



FAS 13 / IAS 17 - Capital lease example



Let's take as an example a copier lease, under the FAS 13 - IAS 17 accounting standards. The copier costs \$3,500 to purchase new; the lessor is willing to lease it to you for 3 years, starting in 2015, at a price of \$115 per month, paid at the beginning of each month. Of that, \$16 is identified as the cost of maintenance. If you borrowed money for three years, you would have to pay 8.5% interest. 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 \$500, which is estimated to be its fair market value at that time.

Buy copier

\$3,500

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 \$115 per month

\$16

maintenance cost per month

8.5%

interest

Option to buy the copier at the end of lease for \$500

First, we check the four capital vs. operating tests. There is no ownership transfer as part of the lease agreement, so criterion #1 is not met. The purchase option is not a “bargain” as defined by FAS 13, so criterion #2 is not met. The lease term of 3 years is less than 75% of the economic life of 5 years, so criterion #3 is not met.

Determining the present value of the rents takes a few more steps. First, we eliminate the maintenance cost; that is considered an “executory cost,” and excluded from this calculation. Thus, the net rent is \$99 per month. At your incremental borrowing rate of 8.5%, the present value of the rent is \$3,158.35, which is more than 90% of the fair value of the asset. Thus, criterion #4 is met and the lease is capital.

The first month, you set up an asset and an obligation, make the first rental payment, then accrue interest and depreciation:

Sample capital lease journal entries, first month:

Account	Debit	Credit
Initial booking		
Capital lease asset	3,158.35	
Current obligation		980.40
Long term obligation		2,177.95
Monthly rent payment		
Current obligation	99.00	
Executory expense	16.00	
Cash		115.00
Obligation transfer, long term to current		
Long term obligation	83.58	
Current obligation		83.58

Account	Debit	Credit
Interest accrual for first month		
Interest expense	21.67	
Accrued interest		21.67
Depreciation accrual for first month		
Depreciation expense	87.73	
Accumulated depreciation		87.73

Note: The first rental payment, since it is made on the first day of the lease, goes entirely into obligation reduction. In 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 obligation reduction. (In certain leases with scheduled rent increases, the rent paid may be less than the accrued interest. This results in an increase to the outstanding obligation, known as negative principal amortization.)

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

Account	Debit	Credit
Current obligation	77.33	
Accrued interest	21.67	
Executory expense	16.00	
Cash		115.00

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

Note: You also need to disclose your future rent commitments, as well as the portion of future rent that is considered nonlease components and interest. At the end of the first year, for example, you have two years of \$115 per month rent remaining.

**So as of the end of year 1,
your disclosure would be:**

The following is a schedule by years of minimum future rentals on noncancelable capital leases as of December 31, 2015:

Account	
Year ending December 31,	
2016	1,380
2017	1,380
Total minimum payments required	2,760
Less executory costs	384
Net minimum lease payments	2,376
Less amount representing interest	198
Present value of net minimum lease payments	2,178

Note: This description applies to the rules set out in FAS 13 for U.S. accounting.

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

- ✓ Enter a Lease Number and/or name for the lease
- ✓ Enter a Begin Date of January 1, 2015
- ✓ Double-click on the box labeled Base Term; in the dialogue that appears, enter 36 months
- ✓ Leave Classification "To be classified" as EZLease will automatically classify this lease
- ✓ On the Main Data tab, in the first line of the Rent Steps grid, enter Gross Rent of 115.00
- ✓ Enter Executory cost of 16.00
- ✓ Enter Economic Life of 60
- ✓ On the Inception tab, enter an Incremental Borrowing Rate of 8.5
- ✓ Enter Fair Value of Building/Equipment of 3,500
- ✓ Click Save Lease
- ✓ Note that the lease is automatically classified as Capital and the Discount Rate is filled in

*Assumes default system settings of an Implementation Date of 1/1/2019 and a 12/31 Year End..

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