ASC 842 Lease Accounting Master Reference Guide

Lessee Classification Criteria, ROU Asset Measurement, Amortization & Journal Entries | US GAAP Aligned

1. LESSEE LEASE CLASSIFICATION: THE 5 CRITERIA TEST

Under ASC 842, a lease is classified as a **Finance Lease** if it meets **ANY ONE** of the following 5 criteria at commencement. If **NONE** are met, it is an **Operating Lease**. Both appear ON the Balance Sheet!

Criterion	Rule & Threshold	GAAP Test & Meaning	Classification Impact
1. Transfer of Ownership	Title transfer	Asset ownership transfers automatically to lessee by the end of lease term.	**Finance Lease**
2. Written Purchase Option	Reasonably certain	Lessee possesses a purchase option that they are *reasonably certain* to exercise.	**Finance Lease**
3. Lease Term Ratio	≥ **75%** economic life	Lease term is 75% or more of remaining economic life (not used if near end of life).	**Finance Lease**
4. Present Value Test	≥ **90%** fair value	PV of lease payments + guaranteed residual value ≥ 90% of asset fair value.	**Finance Lease**
5. Specialized Asset	No alternative use	Underlying asset is so specialized it has no alternative use to lessor at term end.	**Finance Lease**

2. FINANCE LEASE VS. OPERATING LEASE: FINANCIAL STATEMENT IMPACT

Financial Statement	Finance Lease (Lessee)	Operating Lease (Lessee)
Balance Sheet	ROU Asset (amortized cost) & Lease Liability (amortized cost).	ROU Asset & Lease Liability recorded at commencement.
Income Statement	**Split Expense:** Amortization Expense (straight-line) + Interest Expense (effective rate). Front-loaded total expense.	**Single Lease Expense:** Recognized on a straight-line basis over lease term included in operating expenses.
Cash Flow Statement	**Financing:** Principal portion of lease payment. **Operating:** Interest portion of lease payment.	**Operating:** Entire lease payment is classified as operating cash outflow.

3. MANDATORY JOURNAL ENTRIES SUMMARY

Transaction Timing	Finance Lease Journal Entry	Operating Lease Journal Entry

Day 1 (Commencement)	Dr. Right-of-Use (ROU) Asset
	  Cr. Lease Liability (PV of payments)
		Dr. Right-of-Use (ROU) Asset
		  Cr. Lease Liability (PV of payments)

Subsequent Periods (Periodic Payment)	Dr. Interest Expense (Carrying Liab × Rate)
	Dr. Lease Liability (Principal Reduction)
	  Cr. Cash (Total Payment)
	And: Dr. Amortization Expense
	  Cr. ROU Asset (Straight-Line)
		Dr. Lease Expense (Straight-Line total)
		Dr. Lease Liability (Principal reduction)
		  Cr. Cash (Payment)
		  Cr. ROU Asset (Amortization plug)

4. CRITICAL CPA EXAM & GAAP TRAPS TO REMEMBER

Trap 1: Short-Term Lease Exemption: Leases with a maximum duration of 12 months or less (with no purchase option reasonably certain) qualify for an accounting policy election: recognize expense straight-line with **NO ROU Asset or Liability** on Balance Sheet.
Trap 2: Discount Rate Priority: Use the rate implicit in the lease if *readily determinable*. If not known, the lessee must use its own *Incremental Borrowing Rate (IBR)*.
Trap 3: Initial Direct Costs (IDC): Legal fees and commissions incurred to execute lease are capitalized into the **ROU Asset** (added to PV of lease payments), NOT the lease liability.

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