Financial institutions: Overview of lessor accounting under ASC 842

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Introduction

Both lessee and lessor accounting will be affected as a result of the issuance of Financial Accounting Standards Board (FASB) Accounting Standards Update (ASU) 2016-02, *Leases (Topic 842)*. In addition, certain specific modifications made to the guidance for lessors are relevant to financial institutions that provide lease financing. The changes outlined within the ASU and the new Accounting Standards Codification (ASC) Topic created with its issuance (Topic 842) will require financial institutions to adjust their existing financial accounting and reporting practices and may affect underwriting and the interaction between the underwriting, approval, credit monitoring, servicing and accounting functions within the organization.

Background

In February 2016, the FASB issued ASU 2016-02, its long-awaited final standard on the accounting for leases, which was codified in Topic 842, *Leases*, of the FASB's ASC. On its effective date, ASC 842 replaces the legacy U.S. generally accepted accounting principles (GAAP) for leases in ASC 840, *Leases*, for both lessees and lessors.

As entities started implementing ASC 842, numerous questions arose, many of which were submitted to the FASB for further consideration. Upon considering many of these questions, the FASB decided certain changes to ASC 842 were necessary. In addition, the SEC staff provided limited effective date relief for ASC 842 and superseded almost all of its preexisting guidance on accounting for leases (which was included in the S99 sections of ASC 840).

To incorporate its and the SEC staff's changes to ASC 842 and 840, the FASB has issued the following eight ASUs:

- ASU 2017-13, *Revenue Recognition (Topic 605), Revenue from Contracts with Customers (Topic 606), Leases (Topic 840), and Leases (Topic 842): Amendments to SEC Paragraphs Pursuant to the Staff Announcement at the July 20, 2017 EITF Meeting and Rescission of Prior SEC Staff Announcements and Observer Comments*
- ASU 2018-01, *Leases (Topic 842): Land Easement Practical Expedient for Transition to Topic 842*
- ASU 2018-10, *Codification Improvements to Topic 842, Leases*
- ASU 2018-11, *Leases (Topic 842): Targeted Improvements*
- ASU 2018-20, *Leases (Topic 842): Narrow-Scope Improvements for Lessors*

- ASU 2019-01, *Leases (Topic 842): Codification Improvements*
- ASU 2019-10, *Financial Instruments-Credit Losses (Topic 326), Derivatives and Hedging (Topic 815), and Leases (Topic 842): Effective Dates*
- ASU 2020-05, *Revenue from Contracts with Customers (Topic 606) and Leases (Topic 842): Effective Dates for Certain Entities*

Effective dates

Most public business entities (PBEs) and certain not-for-profit entities and employee benefit plans that file with the SEC were required to adopt the provisions of ASC 842 for fiscal year ends beginning on or after December 15, 2018. With the issuance of ASU 2019-10 and ASU 2020-05, the effective date of the standard for other entities has been deferred as described in the following paragraphs.

Prior to June 3, 2020, the effective date of ASC 842 was as follows:

- For PBEs, 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 (i.e., public not-for-profit entities) and employee benefit plans that file or furnish financial statements to the SEC (i.e., public employee benefit plans), ASC 842 was effective in annual reporting periods beginning after December 15, 2018 and the interim periods therein. A limited exception to this effective date was provided by the SEC staff for entities that are PBEs solely because their financial statements or financial information is included in another entity's filing with the SEC pursuant to SEC rules and regulations. For additional information about this exception, refer to ASC 842-10-S65-1.
- For all other entities (e.g., private companies), ASC 842 was effective in annual reporting periods beginning after December 15, 2020, and interim periods within fiscal years beginning after December 15, 2021.

On June 3, 2020, the FASB issued ASU 2020-05, which deferred the effective date of ASC 842 for certain entities as follows:

- For public not-for-profit entities that had not issued (or made available for issuance) financial statements as of June 3, 2020 that were fully compliant with U.S. GAAP (which would have included the adoption of ASC 842), the effective date of ASC 842 was deferred to fiscal years beginning after December 15, 2019, including interim periods within those fiscal years. Paragraphs BC29 to BC34 of ASU 2020-05 discuss whether a public not-for-profit entity is eligible for the deferral if it has filed financial information reflecting the application of ASC 842 in the Electronic Municipal Marketplace Access system.
- For entities other than PBEs, public not-for-profit entities and public employee benefit plans (e.g., private companies, private not-for-profit entities), the effective date of ASC 842 was deferred to fiscal years beginning after December 15, 2021, and interim periods within fiscal years beginning after December 15, 2022.

ASC 842 may still be adopted early by the entities eligible for the related deferrals.

Nonpublic financial institutions with lessor activities should use this additional time to thoroughly review the standard and the changes applicable to lessors and to revise internal policies, procedures and controls, as necessary, to comply with the standard by its effective date. While the accounting and reported amounts may not change drastically for lessors as a result of the standard, a number of decisions and operational changes will be needed to ensure the entity is accounting for its leases in accordance with ASC 842.

This whitepaper includes a discussion of the highlights of ASC 842 for financial institutions that are lessors, as well as a discussion of certain operational considerations when implementing the standard. It does not include a complete discussion of the provisions relevant to lessors. For additional information, refer to our publication, *Leases: Overview of ASC 842*, and our Lease Accounting Resource Center.

Highlights for lessors

Lease and nonlease components

Once a lease has been identified, the entity generally is required to separate the contract into its lease and nonlease components and allocate the consideration of the contract based on the relative standalone selling price in accordance with ASC 606, *Revenue from Contracts with Customers*.

Lessor practical expedient

In certain cases, the lessor may elect an accounting policy by class of underlying asset to combine a separate lease component with the nonlease component(s) (i.e., not separate into separate components as outlined above).

Per this practical expedient, when the following criteria are met, a lessor may elect an accounting policy by class of underlying asset to combine an individual lease component with its related nonlease component(s):

- The nonlease components otherwise would be accounted for under ASC 606;
- The timing and pattern of transfer of the nonlease component(s) and associated lease component are the same; and
- The lease component, if accounted for separately, would be classified as an operating lease.

When the practical expedient is elected, the combined component is treated as one unit of account, and the lessor may combine an individual lease component with its related nonlease component(s). In such cases, ASC 842-10-15-42B requires the lessor to account for the combined component under ASC 606 if the nonlease components are the predominant component(s) of the combined component. Otherwise, the lessor would account for the combined component as an operating lease under ASC 842. In most instances, we would expect the lease component to be the predominant component.

When the necessary criteria are not met or the practical expedient is not elected for the applicable class of underlying asset, the lease and nonlease components are separated from each other for accounting purposes. The contract consideration is allocated between the lease and nonlease components using the allocation model in ASC 606-10-32-28 to 32-41, which generally requires the contract consideration to be allocated to the units of account using their relative standalone selling prices. The contract consideration allocated to the lease component(s) is accounted for in accordance with ASC 842, and the contract consideration allocated to the nonlease component(s) is accounted for in accordance with other applicable U.S. GAAP (e.g., ASC 606).

Operational considerations

For financial institutions that are lessors, certain leases are not operating in nature, and therefore the practical expedient would not be able to be elected. However, if a financial institution is a lessor for a large volume of operating leases, or if leases associated with a particular class of underlying asset generally qualify as operating leases, the lessor should consider whether the practical expedient should be elected.

Lease components

A lease component is the element within the contract that results in a right to use an underlying asset. There may be multiple lease components in one contract, and if this is the case, each individual lease component needs to be identified and segregated for accounting purposes. When evaluating the contract to identify individual lease components, the lessor must consider whether the following two conditions exist:

- The lessee can benefit from the right to use the leased asset on its own or together with other readily available resources; and
- The right to use the leased asset is not highly dependent on, nor highly interrelated with, other rights to use underlying assets in the contract.

Both conditions above must exist in order to separate the leased assets into distinct lease components. For example, a lessor may execute a single contract with a lessee for equipment consisting of two pieces of machinery, Machine A and Machine B. If, based on the facts and circumstances, the customer could use Machine A and Machine B separately in operations and they are not interrelated with nor dependent upon one another, the lessor would identify and account for two distinct lease components. If however, Machine A's operations depend on Machine B to execute a certain process, this would not satisfy both of the criteria above and the leased assets would be accounted for as a single lease component.

Lease components identified are generally accounted for in accordance with ASC 842. There are certain instances under the practical expedient noted earlier where the accounting may fall under ASC 606. Refer to ASC 842-10-15-42B for detailed discussion.

Nonlease components

Nonlease components consist of elements of the contract with the customer that provide a good or a service, but that are generally distinct from the right to use the identified asset(s). Common examples for financial institutions include utilities, maintenance on leased assets, and transfers of supplies or consumables for use with the leased asset. If the financial institution is involved in real estate leasing activities, common area maintenance is another common nonlease component in those types of contracts.

Certain activities by the lessor are related to fulfilling a good or service associated with the contract but generally are not considered to be separate nonlease components. This is because they are not inherently distinct from the leased asset itself. In other words, they are provided or performed as part of satisfying a lease or nonlease component. For example, repositioning of a leased asset is generally considered to be related to the identified lease component and is included as part of the consideration associated with that component.

Identified nonlease components are accounted for in accordance with other topics such as ASC 606 for revenue recognition or ASC 310, *Receivables*, for a financed component, unless the practical expedient discussed above is elected.

Noncomponents

Other aspects of the contract may fall into a category herein referred to as *noncomponents*. Noncomponents do not transfer a good or service to the customer and, therefore, no contract consideration is allocated to noncomponents. Common examples of noncomponents for financial institutions include delivery of the leased asset, reimbursements for taxes, insurance and fees or other administrative costs.

Lease term

Under legacy guidance (ASC 840), a lease contract is evaluated for initial measurement and classification at inception, and recognition takes place on the commencement date. Under ASC 842, however, lessors will evaluate initial measurement and classification and recognize the lease as of the commencement date. The commencement date is defined in ASC 842 as the date the lessor makes the underlying asset available to the lessee for its use.

Operational considerations

For many financial institutions, a lease agreement may be approved and signed in advance of commencement. Policies and procedures will have to be adjusted as a result of the change in ASC 842 to ensure that initial measurement and classification take place as of the lease's commencement date. Additional fields in the lease or loan IT system may need to be added to distinguish between the inception date (e.g., date the contract is signed) and the lease commencement date. Also, a process will need to be in place to ensure that the accounting department receives the commencement date information as of the proper date to account for the lease as of the commencement date.

The lease term under ASC 842 begins on the commencement date and consists of the following:

- Noncancellable period, including any rent-free periods (rent abatement)
- Optional renewal periods if the lessee is reasonably certain to exercise
- Periods covered by options to extend or terminate that are exercisable by the lessor
- Periods after a termination option if the lessee is reasonably certain not to exercise the termination option

If there is no stated term or the lease is month-to-month in nature, the lessor is required to consider whether it is *reasonably certain* that the lessee will continue to use the asset. If it is reasonably certain that the lessee will continue to use the asset, the lessor is required to assess for how long and then incorporate those conclusions into the evaluation of the lease term.

Operational considerations

While the noncancellable period and options exercisable by the lessor are likely easy to evaluate for a financial institution lessor, customer-related inputs or those associated with leases involving no stated term are more subjective in nature and will require assumptions to be made about the intent and ability of the customer in the future. The financial institution will need to consider how it will determine whether renewal options are *reasonably certain* to be exercised by the lessee, including who will make this determination and how it will be communicated to those parties performing the classification assessment. Changes to underwriting and (or) loan approval documentation may be warranted to document considerations and conclusions.

Lessors are not required to reassess the lease term unless the lease contract is modified and the modification is not accounted for as a separate contract. For additional discussion of modifications, refer to the guidance on modifications beginning at ASC 842-10-25-8.

Lease classification

While it is not expected that lease classification and the resulting accounting treatments of leases by lessors will change dramatically under ASC 842, it remains critical for financial institutions that act as lessors to understand the changes to classification.

Overall, the lease classification guidance becomes more principles-based under ASC 842, removing some of the previous *bright line* guidance from ASC 840. In accordance with the new standard, classification of leases by lessors begins by evaluating the following five elements:

1. Does the lease transfer ownership to the lessee by the end of the lease term?
2. Does the lease contain a purchase option that the lessee is *reasonably certain* to exercise?
3. Is the lease term a *major part* of the remaining economic life of the asset?
4. Is the sum of the present value of the lease payments and any residual value guaranteed by the lessee equal to or greater than *substantially all* of the fair value of the leased asset?
5. Is the underlying asset of a specific nature such that it would have no alternative use to the lessor?

There are ultimately three categories of leases for lessors under ASC 842: sales-type, direct-financing and operating.

If any of the criteria outlined in 1 through 5 above are met, the lease is considered to be a *sales-type* lease by the lessor.

If none of the criteria outlined in 1 through 5 above are met, the classification by the lessor depends on responses to the following questions:

- Does the present value of the sum of the lease payments and any residual value guaranteed by the lessee or by a third party unrelated to the lessee equal or exceed *substantially all* of the fair value of the underlying asset?
- Is collectability probable?

If both of the conditions above are satisfied, the lease is considered to be a direct-financing lease by the lessor. If not, the lease is considered to be an operating lease by the lessor.

Operational considerations

ASC 842 does not define *major part* or *substantially all* within the provisions of the standard. As a result, financial institutions will need to define this terminology within their policies and procedures and adjust any underwriting, classification and (or) accounting tools and documentation that includes the criteria for lease classification. The implementation guidance in ASC 842 does state that the following may be reasonable approaches for applying the revised criteria:

- For purposes of determining whether the lease term makes up a major part of the underlying asset's remaining economic life, one reasonable approach would be to use a threshold of 75 percent or more (in line with ASC 840).
- For purposes of determining whether the lease commences at or near the end of the underlying asset's economic life, one reasonable approach would be to use a threshold of 25 percent or less of the underlying asset's total economic life.

- For purposes of determining what represents substantially all of the underlying asset's fair value, one reasonable approach would be to use a threshold of 90 percent or more (in line with ASC 840).

The entity should update its policies and procedures to reflect the revised classification criteria discussed above.

Initial direct costs (IDCs)

IDCs that qualify for capitalization under ASC 842 do not include costs incurred prior to signing the lease. As a result, common costs that will qualify as IDCs include commissions and payments made to an existing tenant or lessee to incentivize termination of the existing lease. In the past, many lessors also would categorize legal fees, costs of evaluating the prospective customer's financial condition, negotiation costs and general overhead as IDCs. These will not qualify as IDCs under ASC 842.

Operational considerations

Given the more narrow definition in the new standard, financial institutions should evaluate their current IDC accounting to identify the types of costs that are identified as IDCs and capitalized. Once this evaluation has been completed, the financial institution should consider when the costs were incurred, and adjust accounting practices accordingly. This may result in expenses being recognized prior to commencement date and higher margins in lease income being recognized over the term of the contract. Changes to policies and procedures and training of personnel in the accounting area likely will be necessary as a result of this change.

Transition

Lessors may elect either of the following transition methods for purposes of its initial application of ASC 842:

- *Transition Method A.* ASC 842 is applied retrospectively to each prior reporting period presented in the financial statements with a cumulative-effect adjustment recognized as of the beginning of the earliest period presented.
- *Transition Method B*. ASC 842 is applied retrospectively to the beginning of the period of adoption through a cumulative-effect adjustment recognized as of the beginning of that period.

When applying either Transition Method A or B, the lessor may elect one or more of the following practical expedients:

- *A package of transition practical expedients.* See discussion in the following section.
- *Hindsight practical expedient.* If this practical expedient is elected, lessors use hindsight in determining the lease term on the date of initial application.
- *Land easement practical expedient.* If a lessor elects this practical expedient, it does not assess whether preexisting or expired land easements that were not previously accounted for as leases under ASC 840 are or contain a lease under ASC 842. However, the lessor must assess whether land easements entered into (or modified) on or after the date of initial application are or contain a lease under ASC 842.

If a lessor elects one (or more) of these practical expedients, it must apply the practical expedient to all of its preexisting leases (or easements).

The complexity of transitioning to ASC 842 depends on many factors, including the elections made by the lessor concerning the transition method and practical expedients. In addition, the classification of the lease under ASC 840 and 842 also affects the complexity of transitioning to ASC 842.

Lessors are required to disclose transition-related information. The nature of that information depends on the transition method elected.

Practical expedient package

In an effort to simplify the transition to and adoption of ASC 842, the FASB incorporated a practical expedient package consisting of the following three provisions:

- No requirement to reassess whether any expired or existing contracts are or contain leases (i.e., re-evaluation of the definition of a lease);
- No requirement to reassess lease classification of expired or existing leases; and
- No requirement to reassess IDCs for any existing leases.

If the package is elected, an entity must apply all three provisions to all leases, both as a lessee and as a lessor. In order to qualify for the package, it is implied that there were sound policies and procedures in place under ASC 840 to ensure that the accounting for contracts within the provisions of that standard was appropriate. If an entity does not qualify for or elect the practical expedient package, it will be required to reassess all of the items outlined earlier based on the transition method selected for all affected leases.

Operational considerations

It generally will be advantageous for financial institutions that serve as lessors to seriously consider electing the practical expedient package based on the volume of leases that are typically in the lender's portfolio. When preparing transition documentation, the financial institution should clearly demonstrate that it had existing processes in place to evaluate lease existence, classification and the propriety of IDCs when leases were initially recognized under ASC 840.

Initial accounting for lessors

The accounting for leases by lessors remains largely unchanged both at commencement and in subsequent periods, with a few exceptions.

Sales-type

While collectability is no longer evaluated in classifying a sale-type lease as outlined above, collectability does come into consideration when recording the sales-type lease in accordance with ASC 842. If collectability is probable at commencement, the entity will derecognize the underlying asset, recognize the net investment in the lease and recognize any selling profit or loss. If collectability is not probable, however, the entity will not derecognize the underlying asset and will account for lease payments received as a deposit liability, similar to the accounting for secured borrowings, thereby deferring any associated profit recognition until collectibility of the remaining lease payments becomes probable.

Operational considerations

Once again, a financial institution will need to implement policies and procedures that assess future collectability at the time of commencement in order to properly account for its contracts. The entity should clearly outline how future collectability will be measured, who will make the assessment and how those in an accounting role will receive such information to make the necessary accounting entries. If an IT system is used in evaluating lease classification or to make any accounting entries, the financial institution should understand the criteria used to evaluate collectability, how the system uses data to make the evaluation and how accounting personnel ensures that the information in the system is complete, timely and accurate.

Direct-financing

As mentioned above in the *Lease classification* section, additional conditions must be met for a lease to be classified as a direct financing lease. When accounting for a direct-financing lease, the entity will derecognize the underlying asset, recognize the net investment in the lease, recognize any selling loss and defer any selling profit and initial direct costs by including those amounts in the initial measurement of the net investment in the lease. This net investment in the lease is then recognized over the lease term.

Operating

No changes were made to the accounting for operating leases for lessors, with the entity continuing to recognize the underlying asset and recording lease payments as income over the lease term, generally on a straight-line basis.

Additional reminders

As financial institutions look to implement the standard from both the lessee and lessor perspectives, certain additional reminders are relevant:

- *Revised definition of a lease.* Under ASC 842, a lease is defined 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." Numerous factors must be considered in determining whether the contract includes an identified asset, including the nature of the asset, whether the asset has been explicitly or implicitly identified in the contract and whether the supplier or lessor has substantive substitution rights. The definition also requires that, for a lease to exist, the customer or lessee must have the right to obtain substantially all of the economic benefits associated with the leased asset and have the right to direct the use of the leased asset. In other words, the customer must have the ability to direct how and for what purpose the asset is being used.

> **Operational considerations**
>
> While the revised definition of a lease is not expected to significantly affect the identification of contracts that are in scope for financial institutions acting as lessors, consideration should be given to the nature of the assets being leased and the provisions of the contracts that may affect control. The financial institution may need to provide training to employees on how to be aware of situations where the contract may not constitute a lease.

- *Short-term lease policy election.* The short-term lease policy election (ref: ASC 842-20-25-2) is only available for lessees.
- *Leveraged leases.* Under ASC 842, leveraged lease accounting no longer exists for new or modified contracts. Any leveraged leases in existence prior to the adoption date for the standard are grandfathered under ASC 840 guidance until such time that the existing lease is modified.

> **Operational considerations**
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> Financial institutions with a significant volume of leveraged leases should develop a tracking mechanism to ensure that any leveraged leases that initially are grandfathered are appropriately adjusted upon modification to comply with ASC 842.

- *Quantitative and qualitative disclosures.* Per ASC 842-30-50-1, "the objective of the disclosure requirements is to enable users of financial statements to assess the amount, timing, and uncertainty of cash flows arising from leases." To achieve this objective, lessors must comply with various quantitative and qualitative disclosure requirements, some of which differ from legacy guidance. Refer to ASC 842-30-50 for a complete discussion of the disclosure requirements for lessors.

Operational considerations

Financial institutions that are lending and depository institutions within the scope ASC 942, Financial Services – Depository and Lending, also should note that the principal portion of payments received from lessees for sales-type and direct financing leases should be classified as investing activities in the statement of cash flows. Payments received for operating leases should be classified as operating activities. The financial institution should ensure that its accounting records can appropriately delineate between the type of the lease and principal vs. interest payments to ensure that the statement of cash flows is stated properly.

- *Lessee accounting implications on lender and lessor activities*. The amendments to lessee accounting as a result of ASC 842 are substantial, particularly the requirement for all leases, including operating leases, to be recorded on the balance sheet as a right-of-use asset and a right-of-use liability. As a result, the financial statements of many customers to whom financial institutions lend will change, and financial institutions serving as lenders and lessors need to be aware of the implications that these changes may have on existing lending policies and procedures.

Operational considerations

Financial institutions should evaluate the metrics used in underwriting and credit monitoring processes, including certain debt covenants within the customer agreements, to determine whether changes need to be made to existing policies and procedures. For example, covenants related to the return-on-assets percentage will be affected by ASC 842 as the customer's balance sheet composition likely will change upon adoption, with a less pronounced effect on the income statement or results of operations expected. As such, the return-on-assets percentage may decrease depending on the significance of the customer's leasing activities. Additionally, certain ratios that consider liabilities also will be affected by the right-of-use liability recorded in the financial statements. Identifying any necessary changes to policies, procedures and agreements and communicating those both internally and externally in a timely manner will help to ensure a smooth transition from an operational perspective.

Conclusion

Process

The following is an overview of the process that should be employed by lessors when evaluating leases under ASC 842 at the lease level:

1. Determine whether the contract is or contains a lease.
2. If the contract is or contains a lease, identify and separate lease components and nonlease components (unless the practical expedient is elected).
3. Compute initial measurement amounts as of the commencement date, which includes the (a) evaluations of lease term, standalone selling prices (in accordance with ASC 606) and the amounts allocated to identified lease and nonlease components in Step 2; and (b) calculation of lease payments, fair value of the underlying asset and discount rate.
4. Determine lease classification as of the commencement date.
5. Record initial journal entries for the lease, as applicable, as of the commencement date. Expense any costs that are not considered to be IDCs as incurred.

Summary

The new leasing standard is not only impactful for lessees but also will affect the policies, procedures and operations of financial institutions that serve as lessors. Financial institutions that have not already adopted ASC 842 should use the additional time as a result of the effective date deferrals to dig deeper into the standard, to create a multidisciplinary implementation team, to develop or revise policies, procedures and controls, to update systems with any necessary changes and to adequately train individuals who will be involved in lease transactions and the accounting for them.

For additional information and resources, refer to our Lease Accounting Resource Center.

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