

JO Knows the Overview of Lease Components

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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. In our last e-mail, we discussed the definition of a lease under the new standard. As a reminder, a lease is defined as 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.

Here, we will take a closer look at components of a contract.

Leases, and contracts containing leases, may contain one or more lease components, nonlease components, and noncomponents. Nonlease components and noncomponents are typically services, and therefore are recorded as expenses in the period incurred. Because lease accounting requires balance sheet treatment (except for short term leases), the new standard places additional emphasis on separating lease and nonlease components.

Lease Components

A separate lease component exists when the contract provides the right to use an underlying asset and both of the following are true:

If both criteria are met, there are multiple right of use assets, and the consideration must be allocated to each of the identified right of use assets.

Nonlease Components

A nonlease component is an activity that transfers a separate good or service to the lessee. Maintenance services are a common nonlease component. Leases for equipment or real estate often contain maintenance services – services that the lessee would either have to perform themselves or hire a separate third party to perform if not bundled with the right of use asset. Unless a practical expedient is elected, consideration must also be allocated to nonlease components.

Noncomponents

Noncomponents are those activities that do not transfer separate goods or services to the lessee. For example, a real estate lease may factor in property taxes. Property taxes are the obligation of the lessor, as such amounts would be owed to the city or town regardless of who the lessee is or if there was a lessee at all. The lessee receives no benefit from paying the property taxes. Unlike lease and nonlease components, no consideration is allocated to noncomponents.

Practical Expedient

Lessees may make an accounting policy election, by class of underlying asset, to not separate nonlease components from lease components. Nonlease components are then accounted for along with the associated lease component as a single lease component. The requirement to separate lease components remains regardless of policy election. Making this policy election should lessen the administrative effort and cost of both implementation of the new standard and ongoing accounting for leases. There are potential downsides, most notably that the resulting lease liability(ies) will be greater, which could in turn have an adverse impact on a debt covenant, if applicable. Lessees should weigh the benefit of the practical expedient with its costs before making their policy election.

Identifying and Allocating Consideration

As noted, consideration must be allocated to each separate lease component and, if the practical expedient is not elected, to each nonlease component. Consideration consists of all fixed and in-substance fixed payments and variable payments based on an index/rate, less lease incentives received or receivable. Allocation must be based on observable standalone prices, unless standalone prices are not available. If not available, it is appropriate for the lessee to estimate the standalone prices based on any observable data available.

Conclusion

Implementing the new lease standard may be a challenging process but one that can be made easier by understanding all of the goods and services included within the lease or contract containing a 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.

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