ASC 842/IFRS 16 Finance lease example

EZLease

Copier lease example

Let's take as an example a copier lease. The copier costs $7,000 to purchase new; the lessor is willing to lease it to you for 3 years at a price of $230 per month, paid at the beginning of each month. Of that, $32 is identified as the cost of maintenance. If you borrowed money for three years to finance the purchase of the copier, your incremental borrowing rate would be 4%. If you bought the copier, you would normally depreciate it over 5 years. There is an option to buy the copier at the end of the lease for $1,000, which is estimated to be its fair market value at that time, however you have determined that you are reasonably certain you won't exercise this option. You have no initial direct costs; you don't know what, if any, initial direct costs the lessor has.

Buy copier

$7,000

to purchase new

If you bought the copier, you would normally depreciate it over 5 years

Lease copier

3 years

lease at a price of $230 per month

$32

maintenance cost per month

4%

interest

ASC 842 only

First, we perform the five capital vs. operating tests. There is no automatic transfer as part of the lease agreement, so criterion #1 is not met. Exercise of the purchase option is not reasonably certain, so criterion #2 is not met. The lease term of 3 years is less than substantially all of the economic life of 5 years (using 75% as benchmark), so criterion #3 is not met.

IFRS 16 only

Under IFRS 16 there is a single accounting model for leases - there is no concept of an on-balance-sheet operating lease. In this example, the lease will be classified as a Finance lease.

Determining the present value of the rent takes a few more steps. First, we exclude the maintenance cost which is considered as a non-lease component. Thus, the monthly payment for the lease component is $198 per month. At your incremental borrowing rate of 4%, the present value of the rent is $6,728.77, which is more than 90% of the fair value of the asset. Thus, criterion #4 is met and the lease should be classified as a finance lease under the standard as the present value (PV) is higher than substantially all of the fair market value (typically the threshold is set as 90%). Also, this is not a short-term (12 months or less) lease; therefore, the lease must be reported on the balance sheet with a right-of-use asset and liability. (The "specialized asset" test is not met and is not necessary, since it has already failed test #4.)

Since you don't know the lessor's initial direct costs, you cannot determine the implicit interest rate in the lease. Therefore, the discount rate for the lease is your incremental borrowing rate of 4%.

In the first month, you set up a right-of-use asset and a liability, make the first rental payment, then accrue interest and depreciation:

Finance lease journal entries, first month:

Account	Debit	Credit
Initial capitalization		
Finance right-of-use asset	6,728.77	
Finance current liability		2,169.18
Finance long-term liability		4,559.59
Monthly rent payment		
Finance current liability	198.00	
Non-lease component	32.00	
Cash rent payment (finance)		230.00
Liability reclassification, long-term to current		
Finance long-term liability	182.80	
Finance current liability		182.80

Account	Debit	Credit
Interest accrual for the first month		
Interest expense	21.77	
Accrued interest		21.77
Depreciation accrual for first month		
Amortization expense	186.91	
Finance accumulated amortization		186.91

Note: The first rental payment (lease component only), since it is made on the first day of the lease, goes entirely into liability payment. In the following months, the interest accrued during the month is paid off by the rental payment, with the excess of rent over accrued interest going to principal (liability) reduction. (For certain leases with scheduled rent increases, the rent paid may be less than the accrued interest. This results in an increase to the outstanding liability, known as negative principal amortization.)

For this lease, the journal entries for month #2's rent payment would be:

Account	Debit	Credit
Finance current liability	176.23	
Accrued interest	21.77	
Non-lease component	32.00	
Cash rent payment (finance)		230.00

Each month, the rent payment is booked in the manner shown above, amortization and interest are accrued and expensed, and liability is reclassified from long-term to current. When the lease expires (or if it is terminated before its scheduled expiration date), the asset and liability are removed from the books, with a gain or loss recognized if the net asset and remaining liability are unequal. This is almost always the case if the lease is terminated early.

So as of the end of year 1 (assuming the lease commenced at the beginning of the year), your disclosure would be as follows:

The following is a schedule by years of minimum future payments on noncancelable finance leases as of December 31, 2021:

Account	
Year ending December 31	
2022	2,376
2023	2,376
Total minimum payments required	4,752
Less amount representing interest	192
Present value of net minimum lease payments	4,560

(ASC 842 and IFRS 16 do not require disclosure of future non-lease component payments. As such, the above reflects the lease component only.)

Note: This description applies to the rules set out in ASC 842 for U.S. accounting and IFRS 16 for international accounting. Under ASC 842/ IFRS 16, you must disclose a maturity analysis of your future lease payments separately from other liabilities.

To enter this lease in EZLease, follow these steps*:

- Enter a Lease Number or name
- Enter a Begin Date of January 1, 2021
- Double-click on the Base Term; in the box that appears, enter 36
- If not already displayed, click on the Main data tab, and in the Rent Steps grid, enter Gross Rent of 230
- Enter NL Comp #1 (non-lease component #1) of 32
- Enter an Economic Life of 60
- Enter an Incremental Borrowing Rate of 4
- Enter Fair Value of Building/Equipment as 7000
- Click Save Lease. Note that the system automatically classified this as a Finance lease at a discount rate of 4%.

Please also see our examples of operating lease accounting for ASC 840/IAS 17 and for ASC 842.

*Assumes ASC 842 or IFRS 16 implementation date on or before 1/1/2019.