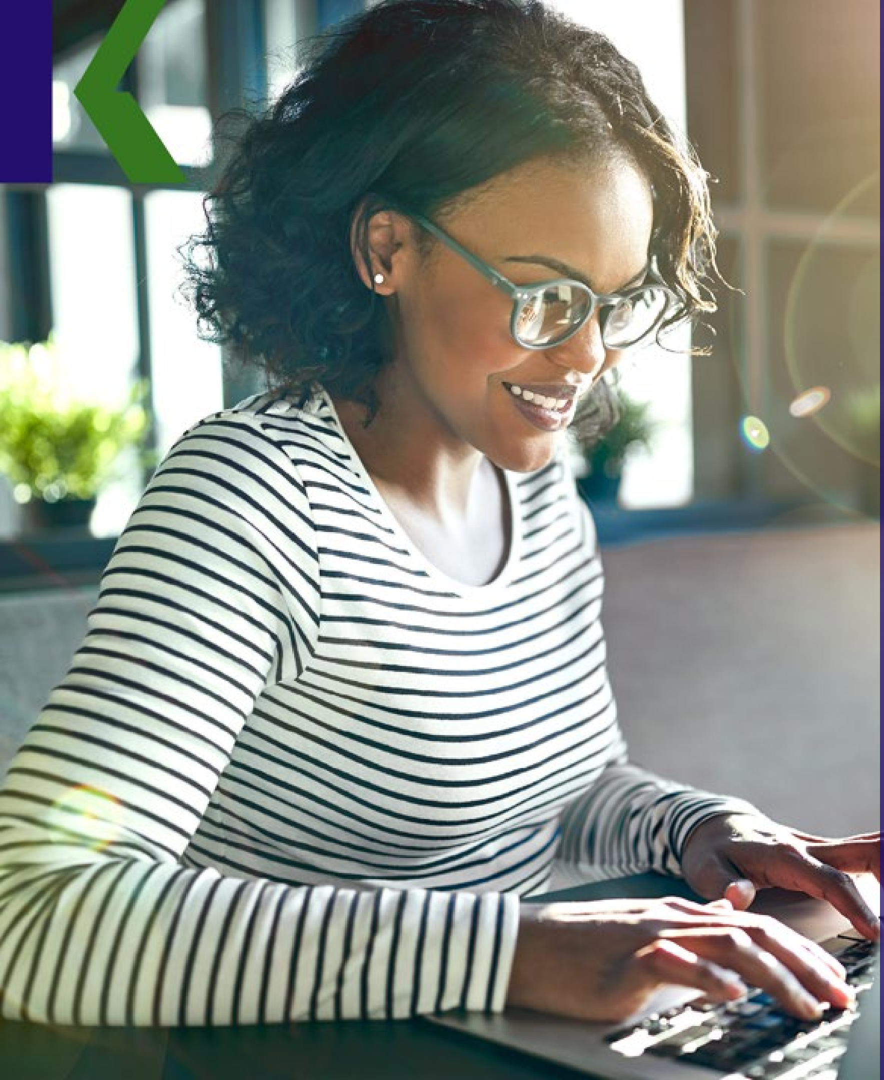

Lease Accounting Update

Session 8D

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Marcithomas2018@gmail.com

KAPLAN

Learning Objectives

At the end of this session participants will be able to:

- Identify differences between ASC 840 and ASC 842
- Implement transition requirements for lessees
- Evaluate the most common lease issues that arise in nonprofits
- Make appropriate lease classifications
- Calculate the leased liability and ROU asset for operating and financing leases
- Construct subsequent measurement journal entries for leases

Significant Differences Between ASC 840 and ASC 842

Differences

- Lessees- Recording operating leases on the balance sheet
- New name for capital leases- finance leases
- Principles based lease classification
- No deferred or prepaid lease expense for operating leases
- More stringent capitalization criteria for initial direct costs
- Enhanced footnote disclosure
- Inception vs. **commencement**

Similarities

- Very few changes for lessors
- Income statement treatment for lessees is unchanged
- Accounting for finance leases is unchanged
- Change in terminology- not significant (ASC 840- reasonably assured vs ASC 842- reasonably certain). Used for adding options to renew leases
- Lease modification and remeasurement accounting

Since there is very little change for lessors this presentation focuses on lessee accounting.

Lease Transition- Overview, Modified Retrospective Approach

Transition Method 1: Adjust comparative periods

- Entities apply ASC 842 to each lease that existed at the beginning of the **earliest comparative period** presented and leases that commenced after that date.
- Prior comparative periods presented are adjusted.
- Cumulative effect adjustment is recognized at that date.

Transition Method 2: Do not adjust comparative periods

- Entities apply ASC 842 to each lease that commenced as of the **beginning of the current reporting period** with a cumulative effect adjustment as of that date.
- Prior comparative periods are not adjusted under this method and are under ASC 840.
- An entity that applies this method must provide the required disclosures under ASC 840 for all periods to which ASC 840 is applied.

Lease Transition- Overview

Transition- Lessee

- If a lease was classified as an operating lease under the guidance in ASC 840 and will continue to be classified as an operating lease under ASC 840, the lessee should recognize a right-of-use asset and lease liability at the application date.
- The application date for companies that choose to adjust comparatives periods is the later of: (1) the beginning of the earliest comparative period presented and (2) the commencement date of the lease.
- The application date for companies that choose to not adjust comparative periods is the effective date.
- Effective date begins with 2022 calendar year ends. For June 30 entities this would be June 30, 2023. Since it is effective at the beginning of the year the implementation date is technically July 1, 2022.

Lease Transition- Overview

- **Deloitte Review of 50 Fortune 125 Companies- Lease Transition Disclosures**
- 100% used the alternative method and did not restate the prior year
- Of those 50 entities, **18** disclosed a quantitative cumulative catch-up adjustment to retained earnings. 61% of those explained that it was from recognizing previously deferred gains on sale-leaseback transactions. The other entities were silent.

Lease Transition- Possible Elections

Package of practical expedients: These are a package and must be elected together. Entity is required to disclose the practical expedients elected.

1. The entity does not have to determine whether leases are included in existing or expired contracts at the transition date.
2. Entities will not need to reevaluate existing lease classifications.
3. Entities will not need to reevaluate and possibly exclude certain outlays classified as initial direct costs under ASC 840.

   ASC 842 is more restrictive in costs that can be capitalized. It defines initial direct costs as those that could have been avoided had the entity not entered into a lease agreement.

Lease Transition- Other Possible Elections

- **Hindsight-** Entities may elect a practical expedient to use hindsight in determining the lease term and assessing the entity's ROU asset.
- **Land Easements -** Entities can elect not to reassess existing or expired land easements under the definition of a lease under ASC 842.
- **Deloitte Review of Practical Expedients Adopted**
  - 46 out of the 50 companies adopted **all** of the practical expedients (package)
  - 2 out of the 50 took the hindsight practical expedient.
  - 13 out of the 50 elected to take the option related to land easements

Lease Transition- Example

A Company enters into a five-year lease of equipment on January 1, 20X1. The annual lease payments of $45,000 are payable at the end of each year. The lease was originally accounted for as an operating lease. On January 1, 20X2 before transition adjustments, the lessee has **accrued rent on the lease of $25,000** reflecting the amount that has been expensed but not paid. At the time of transition there were 4 years left on the lease. The ROU asset is equal to the lease liability before adjustment for accrued rent. The adjustment removes the accrued rent, adjusting the ROU asset.

Assume no remaining balance of any lease incentives, and practical expedients elected

Yearly payment	45,000
Discount rate 6%	3.4651
PV of 4 payments	155,930

Yearly payment	45,000	
Discount rate 6%	3.4651	
PV of 4 payments	155,930	
ROU Asset	155,930	
Lease liability		155,930
Accrued rent	25,000	
ROU asset		25,000
To record the ROU asset, lease liability and to remove the previously accrued rent.		

Lease Refresher- Possible Elections

Practical Expedients- Recognition

- **Use of the Risk-free Rate -** Election only applies to private entities. Use a risk-free rate, for example, a U.S. Treasury obligation, to discount the lease liability and avoid the more complicated calculation of its incremental borrowing rate.
  - Entities should be aware that the lower the discount rate the higher the liability.
  - Entities may now elect by class of asset. (ASU 2021-09)

Lease Refresher- Practical Expedients

Practical Expedients- Recognition

Short Term Lease Exemption - lease with a term of 12 months or less as of the commencement date, without a purchase option, the lessee is reasonably likely to exercise.

- Entities are not required to capitalize and record those leases
- There are disclosure requirements related to this election. This election can be made by class of assets.

Deloitte Review of Fortune 125 Companies

- 41 of the 50 elected the short-term lease recognition exemption
- Only 21 of the 50 entities disclosed short term lease costs. The most common reason is materiality.

Lease Refresher- Practical Expedients

Practical Expedients- Recognition

Separation of Lease and Nonlease Components

- A lessee can elect **not** to separate the consideration into lease and nonlease components.

Deloitte Review of Fortune 125 Companies

- 37 of the 50 elected not to separate the lease and non lease components

ASU 2021-09 Leases, amendment

- ASC 842, *Leases,* provides for lessees to use a discount rate as follows:
  - Rate implicit in the lease
  - Incremental borrowing rate of implicit rate is not determinable
  - Nonpublic entities may elect to use a risk-free rate and disclose this as an accounting policy election
- Risk free rate was an **entity wide** election until this amendment.
- FASB decided to provide more flexibility – risk free rate will result in a higher liability since rates are low. Sometimes it is challenging to determine an incremental borrowing rate.
- Amendment has made this an election by **class of assets**

ASU 2021-05, Lessor Accounting

- July 19, 2021, the FASB issued ASU 2021-05, *Leases (Topic 842): Lessors—Certain Leases with Variable Lease Payments*
- Requires a lessor to classify a lease with variable lease payments (that do not depend on a rate or index) as an operating lease on commencement date if classifying the lease as a sales-type or direct financing lease would result in a selling loss.
- Effective for fiscal years beginning after December 15, 2021, for all entities, and interim periods within fiscal years beginning after December 15, 2022, for all nonpublic business entities.

Lease Refresher - Considerations

Materiality- The FASB's basis for conclusions (BC421) discuss how IFRS allows for the establishment of a materiality threshold of $5,000 or less for leases that would not be recognized.

- The FASB included no such threshold. FASB observed that, in addition to accounting for some leases at a portfolio level, entities will likely be able to adopt reasonable capitalization thresholds

Related Party Leases- leases between related parties should be classified in accordance with the lease criteria applicable to all other leases on the basis of the legally enforceable terms and conditions of the lease.

- Entities should assess the need for disclosures
- **NEW!** FASB approves practical expedient for entities under common control. Expected to be effective for years beginning after 12/15/23.

FASB Targeted Relief for Lessees in Private Companies

- **NEW!** FASB approves practical expedient for entities under common control. NFP that are conduit bond obligors are not eligible.
- 2 narrowly focused practical expedients

1. Entities under common control- if the lease is not documented in writing then the same “legally enforceable” standard must be met. This could be costly.
    - If leases are in writing the need to determine legal enforceability is not required. Look to terms and conditions in writing.
2. Amortization of leasehold improvements- amortize over useful life. If the lease terminates before that time LHI are derecognized and a equity transfer to the lessor results

Lease Refresher- Basics

Definition of a lease:

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.

1. **Lease-** the contract needs to convey the right to **control** the use of an **identified** asset. Customer must have **both**:
   - right to obtain substantially all of the economic benefits from use of identified asset
   - right to direct the use of the identified asset

Lease Refresher- Basics

- A customer does not have the right to use an identified asset if the supplier has the substantive right to substitute the asset throughout the period of use.
- A supplier’s right to substitute an asset is substantive only if both of the following conditions exist:
  - The supplier has the practical ability to substitute alternative assets throughout the period of use
  - The supplier would benefit economically from the exercise of its right to substitute the asset
  - Protective rights are ok

Lease Refresher- Basics

- **Lessees.** Services should be separated from the leased space and recognized separately. **ELECTION:**
  - ASC 842 allows an entity to choose **not** to separate the lease and nonlease components.
  - The guidance states provides specifically for new leases but does not say whether the lessee may elect the accounting policy not to separate for the existing leases in calculating the lease liability at transition.

Lease Refresher- Basics

Taxes and Insurance

- Lease payments for taxes and insurance are not a lease component. They may be included in a lease liability and ROU asset.
- Who pays the bill does not matter (reimburse lessor or paying a third party of the lessor's behalf).
- Deciding factor is whether the **payments are fixed or variable**
  - Payments are fixed- should be included in contract consideration as a fixed lease payments. Allocate to the lease and nonlease components.
  - Payments are actual amounts – considered variable lease payments not tied to a rate or index and they are **excluded** from the ROU asset and liability. Expense as incurred.

Lease Refresher- Basics

Lease Term

- Begins at commencement and includes rent free periods. Includes:
  - Noncancellable period
  - Periods under an option to extend the lease if the lessee is reasonably certain to exercise that option
  - Periods under an option to terminate the lease if the lessee is reasonably certain not to exercise that option
  - Periods under an option to extend (or not to terminate) controlled by the lessor.

Lease Refresher- Basics

- Reasonably certain- FASB describes as a high threshold, such as a probability exceeding 75-80 percent.
- Consider all contractual provisions, including renewal and termination options that are reasonably certain of exercise by the lessee
- If a renewal option is controlled by the lessor, include that renewal period in determining the lease term.
- Entity must use judgment to determine whether an option controlled or effectively controlled by a third party should be reflected in the lease term.

Lease Refresher- Basics

- Assessment to exercise/ not exercise option should **not** be based solely on the lessee's intentions, past practices, or estimates.
- Management should focus on the factors that create economic incentive for the lessee, including contract, asset, entity, or market-based factors.
- When assessing the length of the noncancellable period of a lease, an entity should apply the definition of a contract to determine whether a contract (lease) is enforceable.
- Lease is no longer enforceable when both the lessee and the lessor each have the right to terminate the lease without permission from the other party with no more than an insignificant penalty.

Example

A bakery enters into an agreement with a lessor for 60 months. At the end of the period of time the lessor can unilaterally terminate the lease. If the lessor does not terminate the lease it continues for another 24 months. The entity will record an 84-month lease since the optional period is controlled by the lessor.

Lease Refresher- Basics

Fiscal funding clause

- Provides for the cancellation of the lease if the legislature or other funding authority does not appropriate the funds necessary for the government to fulfill its obligations
- Evaluate whether it is more than remote that a lessee will exercise the clause.
- If exercise is more than remote, only the periods for which exercise is remote should be included in the lease term.

Calculating the Leased Asset and Liability- Lessee

Finance or Operating Lease -If any are met it is a finance lease

1. Lease transfers ownership of the asset to the lessee by end of the lease term.
2. Lease grants the lessee an option to purchase the underlying asset that the lessee is reasonably certain to exercise
3. Lease term is for the major part of the remaining economic life of the underlying asset.
   - If the date falls within the last 25% of the total economic life of the asset this is not used.
4. PV of the sum of the lease payments and any residual value guaranteed by the lessee that is not already reflected in the lease payments equals or exceeds substantially all of the fair value of the underlying asset.
5. Underlying asset is of such a specialized nature that it is expected to have no alternative use to the lessor at the end of the lease term.

Calculating the Leased Asset and Liability- Lessee

Example analysis

1. Lessee enters into a 10-year lease for equipment. The equipment has an economic life of 12 years. The lease payments are $9,000. The controller calculated the PV of the payments at $69,500. The fair value of the equipment was $75,000 at commencement. Should the controller classify this lease as an operating or finance lease.
   - Lease term is for 83% of the economic useful life of the asset
   - PV of lease payments is 92% of the fair value of the underlying asset.
2. Lease of a building where the lease is 10-years but the useful life of the asset is 30-years and the PV of the lease payments are approximately 30% of the fair value of the asset. Is this an operating lease or a finance lease?

Calculating the Lease Liability- Lessee

Initial Measurement of Lease liability is sum of:

- 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 rate such as the consumer price index or a market interest rate. This is **measured using the index or rate at the commencement date.**
- Fees paid to the owners of a special-purpose entity for structuring the transaction.
- Amounts probable of being owed by the lessee under a residual value guarantee.
- Exercise price of a purchase option -reasonably certain that the lessee will exercise
- Payments for penalties for terminating the lease if the lase term reflects the lessee exercising an option to terminate the lease.

Calculating the Lease Liability- Lessee

Fixed Lease payments

- Payments required by the terms of the contract. Can be fixed, in-substance fixed or variable.
- If a lease includes a payment of taxes and insurance along with the lease payment, it is fixed. And it is not a separate component of the lease. Therefore, it's included.
- Leasehold improvement payments may also be included. The lessee will determine whether the leasehold improvements belong to the lessor.
    - If they do not, then they would not be included.
    - Diversity in practice. Generally excluded. The lessee should consider whether they are required to be paid under the lease. If not, then excluded.
    - If they could be used by future tenants and are a required part of the lease payment then include

Calculating the Lease Liability- Lessee

Variable Lease payments

- If payments are **tied to a rate or index** then they are included in the liability
- Often variable lease payments are tied to performance such as a percentage of revenue
- Sometimes they are based on the usage of an asset. Car loans have features like this where if milage is too high an additional payment results

Calculating the Lease Liability- Lessee

Variable Lease payments- Example

- A lessee enters into an agreement to lease space in a building. The contract calls for an escalation rate equal to the 5-year US Treasury at the date of the lease commencement. The rate was 3.5%. The initial rent was $13,000. The controller calculated the following.

Year 1	13,000
Year 2	13,455
Year 3	13,926
Year 4	14,413
Year 5	14,918

- The leased liability equals the sum of the payments (including escalation) over the period.
- A remeasurement does **not** occur, even if the Treasury rate changes.

Calculating the Lease Liability- Lessee

Variable Lease payments- Examples

Change in the CPI

A lessee enters into an agreement to lease space in a building. The contract calls for an escalation rate equal to the **increase** in the CPI at the date of the lease commencement. The initial rent was $13,000. The controller had no calculation to make because the change in the CPI is not known at the commencement of the lease.

In-substance fixed payments

Lessee enters into an agreement that calls for increase each year of the greater of 1.5% of revenue or 2% of the previous year's lease payments. Since there is a floor of 2% of the previous year's lease payments that would be calculated and used in the calculation of the liability.

Calculating the Lease Liability- Lessee

Residual Value Guarantee

- Guarantee to the lessor that the value of the asset will be at least a certain amount at the end of the lease.
- Guarantees may be made the lessor or by a 3rd party.
- Only the amount **probable** of being paid under the guarantee is included in the lease liability and ROU asset.
- Important consideration determining lease classification- in that analysis use the full amount, not just the probable amount.

Calculating the Lease Liability- Lessee

Discount Rate

The discount rate used to determine the present value of the lease payments is determined with the following priority:

- **Lessor's Implicit Rate** – rate of interest that causes the aggregate present value of the lease payments and the amount that the lessor expects to derive from the underlying asset following the end of the lease term to equal:
  - FV of the underlying asset less any related investment tax credit retained
  - Any deferred initial direct costs of the lessor
- Not likely that the implicit rate will be readily available

Calculating the Lease Liability- Lessee

Discount Rate

The discount rate -priority (con't):

- **Lessee's Incremental Borrowing Rate** – rate of interest lessee would have to pay to borrow on a **collateralized** basis over a similar term in similar economic conditions.
- Determine either lease by lease or on a portfolio basis (should not yield materially different results)
- **Risk Free Discount Rate**
  - This election can be made by asset classification.
  - FASB compares this to US Treasury Rate, others may look to the Applicable Federal Rate used by the IRS.

Calculating the Leased Asset- Lessee

Initial Measurement of the Right of Use Asset

- Amount of the initial measurement of the lease liability
- Any lease payments made to the lessor at or before the commencement date less any lease incentives received
- Any initial direct costs incurred by the lessee as defined by ASC 842. These are much more restrictive than those under ASC 840

Example- Operating Lease (Lessee)

A Company entered into a 5-year lease for office space that was classified as an operating lease. The Company used an incremental borrowing rate of 5% to discount the lease since the rate implicit in the lease was not readily determinable. There were no initial direct costs, no prepayments before the commencement, no lease incentives and no option to purchase. The payments illustrated below were at fixed escalating amounts each year. No variable payments. The ROU asset and lease liability were the same.

	Interest	Liability Amortization	Payment
December 31			
20X1	4,250	10,750	15,000
20X2	3,713	12,288	16,000
20X3	3,098	13,902	17,000
20X4	2,403	15,597	18,000
20X5	1,623	17,377	19,000
	15,087	69,913	85,000

Example- Operating Lease (Lessee)

- The ROU asset was amortized using the SL method. Straight line expense makes the amortization different than the lease liability. The “plug” is the difference between the cash outlay and **SL lease expense**.

December 31	Interest	Lease Expense	ROU Amortization
20X1	4,250	17,000	12,750
20X2	3,713	17,000	13,288
20X3	3,098	17,000	13,902
20X4	2,403	17,000	14,597
20X5	1,623	17,000	15,377
	15,087	85,000	69,913

Example- Operating Lease (Lessee)

- Journal entries for the first-year follow:

1/1/X1	Record the operating lease			
	ROU Asset		69,913	
	Lease liabiity			69,913
12/31/X1	Record the 1st year amortization and payment of cash to the lessor.			
	Lease expense		17,000	
	Lease liability		10,750	
	ROU asset			12,750
	Cash			15,000

Accounting for a Purchase Option- Example

Lessee enters into 5-year lease of equipment. Annual payments are $59,000 at the end of the year. No initial direct costs. The lessee has an option to purchase the equipment for $5,000. The lessee has a significant economic incentive to exercise the purchase option. Fair value at the commencement of the lease is $250,000. The estimated useful life is **7 years**. The rate implicit in the lease is 6.33%. This lease is classified as a finance lease.

Payment Y 1	59,000			
Payment Y 2	59,000			
Payment Y 3	59,000			
Payment Y 4	59,000			
Payment Y 5	59,000			
Purchase option	5,000			
	300,000			
Discounted at 6.33%	(50,000)			
	250,000			
ROU Asset	250,000			
Lease liability		250,000		
Amortization over 7 years since there is an economic incentive to purchase.				
At the end of year 5 the lessee pays the lessor $5,000.				
Lessee can choose to present the ROU asset in property or separately.				

Donated Rent

- ASU 842 defines a lease as a contract that provides the use of identified property and equipment for a period of time in exchange for consideration. No consideration- no lease.
- Use of space at below market value. Bifurcate into the lease and donation components
- The amount of the contract that represents consideration is considered the lease and is account for under ASC 842. Remainder is a donation.
- When the contract specifies a certain number of periods, record the fair value of the use of the property as a donor restricted (time) contribution and a receivable.
- With each period, the restriction is released, and the net assets are reclassified to the "without donor restriction" category.

Example - Below Market Rent (con't)

Operating Lease

A social service agency (SSA) received the use of space from a business entity. The undiscounted value for the annual rental is $69,000 which is computed at $20,000 Y1, $23,000 Y2 and $26,000 Y3. Consideration paid each year is $5,000 each year so there is a lease component. The remainder is considered an unconditional promise to give which has been assessed as fully collectible. The space is usable in future periods, so the contribution is donor restricted.

Management evaluated the lease and determined it should be classified as an **operating lease**. They do not know the rate implicit in the lease, so SSA used its incremental borrowing rate of 5% to discount.

The first step is to separate the lease component from the contribution. This would be the amount attributable to the lease at fair value.

Example - Below Market Rent (con't)
Operating Lease

Calculating the ROU asset and lease liability	
Value of Lease	
Fair value of rental - 3 X $5,000	15,000
Discount at 5%	(1,380)
Discounted value of rental	13,620
Value of contribution	
Total fair value of arrangement	69,000
Less fair value rents to be paid	(15,000)
Amount attributable to contribution	54,000
Discount on contribution receivable	(5,250)
Discounted value of contribution	48,750

Example - Below Market Rent (con't)

The next chart illustrates the rent (lease) expense. In an operating lease under ASC 842 the lease is a consistent amount. Although it represents the same components of interest and amortization of the ROU asset, the distinction is that the ROU asset is adjusted so that the lease expense is ratable over the years. In the finance lease, the ROU asset is amortized at a consistent rate and the lease expense is not consistent.

Operating Lease	**Year 1**	**Year 2**	**Year 3**
Lease liability, beginning	13,620	9,290	4,750
Amortization treated as lease expense	670	460	250
Minus lease payment	(5,000)	(5,000)	(5,000)
	9,290	4,750	-
Right of Use Asset			
ROU asset, beginning	13,620	9,290	4,750
Less amortization - lease expense	(4,330)	(4,540)	(4,750)
	9,290	4,750	-
Lease expense is one consistent amount	5,000	5,000	5,000

$4,330
$4,540
$4,570

Example - Below Market Rent (con't)
Operating Lease

Analysis of contribution receivable

Contribution Receivable						
		Year 1		**Year 2**		**Year 3**
Contribution rec. beginning of year	$	54,000	$	36,190	$	20,000
Beginning of year discount		(5,250)		NA		NA
Amortization of discount (5%)		2,440		1,810		1,000
Fair value of donated lease rental		(15,000)		(18,000)		(21,000)
Contribution rec. end of year	$	36,190	$	20,000	$	-

Journal entries- operating lease		
ROU Asset (net of discount)	13,620	
Lease liability		13,620
Entry to record contribution		
Contribution receivable	48,750	
Contribution revenue - donor restricted		48,750

Example - Below Market Rent (con't)

Operating Lease

Journal entries for operating lease - 3 years						
	Year 1		Year 2		Year 3	
Portion that represents the lease						
Lease expense	5,000		5,000		5,000	
Lease liability	4,330		4,540		4,750	
Cash		5,000		5,000		5,000
ROU asset		4,330		4,540		4,750
Portion that represents the contribution						
Lease expense	15,000		18,000		21,000	
Contribution receivable		15,000		18,000		21,000
Net assets released from restriction (donor restrictions)	15,000		18,000		21,000	
Net assets released from restriction (w/o donor restrictions)		15,000		18,000		21,000
Contribution receivable	2,440		1,810		1,000	
Amortization of discount (cont. revenue with donor restrictions		2,440		1,810		1,000

Disclosures

Disclosures - Qualitative Information, Lessee

- Information about the nature of leases and subleases including:
- General description
- Basis on which variable lease payments are determined
- Existence and terms and conditions of options to extend or terminate the lease. The narrative should discuss those that are included in ROU assets and liabilities as well as those that are not.
- Existence and terms and conditions of residual value guarantees
- Restrictions or covenants imposed by leases
- Information about leases that have not commenced but that create significant rights and obligations

Disclosures - Qualitative Information, Lessee

- Information about significant assumptions and judgments made in applying the standard which includes:
  - Whether the contract contains a lease
  - Allocation of consideration in a contract between leases and nonlease components
  - Determination of the discount rate
  - Main terms and conditions of any sale and leaseback transactions
  - Whether an accounting policy was made for short term lease exemption.
  - If the short-term lease expense does not reflect the lessee's short term lease commitments a lessee should disclose that fact and the amount of the short-term commitments

Disclosure Requirements- Common Control Practical Expedient Adopted

- Lessee adopts practical expedient related to amortization of leasehold improvements
    - The unamortized balance of the leasehold improvements at the balance sheet date
    - The remaining useful life of the leasehold improvements
    - The remaining lease term

Disclosures - Significant Judgments and Estimates

Example Footnote 1:

The present value of the lease payments is calculated using the incremental borrowing rate for operating and finance leases, which was determined using a portfolio approach based on the rate of interest that we would have to pay to borrow an amount equal to the lease payments on a collateralized basis over a similar term. We use the unsecured borrowing rate and risk-adjust that rate to approximate a collateralized rate which will be updated on a quarterly basis for measurement of new lease liabilities.

Example Footnote 2:

For most leases the implicit rate is not readily determinable. Accordingly, we use a discount rate in determining the present value of future payments based on the yield-to-maturity of our secured publicly traded debt instruments interpolating the duration of the debt to the term of the executed lease.

Disclosures - Significant Judgments and Estimates

Example Footnote 3:

The lease liabilities are measured at the lease commencement date and determined using the present value of the minimum lease payments not yet paid and the Organization's incremental borrowing rate, which approximates the rate at which the we could borrow, on a secured basis. The interest rate implicit in the lease is generally not determinable in transactions where the Organization is the lessee.

Example Footnote 4:

The Organization generally uses its fully collateralized incremental borrowing rate as of the commencement date to calculate and record the lease. The incremental borrowing rate is influenced by factors such as credit rating and lease term and therefore, may differ for individual leases, embedded leases or portfolios of leased assets.

Disclosures - Quantitative Information, Lessee

- Finance lease expense segregated between amortization of ROU asset and interest on lease liabilities
- Operating lease expense
- Short term lease expense and disclosure where future significant ST lease commitments are known.
- Variable lease expense
- Sublease income

Disclosures - Quantitative Information, Lessee

- Weighted average discount for finance and operating leases as of the reporting date
- Gains and losses arising from sale and leaseback transactions
- Related party disclosures
- Maturity analysis of lease liabilities showing undiscounted cash flows on an annual basis for each of the first 5 years and total of remaining as well as reconciling the undiscounted cash flows and lease liabilities recognized in the balance sheet.

Short Term Lease- Example

The Bay Street Advocacy Group (BSAG) elects to apply the short-term lease measurement and recognition exemption to its office equipment. For the majority of the reporting period ending 12/31/X1, there were only two short-term leases in that class. However, on 12/27/X1, BSAG entered into 8 new lease agreements for office equipment, and they all qualify for the short-term lease measurement and recognition exemption. The short-term lease expense for the reporting period ending 12/31/X1 was $30,000, but the total short-term lease payments for the following year will be $120,000.

Disclosure Example

- Following are excerpts from Microsoft Corporation's June 30, 2022 year end 10-K filing
- FASB did not provide nonpublic entities with the opportunity for reduced disclosures, so these are excellent examples.

Accounting Policy- Lessee

Leases

We determine if an arrangement is a lease at **inception**. Operating leases are **included** in operating lease right-of-use ("ROU") assets, other current liabilities, and operating lease liabilities in our consolidated balance sheets. Finance leases are **included** in property and equipment, other current liabilities, and other long-term liabilities in our consolidated balance sheets. ROU assets represent our right to use an underlying asset for the lease term and lease liabilities represent our obligation to make lease payments arising from the lease. Operating lease ROU assets and liabilities are **recognized** at **commencement date** based on the present value of lease payments over the lease term. As most of our leases do not provide an implicit rate, **we generally use our incremental borrowing rate** based on the estimated rate of interest for collateralized borrowing over a similar term of the lease payments at commencement date.

Accounting Policy- Lessee

Leases (con’t)

The operating lease ROU asset also includes any lease payments made and excludes lease incentives. Our lease terms may include options to extend or terminate the lease when it is reasonably certain that we will exercise that option. Lease expense for lease payments is recognized on a **straight-line basis** over the lease term.

We have lease agreements with **lease and non-lease components**, which are generally **accounted for separately**. **For certain equipment leases, such as vehicles, we account for the lease and non-lease components as a single lease component**. Additionally, for certain equipment leases, **we apply a portfolio approach to effectively account for the operating lease ROU assets and liabilities.**

Disclosures Related to Income Statement- Lessee

Note 14 Leases

We have operating and finance leases for datacenters, corporate offices, research and development facilities, Microsoft Experience Centers, and certain equipment. Our leases have remaining lease terms of 1 year to 19 years, some of which include options to extend the leases for up to 5 years, and some of which include options to terminate the leases within 1 year.

The components of lease expense were as follows (millions):

Year ended June 30,	2022	2021	2020
Operating Lease Cost	2,461	2,127	2,043
Finance Lease Cost			
Amortization of right-of-use assets	980	921	611
Interest on lease liabilities	429	386	336

Financial Statement Presentation- Lessee

- Deloitte Review of **50** Fortune 125 Companies noted:
  - **ROU Assets- Operating leases-** 19 respondents presented the information in its own line item, 30 in other assets and 1 in property, plant and equipment.
  - **ROU Assets- Finance leases-** 27 respondents presented information within property, plant and equipment. The remainder did not disclose finance leases.
  - **Operating Lease liabilities (current)-** 11 of respondents presented information in its own line item and 39 within an existing line item.
  - **Operating Lease liabilities (noncurrent)-** 18 respondents presented information in its own line item and 32 within an existing line item.
  - **Finance Lease liabilities (current and noncurrent)-** 2 respondents presented finance leases on a separate line (both). The remaining disclosed within the existing debt line item or other liabilities line item.

Financial Statement Presentation- Lessee

Balance Sheet

- ROU asset separate from other assets and finance leases separated from operating leases
- Lease liabilities separate from other liabilities and finance leases separated from operating leases
- Alternatively, present the ROU assets with assets which are owned and disclose information in the notes about where the information is located on the balance sheet

Financial Statement Presentation- Lessee

Microsoft Corporation

BALANCE SHEETS (In millions)				
June 30,		2022		2021
Assets				
Current assets:				
Cash and cash equivalents	$	**13,931**	$	14,224
Short-term investments		**90,826**		116,110
Total cash, cash equivalents, and short-term investments		**104,757**		130,334
Accounts receivable, net of allowance for doubtful accounts of $633 and $751		**44,261**		38,043
Inventories		**3,742**		2,636
Other current assets		**16,924**		13,393
Total current assets		**169,684**		184,406
Property and equipment, net of accumulated depreciation of $59,660 and $51,351		**74,398**		59,715
Operating lease right-of-use assets		**13,148**		11,088
Equity investments		**6,891**		5,984
Goodwill		**67,524**		49,711
Intangible assets, net		**11,298**		7,800
Other long-term assets		**21,897**		15,075
Total assets	$	**364,840**	$	333,779

		2022		2021
Liabilities and stockholders' equity				
Current liabilities:				
Accounts payable	$	**19,000**	$	15,163
Current portion of long-term debt		**2,749**		8,072
Accrued compensation		**10,661**		10,057
Short-term income taxes		**4,067**		2,174
Short-term unearned revenue		**45,538**		41,525
Other current liabilities		**13,067**		11,666
Total current liabilities		**95,082**		88,657
Long-term debt		**47,032**		50,074
Long-term income taxes		**26,069**		27,190
Long-term unearned revenue		**2,870**		2,616
Deferred income taxes		**230**		198
Operating lease liabilities		**11,489**		9,629
Other long-term liabilities		**15,526**		13,427
Total liabilities		**198,298**		191,791
Commitments and contingencies				
Stockholders' equity:				
Common stock and paid-in capital – shares authorized 24,000; outstanding 7,464 and 7,519		**86,939**		83,111
Retained earnings		**84,281**		57,055
Accumulated other comprehensive income (loss)		**(4,678)**		1,822
Total stockholders' equity		**166,542**		141,988
Total liabilities and stockholders' equity	$	**364,840**	$	333,779

Disclosures- Balance Sheet, Lessee

Supplemental balance sheet information related to leases was as follows				
(In millions, except lease term and discount				
June 30,		**2022**		**2021**
Operating Leases				
Operating lease right-of-use assets	**$**	**13,148**	$	11,088
Other current liabilities	**$**	**2,228**	$	1,962
Operating lease liabilities		**11,489**		9,629
Total operating lease liabilities	**$**	**13,717**	$	11,591
Finance Leases				
Property and equipment, at cost	**$**	**17,388**	$	14,107
Accumulated depreciation		(3,285)		(2,306)
Property and equipment, net	**$**	**14,103**	$	11,801
Other current liabilities	**$**	**1,060**	$	791
Other long-term liabilities		**13,842**		11,750
Total finance lease liabilities	**$**	**14,902**	$	12,541

Weighted Average Remaining Lease Term		
Operating leases	**8 years**	8 years
Finance leases	**12 years**	12 years
Weighted Average Discount Rate		
Operating leases	**2.1%**	2.2%
Finance leases	**3.1%**	3.4%

Example Calculation- Weighted Average Cash Flow

Weighted Average Lease Term

	Lease liability at 12/31/X1	Percent of total lease liability	Months remaining on the	Weighted Average	
Operating lease 1	45,440	14.88%	24	3.572	
Operating lease 2	125,885	41.23%	51	21.026	
Operating lease 3	68,970	22.59%	12	2.711	
Operating lease 4	39,850	13.05%	15	1.958	
Operating lease 5	25,200	8.25%	25	2.063	
Total lease liability	305,345	100.00%		31.33	2.610731304

The weighted average remaining lease term for operating leases was 2.6 years or 31.33 months.

Example Calculation- Weighted Average Cash Flow

Weighted Average Discount Rate

	Lease 1 Remaining Lease Payments	Lease 2 Remaining Lease Payments	Lease 3 Remaining Lease Payments	Lease 4 Remaining Lease Payments	Lease 5 Remaining Lease Payments	Total remaining lease payments
20X2	22,720	29,616	68,970	31,872	12,096	165,274
20X3	22,720	29,616		7,978	12,096	72,410
20X4		29,616			1,008	30,624
20X5		29,616				29,616
20X6		7,421				7,421
	45,440	125,885	68,970	39,850	25,200	305,345
Percentage lease remaining payments to total	14.88%	41.23%	22.59%	13.05%	8.25%	100.00%
Discount rate at commencement	4.20%	4.40%	5.00%	3.75%	4.50%	
Weighted average discount rate	0.63%	1.81%	1.13%	0.49%	0.37%	4.43%

The weighted average discount rate for operating leases was 4.43%

Disclosures- Balance Sheet, Lessee

The following table outlines maturities of our lease liabilities as of June 30, 2022		
(In millions)		
Year Ending June 30,	Operating Leases	Finance Leases
2023	$ 2,456	$ 1,477
2024	2,278	1,487
2025	1,985	1,801
2026	1,625	1,483
2027	1,328	1,489
Thereafter	5,332	9,931
Total lease payments	15,004	17,668
Less imputed interest	(1,287)	(2,766)
Total	$ 13,717	$ 14,902

As of June 30, 2022, we have additional operating and finance leases, primarily for datacenters, that have not yet commenced of $7.2 billion and $8.8 billion, respectively. These operating and finance leases will commence between fiscal year 2023 and fiscal year 2028 with lease terms of 1 year to 18 years.

Financial Statement Presentation- Lessee

- **Statement of Cash Flows**
  - Cash payment for the principal portion of the lease liability arising from finance leases- in financing activities
  - Cash payment for the interest portion of the lease liability arising from operating leases- in operating activities
  - Cash payment arising from operating leases- in operating activities
  - Variable lease payments and short-term lease payments not included in the lease liability within operating activities
  - Excerpt from Microsoft Corporation’s footnotes follows.

Cash Flow Disclosure -Lessee

Supplemental cash flow information related to leases was as follows (in millions):

Year ended June 30,	2022	2021	2020
Cash paid for amounts included in the measurement of lease liabilities			
Operating cash flows from operating leases	2,368	2,052	1,829
Operating cash flows from finance leases	429	386	336
Financing cash flows from finance leases	896	648	409
Right of Use assets obtained in exchange for lease obligations			
Operating leases	5,268	4,380	3,677
Finance leases	4,234	3,290	3,467

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