ASC 840 / IAS 17 Operating lease example

EZLease

Let's take as an example an office lease, for a portion of an office building. It lasts for ten years. The first 5 years, the rent is $5,000 per month; the second five years, the rent increases to $6,000 per month.

In many cases, the "fair value" of a portion of a building is not easily determinable. If this is true, ASC 840 allows you to skip the present value test. Such leases will, as a rule, not convey ownership, so the only test left to determine whether the lease is capital/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.

Office lease

$5,000 per month
for rent during first 5 years

$6,000 per month
for rent after 5 years

5 years

10 years

EZLease

If there were no change in the rents, the rental payments would simply be expensed as incurred, making very simple accounting (though the future rent commitment of all leases needs to be disclosed). Since this lease has a scheduled rent increase, which does not reflect a change in the availability of the asset (for example, an increase in the space covered by the lease), FASB Technical Bulletin 85-3 (FTB 85-3) requires the rent to be recognized on a straight-line basis over the life of the lease, with a deferred liability that accounts for the difference between cash rent paid and accrued rent expense. (A lessor also straight-lines the rent, recognizing a deferred asset.)

Account	Debit	Credit
Monthly journal entry (first 5 years)		
Operating rent expense	5,500.00	
Deferred liability		500.00
Cash		5,000.00
Monthly journal entry (second 5 years)		
Operating rent expense	5,500.00	
Deferred liability	500.00	
Cash		6,000.00

Note: At the end of the life of the lease, the deferred liability will be zero. If a lease is terminated early, you recognize a gain equal to the balance in the deferred liability account (because rent that you have expensed will not actually need to be paid). Any termination penalty is an offsetting loss.

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

- ✓ Click 'Add new lease'

- ✓ Enter a Lease Number and/or name for the lease

- ✓ Enter a Begin Date of January 1, 2015

- ✓ Double-click on the Base Term box; in the box that appears, enter 120 (months).

- ✓ Leave Classification as "To be classified" as EZLease will automatically classify this lease.

- ✓ On the Main Data tab, on the first line of the Rent Steps grid, enter a Gross Rent on the first line of 5000

- ✓ Enter a Step End date 5 years after the begin date Dec. 31, 2014

- ✓ On the second rent line, enter Gross Rent of 6000; the Step End date matching the end of the lease will automatically update

- ✓ Enter an Economic Life of 240 (20 years)

- ✓ Stay on Main data tab, enter 8.5 as the Incremental Borrowing Rate and check the box that reads Fair Value Not Determinable

- ✓ Add transitional IBR (8.5)

- ✓ Click Save Lease

- ✓ Note that the lease is automatically classified as Operating

*Assumes default system settings of an Implementation Date of 1/1/2019 and a 12/31 Year End.

IFRS implementation date is 1/1/2019. For US GAAP implementation date is 1/1/2022 and 12/31 FYE