ASC 842 Operating lease example

EZLease

Operating leases

The FASB decided to adopt a dual lessee accounting model, classifying leases in a similar manner to the previous requirements in US Generally Accepted Accounting Principles (US GAAP) for distinguishing between operating leases and capital leases, and to account for those two types of leases differently.

Under IFRS 16 there is a single accounting model for leases which is described under the Capital/Finance lease example. There are no Operating leases under IFRS 16.

Of the following five criteria, if any one is met, the lease would be classified as a finance lease. If none are met, the lease would be classified as an operating lease.

1 | Automatic transfer of ownership at the end of the lease.

2 | Purchase option that is reasonably certain to be exercised.

3 | The lease term is substantially all of the remaining economic life of the underlying asset.

4 | Present value (PV) of the lease payments (including any contractual obligation at end of lease) represents substantially all of the fair value of the underlying asset.

5 | The asset is of a specialized nature.

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Let's take as an example an office lease which starts on 1/1/2022 for a portion of an office building. It lasts for ten years and rent is due on the first day of each month. The first 5 years, the rent is $5,000 per month; the second five years, the rent increases to $6,000 per month. No services are provided with the lease.

The current cost of a commercial mortgage for 10 years is 4%.

In many cases, the "fair value" of a portion of a building is not easily determinable, because a part of a commercial building is rarely available for sale. If this is true, you may skip the present value test. Such leases will, as a rule, not convey ownership, so the only test left to determine whether the lease is finance is whether the lease term is 75% or more of the economic life (75% is almost universally used as the threshold for "substantially all" of the economic life). A building is typically assigned a life of 20 years or more, so this lease's 10-year term is considerably less than 75%, and the lease is considered operating. Since this is not a short-term (12 months or less) lease, the lease must be reported on the balance sheet with a right-of-use asset and liability which is the PV of the rental payments of $540,116.39.

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Account	Debit	Credit
Initial capitalization		
Operating right-of-use asset	540,116.39	
Operating current liability		39,310.85
Operating long-term liability		500,805.54
Monthly rent payment		
Operating current liability	3,216.28	
Operating lease cost	5,500.00	
Cash		5,000.00
Operating accumulated amortization		3,716.28
Liability reclassification, long-term to current		
Operating long-term liability	3,347.32	
Operating current liability		3,347.32

The accumulated amortization activity for the period is calculated as the sum of change in liability (rent paid of $5,000 less effective interest of $1,783.72) and the difference between cash and straight-line rent ($500). If a lease has initial direct costs or lease incentives to amortize, those are also included in the asset and are amortized straight-line over the lease term. Amortization and interest are not expensed explicitly but bundled together as "operating lease cost."

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You also need to disclose your future rent commitments. At the end of the first year, for example, you have four years of $5000 per month rent remaining, plus five years of $6000 per month.

The following is a schedule by years of minimum future rentals on noncancelable operating leases as of December 31, 2022:

Account	
Year ending December 31, 2022	
2023	60,000
2024	60,000
2025	60,000
2026	60,000
2027	60,000
Later years	288,000
Total minimum future payments required	600,000
Less imputed interest	99,914
Net present value of future lease payments	500,806

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

- ✓ Click 'Add new lease'

- ✓ Enter a Lease Number or name

- ✓ Enter the Begin Date as January 1, 2022

- ✓ Double-click on the Base Term box; in the dialogue that appears, enter 120

- ✓ On the Main Data Tab, enter Gross Rent on the first line of 5,000

- ✓ Enter a Step End date of Dec 31, 2025

- ✓ On the second rent line, enter Gross Rent of 6000; the Step End date matching the end of the lease will automatically be populated

- ✓ Enter Economic Life of 240 (20 years)

- ✓ Stay on Main data tab and enter an incremental borrowing rate of 4%

- ✓ Check the box that reads Fair Value Not Determinable

- ✓ Click Save Lease. Note that EZLease automatically classified this as an Operating lease.

*Assumes default system settings of an Implementation Date of 1/1/2022 and a 12/31 Year End.

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