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, you would have to pay 4% 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 $1000, 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 check the five capital vs. operating tests. There is no ownership 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 75% of the economic life of 5 years, so criterion #3 is not met. (We are following the guidance in ASC 842-10-55-2 that says "one reasonable approach" to the lease term and present value tests is the 75% and 90% thresholds of FAS 13.)

IFRS 16 only

Under IFRS 16 there is a single accounting model for leases - there is no concept of finance lease/ operating lease. However, for purposes of this example, the lease will be described as a Finance lease.

IFRS 16 permits you to not elect to apply lease accounting for leases where the underlying asset is of low value and treat it similarly to an IAS 17 operating lease.

Determining the present value of the rents takes a few more steps. First, we eliminate the maintenance cost; that is considered a "nonlease component," and excluded from this calculation. Thus, the net rent 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 is finance. (The "specialized asset" test is not met and is not necessary.)

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%.

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

Sample finance lease journal entries, first month:

Account	Debit	Credit
Initial booking		
Right-of-use asset	6,728.77	
Current liability		2,169.18
Long-term liability		4,559.59
Monthly rent payment		
Current liability	198.00	
Nonlease component expense	32.00	
Cash		230.00
Liability reclassification, long term to current		
Long-term liability	182.80	
Current liability		182.80

Account	Debit	Credit
Interest accrual for first month		
Interest expense	21.77	
Accrued interest		21.77
Depreciation accrual for first month		
Depreciation expense	186.91	
Accumulated depreciation		186.91

Note: The first rental payment, since it is made on the first day of the lease, goes entirely into liability payment. The ASC 842/IFRS 16 standards actually call for setting up a different asset and liability, with the rent payment recognized as part of the initial setup of the lease, but the transactions above illustrate more clearly the activity involved. 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 principal (liability) 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 liability, known as negative principal amortization.)

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

Account	Debit	Credit
Current liability	176.23	
Accrued interest	21.77	
Nonlease component expense	32.00	
Cash		230.00

Each month, the rent payment is booked in the manner shown above, depreciation 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 early terminated.

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

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 nonlease component payments.)

Notes: 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 have to 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 (nonlease component #1) of 32
- Enter an Economic Life of 60
- Click on the Inception tab
- Enter an Incremental Borrowing Rate of 4
- Enter Fair Value of Building/Equipment of 7000
- Click Save Lease. Note that the system automatically classified this as a Finance lease at a discount rate of 4%.

Please see also our examples of operating lease accounting for FAS 13/IAS 17 and for ASC 842.

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