



**ASC 842 Operating lease example**



# 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.

**There are 5 criteria that, if any one is met, the lease would qualify as a finance lease. If none are met, the lease would qualify as an operating lease.**

- 1** | Transfer of ownership
- 2** | Purchase option that is reasonably certain to be exercised
- 3** | The lease term is greater than a major part of the remaining economic life of the asset
- 4** | PV of the lease payments (plus residual value) is equal to or exceeds substantially all of the fair value
- 5** | Asset of a specialized nature

# Operating lease example

Let's take as an example an office lease 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, never 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. 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.

Account	Debit	Credit
<b>Initial booking</b>		
Right-of-use asset	540,116.39	
Current liability		39,310.85
Long term liability		500,805.54
<b>Monthly rent payment</b>		
Current liability	3,216.28	
Operating lease cost	5,500.00	
Cash		5,000.00
Accumulated depreciation		3,716.28
<b>Liability reclassification, long term to current</b>		
Long term liability	3,347.32	
Current liability		3,347.32

The accumulated depreciation activity for the period is calculated as the sum of change in liability (rent paid of 5,000.00 less effective interest of 1,783.72) plus the 500 difference between cash and straight-line rent. If a lease has initial direct costs or lease incentives to amortize, those are also included in the asset and the calculation of the depreciation. Depreciation and interest are not expensed directly, but only within the “operating lease cost.”

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. 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 operating leases as of December 31, 2021:**

<b>Account</b>	
<b>Year ending December 31,</b>	
<b>2022</b>	60,000
<b>2023</b>	60,000
<b>2024</b>	60,000
<b>2025</b>	60,000
<b>2026</b>	72,000
<b>Later years</b>	288,000
<b>Total minimum future payments required</b>	600,000
<b>Less imputed interest</b>	99,194
<b>Net present value of future lease payments</b>	500,806

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

- ✓ Enter a Lease Number or name
- ✓ Enter the Begin Date as January 1, 2021
- ✓ 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)
- ✓ Click on the Inception 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 1/1/2019 and a 12/31 Year End.

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