JO Knows How to Account for Finance Leases

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With the implementation of the new lease accounting standard upon us (Accounting Standards Codification 842, Leases (ASC 842)), and the impact that this new standard could potentially have on the financial statements for so many entities, we have so far focused on providing entities with a high level understanding of the new lease standard. Thus far in our series, we have discussed how to identify a lease, the various components of a contract containing a lease, and the key inputs (lease term, lease payments and discount rate) necessary to determine the type of lease and ultimately, calculate the right of use asset and lease liability.

Next up, we will take a look at finance leases under the new standard.

For lessees, leases are classified as either finance leases or operating leases. This assessment is performed on the lease commencement date, which is the date the underlying leased asset is made available for use by the lessee.

If a lease meets any of the five criteria set forth in the new standard, the lessee will classify the lease as a finance lease. The criteria, compared to legacy accounting for capital leases, are as follows:

Finance Lease (ASC 842)	Capital Lease (ASC 840)
The lease transfers ownership of the underlying asset to the lessee by the end of the lease term.	The lease transfers ownership of the property to the lessee by the end of the lease term.
The lease grants the lessee an option to purchase the underlying asset that the lessee is reasonably certain to exercise.	The lease contains a bargain purchase option.
The lease term is for the major part of the remaining economic life of the underlying asset	The lease term is equal to 75 percent or more of the estimated economic life of the leased property
The present value of the sum of the lease payments and any residual value guaranteed by the lessee that is not already reflected in the lease equals or exceeds substantially all of the fair value of the underlying asset.	The present value at the beginning of the lease term of the minimum lease payments equals or exceeds 90 percent of the excess of the fair value of the leased property to the lessor at lease inception.
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.	N/A

There is similarity in each of the first four criteria and thus it is likely that in most instances, a lease that was considered to be a capital lease under legacy accounting would be considered a finance lease under the new standard. The fifth and "new" criterion is only expected to be relevant on its own in limited situations.

One stark difference with the new standard is the removal of the so-called "bright lines" on the economic life and fair value tests. Those same thresholds (75% of the economic life; 90% of the fair value) are reasonable to use under the new standard, however, evaluating the third and fourth criteria should not be viewed simply as a pass/fail exercise. For example, historically it was not uncommon for a lease to be structured in such a way that the present value of the minimum lease payments was equal to 89.9% of the estimated fair value of the leased asset. Assuming no other criteria had been met, this would have resulted in operating lease classification – and perhaps more importantly to the lessee – kept the lease off the balance sheet. Under the new standard, a prudent person may conclude that 89.9% is in fact substantially all of the fair value of the leased asset, and therefore may classify the lease as a finance lease. Judgment will be involved in making this determination.

The initial accounting at lease commencement is the same for both finance leases and operating leases. The lessee will record a right of use asset and corresponding lease liability on the balance sheet. The lease liability is equal to the present value of the lease payments not yet paid. The right of use asset is equal to the lease liability plus initial direct costs paid plus prepaid lease payments less any lease incentives received.

Subsequent accounting will differ depending on whether the lease is classified as a finance lease or an operating lease, the latter of which will be covered in our next e-mail blast.

In a finance lease, the lease liability will be accounted for using the effective-interest method. Simply put, a portion of each payment is recorded as interest expense while the remainder reduces the lease liability. The final payment at the end of the lease term would reduce the remaining liability to zero. The right of use asset should be amortized (generally using the straight-line method) over the shorter of the useful life of the asset or the lease term. However, if the lease results in the transfer of ownership of the leased asset at the end of the lease term, or if there is a purchase option that the lessee is reasonably certain to exercise, the right of use asset should be amortized over the useful life of the asset. This is substantially the same as the accounting for the capital lease asset and related obligation for a capital lease under legacy accounting.

There are certain situations that may require reassessment after lease commencement. Some examples include modifications to the lease that are not accounted for as a separate contact, changes in the lease term, or changes in the conclusion about whether the exercise of a purchase option is reasonably certain.

Conclusion

There are many similarities between a finance lease under the new standard and a capital lease under legacy accounting. As with many aspects of the new standard judgment will be involved in making certain determinations so that leases are properly classified at the lease commencement date.

Effective Date

ASC 842 is effective for private companies and nonprofit organizations with annual reporting periods beginning after December 15, 2021 and interim periods within fiscal years starting after December 15, 2022.

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