ASC Topic 842 - Accounting for Leases

The FASB's new lease accounting standard has rapidly approached for organizations with operating and finance leases. Under Accounting Standards Codification ("ASC") Topic 842, *Leases* (the "new standard"), all lease obligations (operating and finance) are required to be recognized as an asset and a liability on the statement of financial position for all non-public entities effective for fiscal periods beginning after December 15, 2021 (i.e., 2022 calendar year-ends and 2023 fiscal year-ends). Under previous Generally Accepted Accounting Principles ("GAAP"), capital leases were required to be recognized as an asset and a liability on the statement of financial position with future commitments related to operating leases being disclosed in the footnotes to the financial statements. The primary objective of this new standard is to provide users of financial statements with greater transparency relating to an organization's lease obligations.

The classification criteria for distinguishing between operating and finance leases is substantially similar to the classification criteria for distinguishing between operating and capital leases in previous GAAP. Both operating and finance leases require recognition of a right-of-use asset ("ROU asset") and a corresponding lease liability (appropriately classified with a current portion and long-term portion), initially measured at the present value of the future (unpaid) lease payments on the statement of financial position. If the organization has leases of less than twelve months, an accounting election can be made for short-term lease exemption. ROU assets and lease liabilities for operating leases must be reflected separately on the statement of financial position whereas finance leases may be included within property and equipment and other long-term liabilities. Furthermore, interest expense has to be recognized for finance leases.

The discount rate used for calculating the present value is the rate implicit in the lease unless the rate cannot be readily determined. In that case, the discount can be based on the lessee's incremental borrowing rate. Given the complexity of determining the implicit as well as the incremental borrowing rate, the new standard provides the ability for non-public lessees to use a risk-free rate provided it makes an accounting policy election by class of the underlying asset. Once the type of discount rate has been determined, organizations will discount the remaining payments on existing leases using the rate in place at the date of adoption of the new standard. After the date of adoption, new leases will be discounted using the rate in place at each such lease commencement date. In the event of significant modifications to the lease during the lease term, subsequent re-measurement of the ROU asset and lease liability may be necessary.

ASC Topic 842 provides organizations with two options for implementation. The first method permits the new lease standard to be implemented retrospectively at the beginning of the earliest comparative period presented in the financial statements. As an alternative transition method, organizations are permitted to apply the new standard to the current period only and present the prior period in accordance with the previous lease standard, ASC 840. Both methods of implementation will require disclosures in the notes to the financial statements. In addition, both methods may require a cumulative adjustment to net assets.

In summary, this accounting treatment for leases may result in a significant increase of reported assets and liabilities for lessees, which may impact financial ratios and compliance with contractual covenants, such as covenant requirements included in loan agreements. After implementation, the new standard will require ongoing compliance from organizations as well as internal control measures and procedures to ensure that all leases are identified and recorded accurately.

For illustrative purposes, we have provided examples of the recording of an operating lease and finance lease for lessees under ASC 842 on the following pages.

If you have any questions relating to ASC Topic 842, *Leases*, please contact your engagement partner.

Inputs*

- Commencement date: 12/31/22
- End date: 12/31/27
- Payment schedule: $100,000 annually on 1/1; Total payments of $500,000
- Assumed implicit rate of 7.5%
- Assumed to be a qualified lease under ASC 842

* These inputs will be used for the operating and finance lease illustrations below.

Step 1: Determine the contract is a lease

- FASB definition of a lease – a contract, or part of a contract, that conveys the right to control the use of identified property, plant, or equipment (an identified asset) for a period of time in exchange for consideration.
- Control over use of the asset means the lessee has:
  - The right to obtain substantially all of the economic benefits from the use of the asset and;
  - The right to direct the use of the asset

Step 2: Determine lease classification (operating or finance lease)

- A lease shall be classified as a finance lease when the lease meets any of the following criteria at lease commencement:
  - Transfer of ownership of underlying asset to lessee by end of term
  - Lease contains an option to purchase the underlying asset that the lessee is reasonably certain to exercise
  - Lease term is for the major part of the remaining economic life of the underlying asset (i.e. 75% or more)
  - Present value of the sum of the lease payments and any residual value guaranteed by the lessee that is not reflected in the lease payments equals or exceeds substantially all of the fair value of the underlying asset (i.e. 90% or more)
  - The underlying asset is of such a specialized nature that it is expected to have no alternative use to the lessor at the end of the lease term
- When none of the finance lease criteria are met, a lessee shall classify the lease as an operating lease

Step 3: Initial measurement (for both operating and finance leases)

The below illustrates the initial measurement of the ROU asset and lease liability at the commencement date of the lease. The illustration also assumes there are no upfront costs or incentives and no significant modifications of the lease or remeasurements of the ROU asset/lease liability during the term. The initial measurement is the same for both operating and finance leases.

Lease payment	Present value
$100,000 – Year 1	**$ 100,000**
$100,000 – Year 2	**$ 93,023**
$100,000 – Year 3	**$ 86,533**
$100,000 – Year 4	**$ 80,496**
$100,000 – Year 5	**$ 74,880**
$500,000 – Total payments	**$ 434,933 – Initial measurement**

To record lease commencement at 12/31/22:

Account	Debit	Credit
ROU Asset	**$ 434,933**	
Lease Liability		**$ 434,933**

Step 4: Record activity (See Step 4a for Operating Lease and Step 4b for Finance Lease)

Step 4a: Operating Lease example: To record cash payments, operating lease expense and amortization of ROU Asset/Lease Liability

For operating leases with equal installments, the new standard effectively expenses the cash payments directly to the operating lease expense account on the statement of activities. The ROU asset and lease liability will be amortized over the lease term against one another in accordance with the present value amortization table.

Year	Lease Payment	Operating Lease Expense	ROU Asset, at Present Value	Lease Liability, at Present Value	Net Change in Present Value (Annual Amortization)
12/31/22			$ 434,933	$ 434,933	
12/31/23	$ 100,000	$ 100,000	334,933	334,933	$ 100,000
12/31/24	100,000	100,000	241,909	241,909	93,023
12/31/25	100,000	100,000	155,376	155,376	86,593
12/31/26	100,000	100,000	74,880	74,880	80,496
12/31/27	100,000	100,000	-	-	74,880
Total	$ 500,000	$ 500,000	$ 434,933	$ 434,933	

Below is a sample journal entry to record the 2025 activity for the operating lease under the new standard:

To record 2025 lease activity:

Account	Debit	Credit
Operating Lease Expense	$ 100,000	
Cash		$ 100,000
Lease Liability	$ 86,593*	
ROU Asset		$ 86,593*

***Present Value at 12/31/24 – Present Value at 12/31/25 ($241,909-$155,376=$86,593)**

Step 4b: Finance Lease example: To record cash payments, interest expense and amortization of ROU Asset/Lease Liability

Finance leases under ASC 842 are treated similarly to capital leases under ASC 840. The ROU asset is amortized to the statement of activities on a straight-line basis over the economic life of the asset. Interest expense is recorded over the term of the lease as incurred.

Year	ROU Asset, at Present Value	Accumulated Amortization of ROU Asset	ROU Asset Amortization Expense-Straight-Line	Lease Payment	Lease Liability, at Present Value	Interest Expense
12/31/22	$ 434,933				$434,933	
12/31/23		$ (86,987)	$ 86,987	$100,000	360,053	$ 25,120
12/31/24		(173,974)	86,987	$100,000	279,557	19,504
12/31/25		(260,961)	86,987	$100,000	193,023	13,467
12/31/26		(347,948)	86,987	$100,000	100,000	6,976
12/31/27	-	(434,933)	86,987	$100,000	-	-
Total	$434,933	$ (434,933)	$434,933	$500,000	$434,933	$ 65,067

Step 4b: Finance Lease example: To record cash payments, interest expense and amortization of ROU Asset/Lease Liability (continued)

Below is a sample journal entry to record the 2025 activity for the finance lease under the new standard:

To record 2025 lease activity

Account	Debit	Credit
Lease Liability	**$ 100,000**	
Cash		**$ 100,000**
Interest Expense	**$ 13,467***	
Lease Liability		**$ 13,467**
ROU Asset Amortization Exp.	**$ 86,987****	
ROU Asset		**$ 86,987**

***(Lease Liability at 12/31/24 – Lease Payment on 1/1/25) x Interest Rate**

($279,557-$100,00) x 7.5% = $13,467

****Initial measurement of ROU Asset/Economic Useful Life of Asset =**

($434,933/5 = $86,987)

****Economic useful life of asset: 5 years, straight-line method (for illustrative purposes)**