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Deep Dive: ASC 842 Accounting Lease Standards and PeopleSoft Lease Administration

Contents

White Paper Introduction

We have created a 5-part white paper for the new accounting lease standards, ASC 842, *Leases*; the full text for ASC 842 can be found in the FASB Accounting Standards Codification.

The 5 parts will be as follows:

1. White paper introduction and lease accounting terminology
2. Basic lease accounting example
3. Expanded lease accounting discussion - I
4. Expanded lease accounting discussion - II
5. White paper wrap-up & next steps

For some of you, this white paper will be a solid introduction as you begin the process towards complying with the ASC 842 accounting lease standards. For others, this will be a review of information that you have already begun to gather and, hopefully, this will be a good reinforcement of that information.

New Lease Accounting Terminology

To begin, we are going to review some of the key terminology that will provide you with a solid foundation of the ASC 842 lease accounting standards and will allow you to explore a handful of lease accounting examples later in this white paper.

Finance vs Operating Leases

With ASC 842, all leases are tested using 5 key criteria to determine if it is a finance or operating lease. Finance leases act primarily as the lessee taking ownership of the asset. Operating leases act primarily as the lessee renting the asset for a specific period of time that is less than the asset's full useful life. Under IFRS 16, all leases are classified as finance leases and the test to classify a lease as an operating lease will not be needed.

Right-of-Use Asset (ROU)

This is how your leased assets is labeled on your balance sheet. If your assets are categorized as a finance lease, then there is also an amortization account. If your assets are categorized as an operating lease, then your right-of-use (ROU) asset balances is adjusted instead of being amortized.

Initial Direct Costs (IDCs)

These are direct costs that are incurred exclusively from obtaining the lease. These amounts are included in the calculation of the right-of-use asset dollar amount but are not included in the lease liability since these amounts are paid upfront.

Interest Borrowing Rate

This may not be a new term for equipment leases but it is new for tracking property leases under the ASC 842 standards for PVLP calculations for both finance leases and operating leases.

Present Value of Lease Payments (PVLP)

This is the present value of the lease payments calculated using the interest borrowing rate. This present value calculation is used to create the right-of-use asset dollar value. A present value table over the life of the lease is also used to calculate interest expense and the liability pay down schedule.

Lease Liability

New for all property leases and for equipment operating leases, organizations are required to have a lease liability on the books for all leases. For each year of the lease, the lease liability is equal to the present value of the remaining lease payments.

Lease Incentives

Payments made to the lessee by the lessor as incentive for signing the lease. Lease incentives received in cash reduce the value of the right-of-use asset.

Residual Value Guaranteed

If this amount is probable, then the residual value guarantee is included in the right-of-use asset and lease liability calculation.

Reasonably Certain

Options that are reasonably certain of being exercised should be included in the value of the right-of-use asset and in the calculation of the present value of the lease payments.

Asset Fair Market Values

The fair market value of the asset at the beginning of the lease is used to determine the classification of a lease as finance or operating. Whereas asset fair market values at the end of the lease can determine if a purchase option for an asset is reasonably certain to be exercised.

At first, the wealth of information on this topic may seem overwhelming but the above list of lease accounting terminology should give you a solid head start. Please do your own research on the topic as well. Overall from an accounting and present value stand point, the new standards are very logical to interpret.

In the next section we will incorporate the above accounting terms into some lease accounting examples. First, we will begin with a basic lease accounting example to compare the current standards to the new standards. Then we will move on to taking an expanded look at the new lease accounting standards with a few more complex lease accounting examples.

Basic Lease Accounting Example

This section will demonstrate a basic lease accounting example to compare the current accounting standards to the new ASC 842 standards.

Property lease: 3 years
Yearly payments: $150,000, $180,000, $210,000 = Total - $540,000
Borrowing interest rate: 9%

Current Lease Accounting Standards

Applying the current accounting standards for this lease, using straight-line accounting is $180,000 for each year. Under the current rules there is not be an asset on the balance sheet and the disclosure for future minimum lease obligations for years 1 & 2 is $390,000 & $210,000 respectively.

Looking at the current accounting standards, the table below summarizes key accounting data; this includes disclosures for future minimum lease obligations. Notice that current lease accounting standards do not specifically require the value of the operating lease asset(s) to be capitalized on the balance sheet.

Operating Lease under the current Lease Accounting Standards					
Year	Cash Payments	Straight Line Accrual/Deferral	Total Rent/Lease Expense	Future Minimum Lease Obligation	Capitalized Asset Value
1	$150,000	$30,000	$180,000	$390,000	n/a
2	$180,000	--	$180,000	$210,000	n/a
3	$210,000	($30,000)	$180,000	--	n/a
Total	$540,000	--	$540,000	--	--

Lease Accounting Standards with ASC 842

Under ASC 842, *Leases*, there is a test with five key criteria. Depending on the outcome of these tests, the lease is classified as either a finance lease or as an operating lease. Later in the white paper we will cover the criteria tests in a little more detail but, for now, let's focus on the accounting. We will use the same lease payment information from above, including the borrowing interest rate, to illustrate the key accounting data for this lease classified as either a finance lease and as an operating lease.

Looking at the table below, in column 2 we still have the same lease payments we used in the old accounting standards example above. Notice with ASC 842, a liability needs to be maintained on the balance sheet for both classifications, as shown in columns 3 & 4.

Finance Lease

If the lease is classified as a finance lease, the expense is broken down into interest expense and amortization expense, columns 6 & 7. With the net balance of the asset on the balance sheet amortized each year as shown in columns 5 & 7.

Operating Lease

If the lease is classified as an operating lease, the lease expense is a straight-line amount as shown in column 10. The adjusted balance of the asset on the balance sheet is shown in column 8 and column 9 displays the adjustment amount which utilizes the borrowing interest rate as part of the adjustment.

Lease Information				Classified as Finance Lease			Classified as Operating Lease		
1	2	3	4	5	6	7	8	9	10
End of Year	Payments	Lease Liability	Liability Paydown	Right of Use Asset (Net)	Interest Expense	Amort Expense	Right of Use Asset	Adjustment to Right of Use Asset	Lease Expense
0		$450,000		$450,000			$450,000		
1	$150,000	$341,177	$108,823	$300,000	$41,177	$150,000	$311,177	$138,823	$180,000
2	$180,000	$192,395	$148,782	$150,000	$31,218	$150,000	$162,395	$148,782	$180,000
3	$210,000	--	$192,395	--	$17,606	$150,000	--	$162,395	$180,000
	$540,000				$90,000	$450,000			$540,000

As you can see, with the old standard disclosing the future minimum lease obligations was key and with the now there are rules for tracking the liability directly on the balance sheet. Tracking the lease expense and the asset balances have different rules depending on how the lease is classified.

Various publications and hundreds of pages were read to research the changes to the lease accounting standard. This white paper is just meant to illustrate a very straight forward and simple example to highlight the accounting balances under ASC 842 that are supported and tracked with PeopleSoft Lease Administration. Now for sections 3 & 4, I will take an expanded look on the new lease accounting standards and discuss more in-depth lease examples.

Expanded Lease Accounting Discussion - I

In the next 2 sections, we are going to take a more in-depth look at our lease to discuss the accounting standards further. Per the title of this white paper, we only mention ASC 842 and do not mention IFRS 16. With ASC 842 all leases need to have a classification test applied and are classified either as a finance lease or as an operating lease. Whereas, with IFRS 16, all leases are classified as a finance lease. Thus, going forward when discussing finance leases, this will apply to both ASC 842 and IFRS 16 and when discussing operating leases, this will apply to only ASC 842.

Here are the lease details from the previous section

Property lease: 3 years
Yearly payments: $150,000, $180,000, $210,000 = Total - $540,000
Borrowing interest rate: 9%
ROU asset value – $450,000
Lease liability - $450,000

In this expanded discussion, let's look at the journal entries that would be created to support our above lease data and the resulting accounting balances. First let's look at the journal entries for this lease before ASC 842:

Journal entries before ASC 842 – Year 1

Start of Lease		
No entries required		
Year 1		
Lease Expense	$150,000	
Cash		$150,000
Lease Expense	$ 30,000	
Straight Line Accrual		$ 30,000

As you can see, the journal entries are very straight forward. No journal entries are required at the start of the lease. The year-end journal entries reflect the cash payment amount and the amount needed to support straight-line accounting. Notice that total lease expense here equals $180,000.

Now let’s move on to the journal entries needed under ASC 842. For review, below are the accounting balances that we covered in the previous section:

Lease Information				Classified as Finance Lease			Classified as Operating Lease		
1	2	3	4	5	6	7	8	9	10
End of Year	Payments	Lease Liability	Liability Paydown	Right of Use Asset	Interest Expense	Amort Expense	Right of Use Asset	Adjustment to Right of Use Asset	Lease Expense
0		$450,000		$450,000			$450,000		
1	$150,000	$341,177	$108,823	$300,000	$41,177	$150,000	$311,177	$138,823	$180,000
2	$180,000	$192,395	$148,782	$150,000	$31,218	$150,000	$162,395	$148,782	$180,000
3	$210,000	--	$192,395	--	$17,606	$150,000	--	$162,395	$180,000
	$540,000				$90,000	$450,000			$540,000

Journal entries under ASC 842 - Year 1

Classified as a Finance Lease		Classified as an Operating Lease	
Start of Lease		*Start of Lease*	
ROU Asset	$450,000	ROU Asset	$450,000
Lease Liability	$450,000	Lease Liability	$450,000
Year 1		*Year 1*	
Interest Expense	$ 41,177	Lease Expense	$180,000
Lease Liability	$108,823	Lease Liability	$108,823
Cash	$150,000	Cash	$150,000
Amort. Expense	$150,000	ROU Asset	$138,823
ROU Asset Acc Amort	$150,000		

Looking at the journal entries above we can now compare the differences between classifying this lease as a finance lease or as an operating lease. In the finance lease, we amortize the capitalized ROU asset whereas in the operating lease we adjust the ROU asset. For the expense amounts, the finance lease uses a combination of amortization expense and interest expense. The operating lease expense amount is equal to the straight-line amount of $180,000 but now includes several components that make up that amount. Also for the operating lease, the ROU asset adjustment is a net amount derived to balance out the journal entry.

To wrap things up for this section of the white paper, the purpose was to take an expanded look at our lease and look at the journal entries required to support the accounting balances detailed in section 2. This should help to identify the accounting data that needs to be tracked.

Expanded Lease Accounting Discussion - II

In this section, we want to introduce some additional lease financial terms and discuss the impacts on our lease.

To begin let's, look at the numbers for our lease again.

Property lease: 3 years
Yearly payments: $150,000, $180,000, $210,000 = Total - $540,000
Borrowing interest rate: 9%
ROU asset value – $450,000
Lease liability - $450,000

Remember, the value of the ROU asset and the lease liability are both calculated by determining the present value of the lease payments (PVLP). From here, we will discuss three lease financial terms: lease incentives, initial direct costs and purchase options. These terms impact the account balances and need to be tracked under ASC 842, *Leases*.

Lease Incentives
If we introduce lease incentives, which is cash received by the lessee upfront, we would debit cash and credit the ROU asset. This essentially lowers the value of the ROU asset on the balance sheet. Additionally, lease incentive only impacts the ROU asset and will not have any impact on the lease liability.

To illustrate, if we were to introduce a lease incentive amount of $10,000, then the ROU asset value would now be $440,000 instead of $450,000 from the basic example.

The journal entries pertaining to the ROU asset would be as follows, with the net amount for the ROU asset now lowered to $440,000:

To record the lease incentive:		
Cash	$ 10,000	
ROU Asset		$ 10,000
To record the ROU asset:		
ROU Asset	$450,000	
Lease Liability		$450,000

Initial Direct Costs
When looking at initial direct costs, we have the opposite impact on the ROU asset value. To record initial direct costs, we would debit the ROU asset and credit cash. Thus, initial direct costs will be added to the ROU asset value. For calculating the lease liability, initial direct costs will be ignored since the amounts are paid upfront.

To illustrate, if we were to introduce initial direct costs in the amount of $15,000, then the ROU asset value would be $465,000 instead of $450,000 from the basic example.

The journal entries pertaining to the ROU asset would be as follows, with the net amount for the ROU asset now increased to $465,000:

To record the initial direct costs:

ROU Asset	$ 15,000	
Cash		$ 15,000

To record the ROU asset:

ROU Asset	$450,000	
Lease Liability		$450,000

A special note for lease incentives and initial direct costs: whether the lease is classified as a finance lease or as an operating lease, the impact on the ROU asset value will the same.

Purchase Options
If a purchase option is reasonably certain to be exercised, then the present value of that purchase option needs to be included as part of the PVLP for the ROU asset value and the lease liability calculations. If the purchase option is not reasonably certain, then it can be excluded from the PVLP. In this case, let's assume that we have a reasonably certain purchase option for $50,000 which has a present value of $38,609. The result would be that our ROU asset and lease liability would now be $488,609 ($450,000 + $38,609).

Unique to this example, if a purchase option is reasonably certain, then this lease can only be classified as a finance lease since the asset is essentially being purchased. Whereas, with lease incentives and initial direct costs, lease classification might not be impacted depending on the dollar amounts involved.

Moving on to one final subject that gets an honorary mention, we will discuss asset fair market values. This would include both the fair market value at the beginning of the lease and the fair market value at the end of the lease. Pre-ASC 842, you may have been working with these amounts as a process of negotiating your leases and then to smaller extent tracking fair market values to determine lease classification. Under ASC 842, the requirement for tracking asset fair market values still exists and is a factor for classifying a lease as finance or operating.

The main goal of this section was to provide some additional depth on our lease and to help provide a solid foundation on ASC 842, *Leases,* as organizations implement the changes.

White Paper Wrap-up

In this closing section, we would like to do some wrap-up discussion and look at the next steps for applying ASC 842.

Lease Classification (ASC 842)
So far in this white paper, we have mentioned classifying leases as either finance or operating leases. Let's take a more in-depth look on the test guidelines for classifying a lease. The five tests are as follows, and if the answer is yes to any of these tests, then the lease should be classified as a finance lease.

1. Ownership transfer to lessee
2. Purchase option is reasonably certain
3. Lease term = major part of asset life
4. Lease payments = substantially the asset fair market value
5. Specialized, customer-specific asset

Overall, these tests are identical to the pre-ASC 842 standards so, in general, how your organization classifies leases should not change materially under ASC 842; the only exception is test #5 which has been added. In addition, pre-ASC 842 standards specifically mention the 75% and 90% bright-line tests whereas the new standards do not specifically mention these levels. However, the new standards do allow for those bright-line test levels to be applied as a guideline for tests 3 & 4 respectively.

Looking further at classification, a lease may apply to more than one asset. If feasible, each asset should be subject to the 5 tests above independently and it is possible that one of the assets could be capitalized under the finance lease classification rules and the other asset(s) could be capitalized under the rules for an operating lease classification.

Disclosure
Under pre-ASC 842 standards, your disclosures included your future minimum lease obligations. However, with the new standards that will change since lease obligations are reported on the balance sheet as lease liabilities. That does not mean the disclosure requirements under the standards will go way completely. Some disclosure items that are required include a general description of your leases, maturity breakdown, related party lease transactions, operating leases vs capital lease breakdown, average term length and average interest rates for calculating present value.

As part of the transition process it would be best to first establish your disclosure requirements and then make sure you are tracking all the necessary data to meet those requirements. By performing this planning upfront, you should benefit by having this information automatically available for reporting.

Financial statement impacts
Organizations may have target goals for certain financial ratios such as return-on-investments, return-on-assets, and debt-to-equity. All these ratios will be impacted. Taking the time to organize your lease data and being able to analyze the financial statement impacts upfront will be valuable and allow your organization to be better prepared for the impacts under ASC 842, *Leases*.

Conclusion

First and foremost, as you begin the transition towards complying with ASC 842, gather and consolidate your list of leased assets now. Regardless of the transition approach you take, this will be a necessary step. By beginning this step now, you will be in a better position to make the transition smoothly. For additional information on next steps, read MIPRO's blog, [Preparing for the new Lease Accounting changes with PeopleSoft Lease Administration].

As a summary here is a high-level list of those steps but for more details please see the above blog.

1. Identify all your leases and identify all the related assets for those leases.
2. Next, align the upcoming accounting standards to all your leased assets.
3. Know your business processes and assemble your transition team.
4. Begin working with the latest updates in PeopleSoft Lease Administration.
5. Know your reporting requirements.