset and the lease liability based on the guidance in ASC 842
  - Amortize the right-of-use asset straight line from the commencement date to the earlier of the end of the useful life of the right-of-use asset or the end of the lease term
  - If the lease transfers ownership of the underlying asset to the lessee or the lessee is reasonably certain to exercise an option to purchase the underlying asset, the lessee shall amortize the right-of-use asset to the end of the useful life of the underlying asset



# LESSEE ACCOUNTING EXAMPLE

- Three-year operating lease, commenced January 1, 2021, in year two as of January 1, 2022
- Lease calls for payments of \$20,833 in year one, \$30,000 in year two and \$35,000 in year three (in arrears)
- Deferred rent liability of \$7,778 as of January 1, 2022
- Discount rate is lessee's incremental borrowing rate of 5%
- Present value of remaining lease payments at January 1, 2022 is \$60,219
- Present value of remaining lease payments at December 31, 2022 is \$33,296

# EXAMPLE

- Adoption (Jan 1, 2022, beginning of lease year #2):

|                 |          |          |
|-----------------|----------|----------|
| ROU             | \$52,441 |          |
| Deferred rent   | \$7,778  |          |
| Lease liability |          | \$60,219 |

*Record lease liability and ROU*

# EXAMPLE

- End of year two:

|               |          |
|---------------|----------|
| Lease expense | \$28,611 |
|---------------|----------|

|                 |          |
|-----------------|----------|
| Lease liability | \$26,923 |
|-----------------|----------|

|     |          |
|-----|----------|
| ROU | \$25,534 |
|-----|----------|

|      |          |
|------|----------|
| Cash | \$30,000 |
|------|----------|

*Record second payment and amortize ROU*

# EXAMPLE

- End of year three:

|               |          |
|---------------|----------|
| Lease expense | \$28,611 |
|---------------|----------|

|                 |          |
|-----------------|----------|
| Lease liability | \$33,296 |
|-----------------|----------|

|     |          |
|-----|----------|
| ROU | \$26,907 |
|-----|----------|

|      |          |
|------|----------|
| Cash | \$35,000 |
|------|----------|

*Record payment and amortize ROU*

# Summary of Example Entries

| Year                | Liability | Cash     | ROU      | Exp    | Defd Rent |
|---------------------|-----------|----------|----------|--------|-----------|
| Year 1<br>(840)     |           | (20,833) | -        | 28,611 | (7,778)   |
| Adopt 842           | (60,219)  |          | 52,441   |        | 7,778     |
| Year 2              | 26,923    | (30,000) | (25,534) | 28,611 |           |
| Year 3              | 33,296    | (35,000) | (26,907) | 28,611 |           |
| Totals for<br>lease | -         | (85,833) | -        | 85,833 | -         |

# DISCLOSURES-QUALITATIVE

- General description of leases
- Basis, terms and conditions on which variable lease payments are determined
- Options to extend or terminate the lease
- Residual value guarantees
- Accounting policy regarding short term leases

# DISCLOSURES-QUALITATIVE

- Assumptions and judgments, including
  - Determination of whether a contract contains a lease
  - Allocation of consideration between lease and nonlease components
  - Determination of discount rate
- Information about lease transactions with related parties
- Information about significant leases which haven't yet commenced

# DISCLOSURES-QUANTITATIVE

- Lease expense, including short-term, variable, operating, finance lease interest, amortization of ROU
- Weighted average remaining lease term (finance and operating)
- Weighted average discount rate (finance and operating)
- Maturity analysis (finance and operating)
- Sublease income
- Cash paid related to lease liabilities



# PRESENTATION IN FINANCIAL STATEMENTS

- Operating lease and finance lease ROUs are presented separately
- Finance lease ROUs can be presented with property plant and equipment (must disclose)
- Lease liabilities presented separately, split into current and long-term portions
- Principal portion of finance lease repayments are financing activities in the statement of cash flows
- Changes in ROU and lease liability are operating activities in the statement of cash flows



# PRACTICAL EXPEDIENTS

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- Upon **transition**, lessees can elect, but only as a package for all leases, not to reassess the following :
  - Whether any expired or existing contracts are or contain leases
  - Classification for any expired or existing leases
  - Whether initial direct costs for any existing leases qualify for capitalization under ASC 842

# PRACTICAL EXPEDIENTS

- As a policy election applicable to all existing leases, lessees can use hindsight in determining the lease term
- Lessees may elect to not separate non-lease components from lease components
- Lessees can elect not to recognize ROU assets and lease liabilities for leases with terms less than 12 months

# ***PRACTICAL EXPEDIENTS***

- Nonpublic business entities can make an accounting policy election to use the risk-free rate
- Existing or expired land easements can be excluded from application of 842

# ***NEXT STEPS***

- Itemize your leases
- Consider renewal or termination options
- Identify any long-term contracts that may fall under ASC 842
- Debt covenants
- Practical expedients
- Consult a qualified professional



**QUESTIONS?**



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