JO Knows How to Account for Lease Payments

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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. Thus far in our series, we have discussed how to identify a lease, the various components of a contract containing a lease, and the lease term, which along with the topics discussed below are necessary to determine the type of lease and ultimately, calculate the right of use asset and lease liability.

The lease liability is measured by taking the future minimum lease payments over the lease term and calculating the present value of such payments using an appropriate discount rate. In our previous email we discussed the lease term. We will now examine lease payments and the discount rate.

Lease Payments

ASC 842's definition of lease payments at the commencement date consists of the following payments related to the use of the underlying asset during the lease term:

- Fixed payments, including in substance fixed payments, less any lease incentives paid or payable to the lessee.
- Variable lease payments that depend on an index or a rate (such as the Consumer Price Index or a market interest rate), initially measured using the index or rate at the commencement date.
- The exercise price of an option to purchase the underlying asset if the lessee is reasonably certain to exercise the option.
- Payments for penalties for terminating the lease if the lease term reflects the lessee exercising an option to terminate the lease.
- Fees paid by the lessee to the owners of a special-purpose entity for structuring the transaction.
- For lessees only, amounts probable of being owed by the lessee under residual value guarantees.

In substance fixed payments are payments that may, in form, appear to contain variability but are, in effect, unavoidable. These payments may include any of the following:

- Payments that do not create genuine variability (such as those that result from clauses that do not have economic substance).
- The lower of the payments to be made when a lessee has a choice about which set of payments it makes, although it must make at least one set of payments.

Lease payments do not include:

- Variable payments other than those that depend on an index or a rate
- Any guarantees by the lessee of the lessor's debt
- Amounts allocated to nonlease components

Discount Rate

The other term we are exploring is the discount rate. For a lessee, the discount rate for the lease is the rate implicit in the lease unless that rate cannot be readily determined. In that case, the lessee is required to use its incremental borrowing rate. There is a practical expedient available to lessees that are not public business entities which permits the use of a risk-free discount rate for the lease, determined using a period comparable with that of the lease term.

For the lessor, the discount rate is the rate implicit in the lease.

The implicit rate in a lease is the rate of interest that, at a given date, causes the aggregate present value of (a) the lease payments and (b) the amount that a lessor expects to be derived from the underlying asset following the end of the lease term, to equal the sum of (1) the fair value of the underlying asset minus any related investment tax credit retained and expected to be realized by the lessor and (2) any deferred initial direct costs of the lessor. However, if the rate determined in accordance with the preceding sentence is less than zero, a rate implicit in the lease of zero shall be used.

Because some of the factors included in determining the implicit rate may not be readily available to the lessee, the standard does allow the lessee to use its incremental borrowing rate. The incremental borrowing rate is 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. This does not exclude the lessee's use of a secured borrowing rate as its incremental borrowing rate if that rate is determinable, reasonable, and consistent with the financing that would have been used in the particular circumstances.

Conclusion

Determining the lease payments along with the discount rate are essential to calculating the lease liability. It is important to understand and evaluate each of these attributes along with the lease term as discussed in previous emails to calculate the lease liability and a component of the right of use asset.

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.

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