LEASECRUNCH®

Transitioning to the New Lease Standard

WITH SAMPLE JOURNAL ENTRIES

You are all ready to implement the new lease standard, but of course that requires a transition for existing leases from ASC 840 to ASC 842 or from IAS 17 to IFRS 16. How do you do this?

STEPS TO IMPLEMENT THE NEW LEASE ACCOUNTING STANDARD

1. PRACTICAL EXPEDIENTS. Consider your policy elections, particularly around the practical expedients that you decide to utilize. Those can dramatically ease the amount of work that you do upon transition. Key practical expedients include:

- **Initial Application Date:** You can elect to apply the lease standard to only the most recent period without restating prior periods. If you choose this option and you report on two periods in your financial statements (for example, years that ended December 31, 2020 and 2021), your first entry occurs on January 1, 2021.
  a. The advantage of electing this practical expedient is that you do not need to restate prior periods. Of course, this does mean you will have inconsistent reporting on leases between the current and prior periods.
- **Reassessing Leases:** You can elect to not reassess three different lease factors:
  a. Whether expired or existing contracts contain leases
  b. The operating vs. capital (now finance) lease classification on existing or expired leases
  c. Whether initial direct costs for existing leases would have qualified for capitalization under the new lease accounting standard
- **Use of Hindsight:** You can elect to uses hindsight on lease renewals and purchase options when determining the lease term, as well as hindsight in assessing impairment of an ROU asset.
- **Discount Rate:** You can elect to apply a single discount to a portfolio of leases with reasonably similar characteristics (such as similar lease term for a similar class of underlying asset).

2. LEASE LIABILITY. Calculate the present value of all future lease payments (monthly rents, including known escalators, residual value guarantees, excluding rent holidays) after the Initial Application Date. This is your lease liability.

3. RIGHT OF USE (ROU) ASSET. Starting with the lease liability, add or subtract balances on the balance sheet related to this lease. This might include deferred rent amounts, incentives received, or other initial direct costs calculated under ASC 840 or IAS 17.

a. In general, this excludes leasehold improvements, the accounting for which remains relatively unchanged under the new lease standard.

4. BOOK IT! Record your asset and liability as of your Initial Application Date and you are ready to go forward with the new lease standard.

5. EQUITY AFFECTED? We are accustomed to changes in accounting standards affecting equity as a Cumulative Effect on Change in Accounting Principle. Adopting the new lease standard will not affect equity for the most common types of leases. We've included a few examples below where equity can be affected and, of course, if you are unsure about a situation with one of your leases, your CPA firm is your best resource to determine its proper treatment.

- **Initial Direct Costs.** If you choose to reassess your leases by not electing the practical expedient noted in 1(b) above, the definition of Initial Direct Costs has now changed and, as a result, your opening entry might affect equity.
- **Hindsight for Impairment or Lease Term.** If you do elect the practical expedient to use hindsight on impairment or lease term of a leased asset, noted in 1(c) above, you may affect your equity.
- **Operating Lease Transition under IFRS 16.** Under IFRS 16, you have two options to determine the ROU Asset for what were operating leases. One option is consistent with ASC 842 and would not affect equity. Another option measures the ROU Asset as if IFRS 16 was applied at the lease commencement date. The journal entry for this option (including the new lease liability and removal of existing balances under IAS 17), would include an entry to equity.
- **Other scenarios that could affect equity.** Built-to-suit arrangements, currency translation differences, and sale leaseback transactions can also affect equity. Again, if you have any questions about these or other situations, your CPA firm is an excellent resource.

Not too bad, right? Let's go through an example for leases that exist as of your Initial Application Date for the new lease standard. →

Sample Journal Entries: Office Space Operating Lease

YOUR ORGANIZATION

For the fiscal year ending December 31, 2021, your initial application date is January 1, 2021 because you elected one of the transition practical expedients that doesn't require you to restate prior periods in your comparative financial statements. You have two leases: your office space, which is an operating lease, and a piece of equipment, which was a capital lease and now is considered a finance lease.

OFFICE SPACE OPERATING LEASE

The office space operating lease runs from 2/1/16 - 1/31/26, with initial monthly payments of $1,000, and an annual 3% rent increase. There is no renewal option and you are unlikely to exercise an early termination option. Your incremental borrowing rate is 3.1%.

Future Payments

1/1/21 - 1/31/21	MONTHLY PAYMENTS = $1,125.51
2/1/21 - 1/31/22	MONTHLY PAYMENTS = $1,159.27
2/1/22 - 1/31/23	MONTHLY PAYMENTS = $1,194.05
2/1/23 - 1/31/24	MONTHLY PAYMENTS = $1,229.87
2/1/24 - 1/31/25	MONTHLY PAYMENTS = $1,266.77
2/1/25 - 1/31/26	MONTHLY PAYMENTS = $1,304.77

Existing balances at 1/1/20 under Previous Lease Accounting Guidance

DEFERRED RENT (CR)	$2,500.00

New Lease Standard Calculations

LEASE LIABILITY
present value of future monthly payments = $69,336.49

ROU ASSET
$69,336.49 (Lease Liability) less $2,500 (Deferred Rent) = $66,836.49

Initial Journal Entry

	Debit	Credit
ROU ASSET	$66.836.49	
DEFERRED RENT	$2,500.00	
LEASE LIABILITY		$69,336.49

Sample Journal Entries: Equipment Finance Lease

EQUIPMENT FINANCE LEASE

The equipment capital (now finance) lease runs from 6/1/19 - 5/31/24, with fixed monthly payments of $500. There is no renewal option, but there is a residual value guarantee of $3,000 that you are reasonably certain to pay. Your incremental borrowing rate is 4.0%.

Future Payments

1/1/21 - 1/31/21 MONTHLY PAYMENTS = $500.00

RESIDUAL VALUE GUARANTEE (RVG) AT 5/31/24 = $3,000

Existing balances at 1/1/21 under Previous Lease Accounting Guidance

CAPITAL ASSET (DR)	$29,697.04
ACCUMULATED AMORTIZATION (CR)	$5,939.40
CAPITAL LEASE LIABILITY (CR)	$24,775.34
UNAMORTIZED INITIAL DIRECT COSTS (DR)	$3,000.00

New Lease Standard Calculations

LEASE LIABILITY
Present Value of Future Monthly Payments + RVG = **$21,812.27**

ROU ASSET
Lease Liability + Unamortized Initial Direct Costs + Capital Asset - Accumulated Amortization - Capital Lease Liability = **$21,812.27**

Initial Journal Entry

	Debit	Credit
ROU ASSET	$23,794.57	
ACCUMULATED AMORTIZATION	$5,939.40	
CAPITAL LEASE LIABILITY *	$24,775.34 *	
CAPITAL ASSET		$29,697.04
UNAMORTIZED INITIAL DIRECT COSTS		$3,000.00
LEASE LIABILITY		$21,812.27

** Due to differences in timing and calculation methods, you might find that your Capital Lease Liability does not exactly equal your Lease Liability under the new lease standard. If this occurs, the difference flows through the ROU Asset.*

Hopefully this clarifies how to treat existing leases upon adoption of the new lease standard. This is arguably one of the more straightforward components of ASC 842 and IFRS 16.

Of course, on an ongoing basis, tracking many leases and compiling the initial entries, ongoing journal entries, and financial footnote disclosures can become incredibly complex. This is where an easy-to-use, cost-effective software solution like LeaseCrunch becomes an important tool to ensure accurate and timely financial statements (as well as providing that initial journal entry for all of your leases). Please contact your CPA firm today to learn more!

ABOUT LEASECRUNCH

LeaseCrunch provides cloud-based lease accounting software for CPA firms, designed to help organizations implement the new lease accounting standards, ASC 842 and IFRS 16. Designed by CPAs, former Big 4 public accounting auditors, software development veterans and a former member of the FASB, LeaseCrunch is easy enough for anyone to use, with simple screens, wizards and tooltips along the way.

Familiar with the tremendous fee pressure placed on CPA firms, our solution was designed with their specific needs in mind, essentially 'audit in a box' for lease accounting. We work exclusively with CPA firms—never competing for their client relationships. Our interface allows the CPA firm to either act in a bookkeeping capacity on behalf of their clients or to hand off lease management directly and operate in a support role for their clients. LeaseCrunch is designed to accommodate organizations with large, complex portfolios, while still being a cost-effective solution for organizations with as few as 1-5 leases.

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