JO Knows How to Account for Operating 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 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.

Last month, we looked at finance leases under the new standard. And today, we will look at operating leases. While finance leases under the new standard resemble capital leases under the old standard, operating leases will present the biggest change on a company's financial statements as these leases were previously only disclosed in the footnotes to the financial statements, and not recorded on the balance sheet.

As previously discussed in last month's e-mail blast, 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 (minus) prepaid (accrued) rent less any lease incentives received. Assuming a calculated present value of $250,000, a journal entry would be recorded on the lease commencement date to reflect both amounts as follows:

	Debit	**Credit**
Right of Use Asset	$250,000	
Lease Liability		$250,000

After initially recording the operating lease, two accounting transactions will occur each month that will need to be reflected in the books and records.

The first transaction will be your monthly lease payment. Under prior guidance, you would ordinarily record an entry to cash for the amount paid with a corresponding entry to rent expense. If your lease had rent escalations or free rent periods, rent expense would have been recorded on a straight-line basis and a portion of your entry would also debit or credit deferred rent. Under the new guidance, the entry to cash will remain the same, but the corresponding entry will be a direct reduction to your lease liability. Assuming a $5,000 monthly rent payment, the journal entry would be as follows:

	Debit	**Credit**
Lease Liability	$5,000	
Cash		$5,000

The second transaction is a little more complex than the first entry to record the actual payment. This entry will reflect the reduction of the right of use asset and the change in the present value of remaining payments relative to the lease liability due to the passage of time. These amounts should come directly from your calculated amortization schedule for your operating lease and would be recorded as follows:

	Debit	**Credit**
Lease Expense	$4,500	

Right of Use Asset	$4,325
Lease Liability	$175

Lease costs will be expensed on a straight-line basis over the term of the lease.

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

Conclusion

While there are many similarities between a finance lease under the new standard and a capital lease under legacy accounting, there are stark differences with operating leases. Future commitments of these types of leases will no longer be the only disclosure; rather the amounts will be recorded on the balance sheet throughout the full term of the leases.

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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