

# Lessor Accounting Asc 842 Example



Lessor accounting ASC 842 example provides a comprehensive framework that guides lessors in accounting for leases under the new standard established by the Financial Accounting Standards Board (FASB). This guidance, which became effective for public companies in 2019 and for private companies in 2020, aims to improve the transparency and comparability of lease transactions in financial statements. This article explores the principles of lessor accounting under ASC 842, provides practical examples, and discusses the implications for financial reporting.

## Understanding ASC 842

ASC 842, titled "Leases," replaces the previous guidance under ASC 840 and introduces a new way of accounting for leases. The standard applies to both lessees and lessors but emphasizes different aspects for each category. For lessors, ASC 842 retains much of the previous guidance while introducing new classification criteria.

## Key Objectives of ASC 842

The main objectives of ASC 842 are to:

1. Enhance Transparency: By requiring lessors to present lease transactions more clearly in financial statements.

2. **Improve Comparability:** Allow users of financial statements to compare leasing arrangements across different organizations effectively.
3. **Provide Relevant Information:** Ensure stakeholders receive information that is relevant for decision-making regarding leasing arrangements.

## **Lessor Classification Under ASC 842**

One of the critical aspects of lessor accounting is the classification of leases, which can be categorized as either operating leases or finance (capital) leases.

### **Lease Classification Criteria**

According to ASC 842, lessors classify leases into the following categories:

- **Operating Leases:** These leases do not transfer substantially all risks and rewards of ownership of the underlying asset. The lessor retains the asset on its balance sheet and recognizes lease income on a straight-line basis over the lease term.
- **Finance Leases:** These leases transfer substantially all risks and rewards of ownership to the lessee. A finance lease is recognized when any of the following criteria are met:
  1. The lease transfers ownership of the underlying asset by the end of the lease term.
  2. The lease grants the lessee a purchase option that is reasonably certain to be exercised.
  3. The lease term is for the major part of the remaining economic life of the underlying asset.
  4. The present value of lease payments equals or exceeds substantially all of the fair value of the asset.
  5. The underlying asset is of a specialized nature that only the lessee can use without major modifications.

## **Accounting Treatment for Lessors**

Understanding how to account for leases involves recognizing the appropriate revenue and asset classifications.

### **Initial Recognition**

At the commencement of a lease, lessors must recognize the following:

- Operating Leases: The underlying asset remains on the balance sheet, and lease payments are recognized as income over the lease term on a straight-line basis, unless another systematic and rational basis is more representative of the time pattern in which use benefit derived from the leased property is diminished.
- Finance Leases: The lessor derecognizes the underlying asset and recognizes a lease receivable at the net investment in the lease. The lease receivable is measured as the sum of the lease payments expected to be received, discounted at the interest rate implicit in the lease.

## **Subsequent Measurement**

Subsequent measurement varies depending on the classification of the lease:

- Operating Leases:
  - The lessor continues to recognize the underlying asset and depreciates it according to the company's depreciation policy.
  - Lease income is recognized on a straight-line basis.
- Finance Leases:
  - The lessor recognizes interest income over the lease term, typically using the effective interest rate method.
  - The carrying amount of the lease receivable is adjusted for any impairment losses.

## **Example of Lessor Accounting Under ASC 842**

To illustrate the application of ASC 842, consider the following example.

### **Scenario Description**

ABC Leasing Company provides machinery to XYZ Manufacturing Company under a three-year lease agreement. The lease payments are \$10,000 per year, payable at the end of each year. The machinery's cost to ABC Leasing is \$25,000, and its estimated useful life is ten years.

### **Step 1: Lease Classification**

ABC Leasing evaluates the lease to determine its classification under ASC 842. The following criteria are reviewed:

- The lease does not transfer ownership at the end of the term.
- There are no purchase options.
- The lease term (3 years) is less than the economic life of the asset (10 years).
- The present value of lease payments ( $\$10,000 \times 3 = \$30,000$ ) exceeds the fair value of the asset.

Based on the criteria, ABC Leasing classifies the lease as a finance lease.

## Step 2: Initial Recognition

Upon commencement of the lease, ABC Leasing will:

- Derecognize the underlying asset from its balance sheet.
- Recognize a lease receivable of \$30,000, which represents the present value of the future lease payments.

## Step 3: Subsequent Measurement

For the subsequent years, ABC Leasing will recognize:

- Interest Income: Assume the implicit interest rate is 5%. The interest income for the first year will be calculated on the lease receivable balance, which decreases as payments are received.
- Lease Receivable: The lease receivable will be adjusted for each payment made, decreasing the carrying amount accordingly.

The revenue recognition for the lease payments will follow the effective interest method, where interest income is recorded as it is earned.

## Disclosure Requirements Under ASC 842

ASC 842 mandates specific disclosures to provide users with adequate information about leasing activities. Lessors are required to disclose:

1. General Information: Nature of the leases, including terms and conditions.
2. Lease Income: Amounts recognized as lease income during the reporting period.
3. Assets: A description of the underlying assets leased and their respective carrying amounts.

4. Lease Receivable: The carrying amount of lease receivables and any impairment losses recognized.

5. Maturity Analysis: A schedule of future minimum lease payments to be received, categorized by the time periods.

## **Conclusion**

Lessor accounting ASC 842 example highlights the significant changes in lease accounting and the importance of understanding the classification and measurement principles under the new standard. By adhering to ASC 842, lessors can enhance the transparency and comparability of their financial statements, ultimately benefiting stakeholders and decision-makers. As businesses continue to navigate the complexities of lease transactions, robust compliance with ASC 842 will be crucial for accurate financial reporting and effective lease management.

## **Frequently Asked Questions**

### **What is ASC 842 and how does it impact lessor accounting?**

ASC 842 is the accounting standard for leases that was introduced by the Financial Accounting Standards Board (FASB). It requires lessors to classify leases as either operating or sales-type leases, impacting how lease income and assets are recognized in financial statements.

### **Can you explain the difference between operating leases and sales-type leases under ASC 842?**

Under ASC 842, an operating lease does not transfer ownership of the asset and the lessor recognizes lease income on a straight-line basis. A sales-type lease, on the other hand, transfers ownership risks and rewards, leading to the recognition of both lease income and a profit at the beginning of the lease term.

### **How do lessors recognize lease income under ASC 842?**

Lessors recognize lease income based on the type of lease. For operating leases, income is recognized on a straight-line basis over the lease term. For sales-type leases, income is recognized at commencement, including any initial direct costs.

### **What are the key disclosures required for lessors under ASC 842?**

Key disclosures for lessors include the classification of leases, the nature and terms of leases, significant judgments made in determining lease classification, and the future lease payments expected to be received.

## How should a lessor account for initial direct costs under ASC 842?

Under ASC 842, initial direct costs incurred by lessors are capitalized and amortized over the lease term for operating leases, while they are recognized as an expense in the period the lease income is recognized for sales-type leases.

## What challenges do lessors face in implementing ASC 842?

Lessor challenges include determining the appropriate lease classification, managing the complexities of lease accounting systems, and ensuring compliance with the new disclosure requirements.

## How does ASC 842 affect lessors' financial ratios?

ASC 842 can affect financial ratios such as debt-to-equity and return on assets. Operating leases may not appear on the balance sheet, potentially leading to more favorable ratios compared to capital leases, which are recorded on the balance sheet.

## Are there any exemptions for lessors under ASC 842?

Yes, ASC 842 provides exemptions for certain short-term leases (less than 12 months) and leases of low-value assets. Lessors can choose not to apply the standard to these leases, simplifying accounting for lessors.

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