JO Knows the Overview of Lease Terms

MARCH 18, 2022 | BY: THE AUDIT TEAM

With the implementation of the new lease accounting standard upon us (Accounting Standards Codification 842, *Leases* (ASC 842)), and the impact that this new standard could potentially have on the financial statements for so many entities, we have so far focused on providing entities with a high level understanding of the new lease standard. In our last e-mail, we discussed the components of a contract, including lease components, nonlease components and noncomponents.

Next up, we will take a look at the lease term and the factors to consider in this calculation.

The lease term is one of the key inputs that can impact the measurement of a lease, as well as its classification. A lease term commences once the lessor makes the asset available to the lessee and lasts for the duration of the stated lease term. However, lease agreements will often include renewal or termination options that must be considered.

In determining the lease term, the following should be considered:

- All **noncancelable periods** (including rent-free periods)
- Periods covered by options to extend by the lessee if it is **reasonably certain** they will be exercised
- Periods covered by options to terminate the lease by the lessee if it is **reasonably certain** that the lessee willNOT exercise
- Periods covered by options controlled by the lessor

Evaluating each of these factors includes judgement as well as some nuances to consider. First, noncancelable periods would exclude periods where both parties have the right to terminate the lease without the other party's permission AND face only an insignificant penalty for doing so. If both conditions exist, the period would not be considered noncancelable.

Next, both the lessee and the lessor should evaluate options to extend or terminate the lease during the enforceable period. Enforceable periods covered by options that provide the lessor with the right to extend or unilaterally terminate the lease are included in the lease term (i.e. it is assumed that the lessor will extend or not terminate the lease). For enforceable periods in which the lessee has the right to extend or terminate the lease, the probability of exercise needs to be assessed. The lease term would include enforceable periods in which it is "reasonably certain" that the lessee will extend or not terminate the lease.

So, what exactly does "reasonably certain" mean? Fortunately, the concept of "reasonably certain" under ASC 842 is comparable to "reasonably assured" in the existing lease guidance. The determination of whether exercise of an option is reasonably certain is based on factors at the lease commencement date that would create an economic incentive for the lessee to exercise the option or not.

Examples of factors that could create economic incentives include:

- Pricing of a lease renewal option below market rates
- Significant leasehold improvements that would be impaired if the term was not extended
- Lease termination or relocation costs that would be avoided by extending the lease; and
- The importance of the leased asset to the lessee's operations in avoiding any business interruption

Once the lease term is determined, the lessee **does not reassess** the lease term unless a significant event or change in circumstances occurs that is within the lessee's control.

Short Term Lease Exception

After concluding on the term of a lease, it is possible that the lease could qualify for the short term lease exception under the new standard. Under this exception, lessees may make an accounting policy election to NOT apply the new recognition guidance for short term leases if, at the commencement date, the calculated lease term is 12 months or less and does NOT include a purchase or renewal option that the lessee is reasonably certain to exercise. This election should be made by class of underlying assets (i.e. leases of office space or leases of office equipment).

If a lessee chooses to elect the short term lease exception, it would NOT recognize a right of use asset or lease liability on its balance sheet and instead would recognize the lease payments as an expense on a straight-line basis over the lease term, consistent with the current lease guidance.

Evergreen leases that are month-to-month should be evaluated under the same lease term factors noted above to determine the term over which the lessee is reasonably certain to extend the lease. The lessee cannot default to a short term lease exception under these arrangements.

Conclusion

Determining the lease term may not be as simple as it seems on the face of the agreement, particularly when extension and termination clauses are included. It's important to understand and evaluate each of the factors to determine an accurate lease term at the commencement of each lease.

Effective Date

ASC 842 is effective for private companies and nonprofit organizations with annual reporting periods beginning after December 15, 2021 and interim periods within fiscal years starting after December 15, 2022.

To learn more about Johnson O'Connor's Accounting & Attest services, click **here**.

RELATED SERVICES

Audit & Assurance