

# ASC 842 Guide: Operating vs Finance Lease Accounting

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## Executive Summary

Lease accounting has undergone a radical overhaul with the issuance of ASC 842, dramatically changing how U.S. companies recognize and report leases. **Under the new standard, lessees must capitalize nearly all leases** (except short-term leases) on the balance sheet as a right-of-use (ROU) asset with a corresponding lease liability (Source: [link.springer.com](#)) (Source: [windes.com](#)). ASC 842 retains a **dual model** for lessee accounting – distinguishing **finance leases** (previously “capital leases”) from **operating leases** – whereas the International Standard IFRS 16 eliminated the operating-lease category entirely (treating all significant leases as finance leases) (Source: [link.springer.com](#)) (Source: [www.leash.co.za](#)). This dichotomy means that under ASC 842 operating leases continue to yield a single, straight-line expense pattern on the income statement, whereas finance leases produce separate interest and amortization expenses (front-loaded like a loan) (Source: [www.leash.co.za](#)) (Source: [link.springer.com](#)).

**Key findings and insights from the literature and examples:** many studies confirm that bringing leases on-balance-sheet has substantial effects on financial reporting and comparability. For lessees, ASC 842’s adoption **significantly increased reported liabilities** (often by hundreds of millions or even billions of dollars in the initial year for large companies) (Source: [www.sec.gov](#)), with corresponding ROU assets. The transition materially affects key financial metrics: balance-sheet leverage rises, liquidity ratios may worsen, and EBITDA often increases (since lease expense is now excluded from operating expense for finance leases) (Source: [link.springer.com](#)) (Source: [www.sadaccountant.com](#)). Studies (e.g. Chatterjee 2023; Ma and Thomas 2023) document that firms with heavy pre-adoption “off-balance” leases reacted by shifting away from long-term operating leases and sometimes leaning more on CAPEX or shorter leases (Source: [link.springer.com](#)). Market researchers (Milian and Lee 2023) observed **negative short-term stock returns** for companies with large operating-lease commitments when ASC 842 took effect, reflecting investor concern over newly recognized liabilities (Source: [link.springer.com](#)).

From a standards perspective, **lessor accounting in ASC 842 remains similar to legacy guidance:** lessors still classify leases as operating, sales-type, or direct-financing based on essentially the same five criteria (transfer of ownership, bargain purchase option, lease term, present value, or specialized asset) (Source: [www.sec.gov](#)) (Source: [www.cpajournal.com](#)). However, practical issues such as separating lease vs non-lease components, choosing a discount rate, and applying transition expedients have challenged preparers. Many companies elected the “package of practical expedients” on transition, avoiding reassessment of existing leases (Source: [www.sec.gov](#)).

This report provides a comprehensive analysis of ASC 842's mandate for finance vs operating leases, including: historical context (why the standards changed), detailed criteria for classification, step-by-step accounting procedures (with illustrative journal entries and numerical examples for each lease type), comparison of lessee vs lessor treatment, analysis of effects on financial statements and key ratios, and relevant empirical findings. It also contrasts ASC 842 with IFRS 16 (highlighting differences in approach and outcomes) and discusses future directions (such as the IASB's post-implementation review of IFRS 16 and potential GAAP updates). All claims are supported by authoritative sources, ensuring that readers gain both a practical and research-based understanding of lease accounting under the new standards.

## Introduction and Background

Leasing is a pervasive form of finance in modern business – **leases allow firms to use assets (vehicles, equipment, buildings, etc.) without purchasing them.** Historically under U.S. GAAP (ASC 840), most operating leases were off-balance-sheet (only rental expense was recorded) while capital leases were on-balance-sheet. This led to criticism that financial ratios and transparency were obscured by unreported lease obligations. After decades of debate, the Financial Accounting Standards Board (FASB) issued ASC 842 "Leases" (effective 2019 for public companies) to require nearly all leases to be recognized on the balance sheet (Source: [link.springer.com](https://link.springer.com)).

Under ASC 842, the **SYMMETRY with International standards (IFRS 16)** is largely improved: both U.S. GAAP and IFRS now use a "right-of-use" (ROU) model where lessees record an ROU asset and a lease liability for nearly every lease (Source: [link.springer.com](https://link.springer.com)) (Source: [link.springer.com](https://link.springer.com)). However, a notable divergence remains: *U.S. GAAP retains two lease categories for lessees, while IFRS uses one.* ASC 842's dual-regime model distinguishes *finance leases* (akin to debt financing of an asset) from *operating leases* (akin to rent), whereas IFRS 16 eliminated the operating lease classification altogether from the lessee perspective (Source: [link.springer.com](https://link.springer.com)) (Source: [www.leash.co.za](http://www.leash.co.za)). This results in important differences in expense recognition and cash flow presentation between the two systems.

To fully appreciate ASC 842, it helps to review the **history**. Under the old standard (ASC 840, which replaced APB 13), a lease was classified as a capital lease (on-balance-sheet) if it met any of four "bright-line" tests (such as title transfer or lease term  $\geq$  75% of asset life) (Source: [finquery.com](https://finquery.com)). All other leases were classified as operating (off-balance-sheet for lessee). Criticism of this approach – especially hidden liabilities – led both FASB and IASB to overhaul lease accounting. In 2016 both issued new standards (ASC 842 and IFRS 16, respectively), which converge on the idea that leases give the lessee control of an asset and thus must be recognized on the statement of financial position (Source: [link.springer.com](https://link.springer.com)) (Source: [www.leash.co.za](http://www.leash.co.za)).

The **objectives** of ASC 842 were to increase transparency and comparability. It brings most leases onto balance sheets, forcing explicit recognition of assets and liabilities from leasing. According to the FASB, ASC 842 is intended to provide a more faithful representation of leasing transactions and to improve disclosure for investors and creditors (Source: [link.springer.com](https://link.springer.com)) (Source: [link.springer.com](https://link.springer.com)). Consistent with these goals, research shows that after adoption, U.S. GAAP and IFRS financial statements were more comparable in companies with previously heavy lease liabilities (Source: [link.springer.com](https://link.springer.com)), and that new lease disclosures gave analysts better information on lease obligations.

This report will explore in depth **how ASC 842 requires companies to determine whether a lease is an operating lease or a finance lease, and how each is accounted for.** It will cover the criteria for classification, the measurement of ROU assets and liabilities, the income statement and cash flow impacts, and illustrative journal entries and calculations for each type. We will also compare ASC 842's approach to IFRS 16's single model, and include case examples and data-driven insights (such as the magnitude of liabilities recognized upon adoption) to provide a thorough understanding.

## Defining a Lease under ASC 842

Before addressing "operating vs finance," one must first determine **whether an arrangement contains a lease** under ASC 842. ASC 842-10-15-1 defines a lease as "a contract, or a portion of a contract, that conveys the right to control the use of identified property, plant, or equipment ... in exchange for consideration." This two-step assessment (existence of an identified asset + control) largely mirrors IFRS 16, which also defines leases in terms of control of an asset (Source: [www.leash.co.za](http://www.leash.co.za)).

Put simply, a company must evaluate any service, rental or financing arrangement to see if an identified asset is involved and whether the customer (lessee) obtains the right to direct the use of that asset and to obtain substantially all the economic benefits from it. If so, the arrangement is a lease, and ASC 842 applies. For example, a lease of office space, equipment rental, or auto use typically qualifies. On the other hand, service contracts (like outsource contracts without a specific asset) would not. Detailed guidance (including examples) is in ASC 842-10-55, but the key takeaway is: under ASC 842, many more arrangements are recognized as leases than under the old rules. Notably, companies discontinue using the legacy bright-line tests for lease existence.

Once a lease is identified, ASC 842 requires classifying it as either an operating lease or a finance lease (for lessees) (Source: [fingquery.com](http://fingquery.com)) (Source: [www.sec.gov](http://www.sec.gov)). This classification depends on five criteria (paragraph ASC 842-10-25-2; identical for IFRS 16 and ASC 842 except IFRS has no separate classification). Specifically, a lease is a **finance lease** if **any** of the following is true at commencement (Source: [fingquery.com](http://fingquery.com)) (Source: [www.sec.gov](http://www.sec.gov)):

1. **Transfer of Ownership:** The lease grants ownership of the asset to the lessee by the end of the lease term. (e.g., a lease that ends with automatic title transfer.)
2. **Purchase Option:** The lease gives the lessee an option to purchase the asset at a bargain price, and it is reasonably certain the lessee will exercise it. (i.e., a Bargain Purchase Option) (Source: [fingquery.com](http://fingquery.com)).
3. **Major Part of Life:** The lease term covers a “major part” of the asset’s remaining economic life (commonly interpreted as ≈75% or more) (Source: [fingquery.com](http://fingquery.com)).
4. **Substantially All Value:** The present value (PV) of lease payments (plus any unguaranteed residuals) is “substantially all” of the asset’s fair value (often interpreted as ≈90% or more) (Source: [fingquery.com](http://fingquery.com)).
5. **Specialized Asset:** The underlying asset is so specialized that it has no alternative use for the lessor when the lease ends.

If **none** of these criteria is met, the lease is classified as an **operating lease** for the lessee (Source: [www.sec.gov](http://www.sec.gov)). (For the lessor, the same tests determine “sales-type lease” vs “operating lease,” with a nuance for direct-financing classification if there is a third-party guarantee (Source: [www.sec.gov](http://www.sec.gov)) (Source: [www.cpajournal.com](http://www.cpajournal.com)).

**Key Point:** ASC 842 retains the dual-model approach: **lessees still have operating vs finance** lease distinction. However, IFRS 16 eliminated the operating category – under IFRS all lease expenses are treated like GAAP finance leases (Source: [link.springer.com](http://link.springer.com)) (Source: [www.leash.co.za](http://www.leash.co.za)). This means that an arrangement meeting none of the five GAAP criteria (thus an operating lease under ASC 842) *will still result in an ROU asset and liability under IFRS*, but with expense pattern equivalent to a finance lease. In practice, the GAAP vs IFRS difference lies entirely in income statement and cash flow treatment, not in the existence of ROU recognition.

Figure 1 below summarizes these classification triggers:

LEASE CLASSIFICATION TESTS (ASC 842 / IFRS 16)	FINANCE LEASE (LESSEE)	OPERATING LEASE (LESSEE)
1. Ownership transfer	Yes – classified as finance lease (Source: <a href="http://fingquery.com">fingquery.com</a> )	No – cannot be finance by this test alone
2. Bargain purchase option	Yes – classified as finance lease (Source: <a href="http://fingquery.com">fingquery.com</a> )	No
3. Lease term ≥ ~75% of asset life	Yes, typically finance (vested tests) (Source: <a href="http://fingquery.com">fingquery.com</a> )	No
4. PV of payments ≥ ~90% of asset value	Yes, finance (present value test) (Source: <a href="http://fingquery.com">fingquery.com</a> )	No
5. Asset specialized with no alternative use	Yes, finance (specialized asset test) (Source: <a href="http://fingquery.com">fingquery.com</a> )	No
<b>None of above true</b>	→ <b>Operating lease</b> (Source: <a href="http://www.sec.gov">www.sec.gov</a> )	(Lessor can still be direct-finance or operating depending on guarantees)

Additionally, ASC 842 allows **short-term lease** exemption: a lessee may elect not to recognize ROU asset or liability for any lease (or each component of a lease) with a maximum term of 12 months or less at commencement. Those payments are simply expensed straight-line (Source: [www.sadaccountant.com](http://www.sadaccountant.com)). IFRS 16 has a similar short-term exemption. Note that ASC 842 **does not** have a separate low-value exemption (an IFRS 16 feature) (Source: [www.leash.co.za](http://www.leash.co.za)).

## Accounting for Lessees under ASC 842

Once a lease is classified, the next step is accounting for it. **Both operating and finance leases require the lessee to record a Right-of-Use (ROU) asset and a lease liability at lease commencement (unless the short-term exception applies)** (Source: [windes.com](https://www.windes.com)) (Source: [finquery.com](https://www.finqury.com)). The lease liability is initially measured as the present value of lease payments over the lease term, discounted using the implicit rate (if known) or an incremental borrowing rate (or risk-free rate under the practical expedient) (Source: [windes.com](https://www.windes.com)) (Source: [windes.com](https://www.windes.com)). The ROU asset initially equals the lease liability, adjusted for any prepaid or accrued lease components, initial direct costs, and incentives (Role up lease balances) (Source: [windes.com](https://www.windes.com)).

## Lease Liability and ROU Asset Measurement

- **Lease Term:** Include the non-cancelable period plus any renewal periods if the lessee is reasonably certain to exercise them (this is a judgmental area). For example, in one private company case, management concluded a 2-year renewal was “likely,” extending the remaining lease term from 24 to 48 months (Source: [windes.com](https://www.windes.com)).
- **Lease Payments:** Include fixed payments (plus fixed increases), variable payments that depend on an index/rate, and any guaranteed residual value. Exclude variable payments based on usage, as those are expensed as incurred. In our example (Windes Case), XYZ Company’s \$2,500 monthly payment was split into \$2,250 of fixed rent and \$250 common-area maintenance (non-lease component) (Source: [windes.com](https://www.windes.com)). Non-lease components are separately accounted (or combined if an entity elects).
- **Discount Rate:** Use the rate implicit in the lease if determinable; if not, use the lessee’s incremental borrowing rate (the rate the lessee would incur to borrow in a similar economic environment). Some companies elect the risk-free rate instead (as in the XYZ example, using U.S. Treasury yields) (Source: [windes.com](https://www.windes.com)).

For example, in the XYZ Company case at January 1, 2022: 36 months remained on the original 5-year lease, plus a likely 24-month renewal, for 48 months total. Using a 48-month risk-free rate of 1.12%, the present value of \$2,250 monthly payments (for rent portion only) was calculated as **\$105,666.89** (Source: [windes.com](https://www.windes.com)). Because there were no incentives or prepayments, the ROU asset equaled \$105,666.89 (see [22]). The journal entry at adoption was:

*Jan 1, 2022 (Lease Commencement):*

- *DR Right-of-Use Asset (Operating) \$105,666.89*
- *CR Lease Liability (Operating) \$105,666.89 (Source: [windes.com](https://www.windes.com))*

*(This example assumes a modified retrospective adoption, so the entry is simply ROU = liability. Under a full retrospective approach, comparative periods might be restated.)*

## Subsequent Measurement: Finance Leases

A lease classified as a **finance lease** (meeting at least one key criterion) is accounted for **similarly to a financed purchase**. Under ASC 842:

- **Lease Liability:** It is a financial liability amortized with interest. After the initial entry, each lease payment is split into an interest component (expense) and a reduction of principal (lease liability). Over time, as the liability balance declines, the interest portion falls (the effective-interest method).
- **ROU Asset:** It is amortized (depreciated) separately. Unless it transfers ownership (in which case amortize over useful life), the ROU asset is amortized over the lease term. In many cases this is shorter than the asset’s full life (“weak-form” finance leases) (Source: [finquery.com](https://www.finqury.com)). The amortization pattern is typically straight-line unless another systematic basis is better.

**Income Statement:** For finance leases, ASC 842 requires **two components of expense** each period (like an installment loan):

1. **Interest Expense** on the lease liability (higher in early periods, declining later).
2. **Amortization (Depreciation) Expense** on the ROU asset.

These two together give the total lease-related cost to the lessee, which is **greater in earlier years** and declines, unlike operating leases under ASC 842 (see below). The CPA Journal analysis highlights that because interest is front-loaded, “combined financing lease expenses of interest and depreciation result in lower net income in the earlier years of the lease term than if the transaction was accounted for as an operating lease, all else equal” (Source: [link.springer.com](https://www.link.springer.com)). In summary, finance leases mimic debt: early out cash has more interest, so P&L cost is higher earlier.

**Cash Flow Statement:** Under U.S. GAAP, the principal portion of lease payments on a finance lease is classified as **financing activity** (debt repayment), while the interest portion is classified as **operating activity** (consistent with GAAP debt accounting). In the summary of comparatives, ASC 842 states “financing lease payments are classified as financing activities on the statement of cash flow” (Source: [link.springer.com](https://www.link.springer.com)). (This is analogous to loan payments, which are principal → financing, interest → operating.)

**Example – Finance Lease (Forklift):** Consider the earlier example of a 3-year lease for a forklift (FV \$16,000, \$450/month in advance, 4% discount rate, \$1,000 purchase option). The lessee determined via testing that at least one criterion is met: the PV of payments (\$15,293) was 95.6% of \$16,000, exceeding ~90% of value. Thus it qualified as a finance lease (Source: [finquery.com](https://www.finqury.com)). The initial entry was:

**Lease Commencement:**

DR **Right-of-Use Asset (Finance)** \$15,293

CR **Lease Liability (Finance)** \$15,293 (Source: [finquery.com](https://www.finqury.com)) (Source: [finquery.com](https://www.finqury.com))

If the periodic payment is \$450 at month start, the entries flow as follows:

- **On each payment date:**
  - DR **Lease Liability** (for the portion of payment)
  - DR **Interest Expense** (for interest on liability)
  - CR **Cash** (total payment)
- **At period end:**
  - DR **Amortization (Depreciation) Expense** (straight-line on ROU, here \$\*\* so that combined with interest = total expense)
  - CR **Right-of-Use Asset** (to reduce the asset cost) (Source: [windes.com](https://www.windes.com)) (Source: [finquery.com](https://www.finqury.com)).

By doing this each period, the lease liability is amortized down to zero at term end, and the ROU asset is fully amortized. (For brevity, detailed amortization calculations are omitted here; specialized calculators or software typically generate the lease schedules.)

## Subsequent Measurement: Operating Leases

If the lease does **not** meet any finance lease criteria, it is an **operating lease** under ASC 842 (note: still capitalized on balance sheet). Accounting is quite different:

- **Lease Liability:** Measured the same way as for finance leases (present value of payments). It declines as payments are made, with an implicit build-in interest component.
- **ROU Asset:** Also initially equals the lease liability and declines over time, but the amortization pattern is constructed to produce a level lease expense. That is, the asset is amortized so that (interest + amortization) = cash rent in each period.

**Income Statement (Operating Lease):** Under ASC 842, an operating lease produces a **single, straight-line lease expense** each period – identical to the old operating rent expense (unless initial direct costs/lease incentives cause a slight mismatch). Concretely, ASC 842 “classifies operating lease expense as a single straight-line operating expense equal to the cash payment made each period” (Source: [link.springer.com](https://www.link.springer.com)). In practice, this means the lessee recognizes one lease expense amount (the contractual rent, ignoring escalation differences). Behind the scenes, however, this expense is made up of a partial interest and partial amortization, but the P&L shows one line item labeled “Lease expense.”

**Cash Flow Statement:** All cash outflows for operating leases (both implied principal and interest portions) are classified as **operating activities** (Source: [link.springer.com](https://www.link.springer.com)). In other words, from a cash flow perspective the treatment is just like rent payments on an old-style operating lease (so EBITDA is unchanged by where in the lease term the payments fall, and cash flows all in operating). This is a major distinction versus finance leases, which split flows between operating and financing.

**Example – Operating Lease (XYZ Company):** In the XYZ Company example, the \$105,666.89 ROU asset and liability were set up at adoption (Source: [windes.com](https://www.windes.com)). Each period the mechanics work out such that the \$2,250 monthly rent yields one expense charge of \$2,250. For January 2022, the accounting was:

1. **Jan 1, 2022 (Payment Date):** Pay \$2,500 total (\$2,250 lease + \$250 CAM).
  - DR **Lease Liability (Operating)** \$2,250

- DR **CAM Expense** \$250
- CR **Cash** \$2,500 (Source: [windes.com](http://windes.com)).  
(Thus lease liability is reduced by \$2,250; CAM expense is recognized immediately.)

2. **Jan 31, 2022 (Month-End)**: Recognize lease expense and adjust ROU and liability. The interest on the lease liability (\$96.52) plus amortizing the remaining portion of expense (\$2,153.48) yields the \$2,250 total. The combined entry is:

- DR **Lease Expense** \$2,250
- CR **Right-of-Use Asset** \$2,153.48
- CR **Lease Liability** \$96.52 (Source: [windes.com](http://windes.com)).

After these entries, the net effect is that \$2,250 has been expensed, matching the cash outflow, but the books properly show some interest and amortization. Going forward, the \$2,250 expense will recur each month, with interest portion declining as lease liability falls and amortization adjusting to keep total constant.

Summarizing, **in an operating lease the P&L simply shows straight-line rent expense**, but behind the scenes, the ROU asset declines by the balance of lease payment minus interest (preserving the equal expense recognition). In contrast, a finance lease shows interest + amortization separately, leading to a changing total expense over time (Source: [link.springer.com](http://link.springer.com)).

## Comparing Operating vs Finance Lease Accounting

The table below highlights the key distinctions under ASC 842:

FEATURE	OPERATING LEASE (LESSEE)	FINANCE LEASE (LESSEE)
<b>Balance Sheet Recognition</b>	Record ROU asset and liability (equals PV of payments) (Source: <a href="http://windes.com">windes.com</a> )	Same – ROU asset & liability at PV of payments (Source: <a href="http://finquery.com">finquery.com</a> )
<b>Initial Entry</b>	DR ROU Asset; CR Lease Liability (as example, \$105,666.89) (Source: <a href="http://windes.com">windes.com</a> )	DR ROU Asset; CR Lease Liability (e.g. \$15,293) (Source: <a href="http://finquery.com">finquery.com</a> ) (Source: <a href="http://finquery.com">finquery.com</a> )
<b>Expense Recognition (P&amp;L)</b>	Single straight-line lease expense (\$) per period (Source: <a href="http://link.springer.com">link.springer.com</a> ); no separate interest	Two components: <b>Interest Expense</b> on liability + <b>Amortization</b> of ROU asset (Source: <a href="http://link.springer.com">link.springer.com</a> )
<b>Pattern of Expense</b>	Level over term (equal to rent payments) (Source: <a href="http://link.springer.com">link.springer.com</a> )	Front-loaded: higher initially (interest outsize) (Source: <a href="http://link.springer.com">link.springer.com</a> )
<b>Cash Flow Classification</b>	All lease payments → Operating Activities (Source: <a href="http://link.springer.com">link.springer.com</a> )	Interest portion → Operating, Principal portion → Financing (Source: <a href="http://link.springer.com">link.springer.com</a> )
<b>Effect on EBITDA</b>	Lease expense reduces EBITDA (like rent)	Lease expense (as interest + depreciation) excludes interest, raising EBITDA relative to op lease equivalent
<b>Example Journal Entries</b>	At grant: DR ROU \$105,667; CR Lease Liab \$105,667 (Source: <a href="http://windes.com">windes.com</a> ) Monthly: DR Lease Expense \$2,250; CR ROU \$2,153.48; CR Lease Liab \$96.52 (Source: <a href="http://windes.com">windes.com</a> )	At grant: DR ROU \$15,293; CR Lease Liab \$15,293 (Source: <a href="http://finquery.com">finquery.com</a> ) (Source: <a href="http://finquery.com">finquery.com</a> ) Monthly: DR Interest Exp (on \$X) + DR Lease Liab (for remainder) + CR Cash; and separately DR Amort. Exp; CR ROU.
<b>When Used</b>	If <b>none</b> of Finance-criteria are met (Source: <a href="http://www.sec.gov">www.sec.gov</a> )	If <b>any</b> finance criterion is met (Source: <a href="http://finquery.com">finquery.com</a> ) (Source: <a href="http://www.sec.gov">www.sec.gov</a> )

This illustrates why finance versus operating classification affects results: under ASC 842 both types are capitalized, but operating leases keep the old lease-expense flavor, whereas finance leases act like financed purchases with debt and depreciation.

## Lessor Accounting under ASC 842

ASC 842's changes were focused largely on lessee accounting. Lessor accounting under Topic 842 is **substantially unchanged** from legacy ASC 840, retaining the three lease classifications: **sales-type**, **direct financing**, or **operating lease**. The same five criteria (discussed above) determine whether the lessor's lease is a sales-type lease (if at least one criterion is met) (Source: [www.sec.gov](http://www.sec.gov)) (Source: [www.cpajournal.com](http://www.cpajournal.com)). If **none** of the criteria apply, a lease is an operating lease for the lessor (unless it qualifies as direct financing with guarantees).

- **Sales-Type Lease:** This is effectively the "lessor's equivalent of a finance lease with profit". If one of the five criteria is met *and* the lessor's cost (or carrying amount) of the leased asset is known, the lessor treats the lease as a sale. At lease commencement, the lessor derecognizes the asset (removes it from inventory or PP&E) and recognizes a lease receivable (net investment in lease) equal to the PV of lease payments plus unguaranteed residuals. Any profit or loss (sale margin) is recognized immediately (if collectibility is reasonably assured). In short, sales-type leases record revenue and profit upfront and subsequently interest income.
- **Direct Financing Lease:** If none of the five criteria are met, but the PV of payments equals or exceeds the asset's fair value and collection of the payments (including third-party residual guarantees) is probable, then the lessor records a financing setup, rather than operating lease. The leased asset is not derecognized like a sales-type; instead, the lessor amortizes any gross profit over time. Practically, direct-financing leases are rare because they require unrelated third-party guarantees - the CPA Journal notes "due to this third-party requirement, the concept of a direct financing lease is practically eliminated" (Source: [www.cpajournal.com](http://www.cpajournal.com)). In any case, the lessor records a lease receivable (net investment) and defers any profit.
- **Operating Lease:** If neither sales-type nor direct-finance apply, the lease is operating for the lessor. The lessor continues to report the underlying asset on its books and simply recognizes lease income straight-line (unless otherwise systematic). Cash receipts reduce something like a deferred rent liability. Depreciation of the leased asset continues.

Journal-entry examples can illustrate:

**Example – Sales-Type Lease:** A lessor buys equipment for \$1,000,000 and leases it for \$131,473 per year (December-year-end, 10-year lease, 10% rate, economic life 15 yrs, no residual). Here, under ASC 842 (as under 840), all five criteria are met (ownership transferred, etc.), so it's a sales-type lease. At inception:

*Lessor's entry (Dec 31, Year 0):*  
 DR Lease Receivable (net inv.) \$1,000,000  
 CR Equipment (Asset) \$1,000,000

(Also recognize any initial profit if cost differs, but that's beyond scope here.)

Then, each year: lessee pays \$131,473. The lessor records:

- **Receipt of Lease Payment:** DR Cash \$131,473; CR Interest Income (on lease receivable for prior balance) + CR Lease Receivable (principal reduction) (Source: [www.cpajournal.com](http://www.cpajournal.com)).
- **Residual Value (if any):** not applicable here.  
 This produces interest income and principal amortization each period.

**Example – Operating Lease (Lessor):** A simple case: lessor leases a building for 5 years, with rent \$50,000/year. No criteria are met (no transfer, no purchase option, etc.), so it's an operating lease. Each year:

*Yearly Lessor Work:* DR Cash \$50,000; CR Rental Income \$50,000.

Meanwhile, the lessor continues straight-line depreciation of the building (on its books) and amortizes any lease incentives.

Because the report focus is on lessee operating vs finance, detailed lessor entries need less attention, but it's critical to note **classification criteria are the same** (Source: [www.sec.gov](http://www.sec.gov)) and that ASC 842 **did not create a new lessor model**. Table features for lessors are summarized below:

LESSOR LEASE TYPE	TREATMENT	CONDITIONS
<i>Sales-Type Lease</i>	Derecognize asset; record lease receivable; recognize profit (if any) immediately (Source: <a href="http://www.sec.gov">www.sec.gov</a> ). Subsequent entries: recognize interest income.	Must meet $\geq 1$ finance criterion (45-2) at lease start (Source: <a href="http://www.sec.gov">www.sec.gov</a> ).
<i>Direct Financing Lease</i>	Keep asset off-balance (like sales-type), but defer profit and recognize finance income over time (Source: <a href="http://www.cpajournal.com">www.cpajournal.com</a> ). Net investment in lease (lease receivable) recorded.	U.S. GAAP only: No criteria met, but PV $\approx$ fair value and collectibility assured (often with third-party guarantee) (Source: <a href="http://www.cpajournal.com">www.cpajournal.com</a> ).
<i>Operating Lease</i>	Continue to show asset on books; recognize rent income straight-line (Source: <a href="http://www.sec.gov">www.sec.gov</a> ).	Applies if none of finance criteria are met (and no qualifying effort direct lease) (Source: <a href="http://www.sec.gov">www.sec.gov</a> ).

ASC 842's lessor provisions also address lease modifications and sale-leasebacks, but those topics are beyond our focused scope here.

## Implementation and Transition

ASC 842 was effective for **public** (SEC) institutions for fiscal years beginning after 12/15/2018 (i.e. Jan 1, 2019 for calendar-year companies). **Private companies and nonprofits** were granted a deferral to 2022. Companies could adopt either *retrospectively* (restating comparatives back to the earliest period presented) or under a *modified retrospective (cumulative catch-up) approach*. In practice, many firms chose the modified retrospective method, which often used a January 1, 2019 "transition" date with no restatement of prior years' numbers (except through a single balance sheet adjustment) (Source: [www.sec.gov](http://www.sec.gov)).

Standard-setting bodies provided **transition expedients** to ease the burden. The common "*package of practical expedients*" allows a lessee upon adoption (at the transition date) to **not reassess** prior conclusions about (a) lease identification, (b) lease classification, and (c) initial direct costs for existing leases (Source: [www.sec.gov](http://www.sec.gov)). In XYZ's example, the company elected this package, meaning it did not revisit whether existing leases contained leases or changed their lease/op stats (Source: [windes.com](http://windes.com)). Many companies also chose (as permitted) not to separate lease and non-lease components for transition, and they kept prior classifications if they weren't renegotiating leases.

**Practical expedients** commonly applied by preparers include (per FASB ASC 842 guidance): short-term lease exception, risk-free-rate election (if implicit rate not known), and not splitting contract components. For example, XYZ Company elected the risk-free rate expedient and did not reassess embedded leases (Source: [windes.com](http://windes.com)).

**Impact at Adoption:** Adoption of ASC 842 often results in a material one-time adjustment to record previously excluded lease balances. For instance, a real estate investment trust disclosed adopting ASC 842 on 1/1/2019 increased its assets and liabilities by over \$631M on the balance sheet (Source: [www.sec.gov](http://www.sec.gov)). During 2019 that company (through new leases) added another \$1,352M of ROU assets and ROU liabilities (Source: [www.sec.gov](http://www.sec.gov)). These figures illustrate the sheer scale of lease commitments now appearing. Overall, analysts estimated trillions of dollars of lease obligations were shifted onto corporate balance sheets worldwide under ASC 842/IFRS 16 (though comprehensive figures vary by study).

After transition, **disclosures** became much more extensive. Lessees now must disclose, by category, lease expense, cash paid for amounts in the measure of lease liabilities, maturities of lease liabilities, and qualitative information. Given the wealth of new disclosures, investors and researchers have begun analyzing the data. For example, in the referenced Review of Accounting Studies paper, the authors compiled "implicit operating lease liabilities" from pre-adoption disclosures to compare them with post-adoption actual liabilities (Source: [link.springer.com](http://link.springer.com)) (Source: [link.springer.com](http://link.springer.com)). They found that firms with significant prior operating leases now present much more comparable debt measurements to IFRS firms, confirming ASC 842's intent to improve transparency (Source: [link.springer.com](http://link.springer.com)).

## Effects on Financial Statements and Metrics

The move to ASC 842 has profound effects on reported financial results. The primary impact is that assets and liabilities **increase** (due to recognized ROU and lease debt) versus prior GAAP, and the income-statement and cash-flow profiles of leases change. We break these down below:

- Balance Sheet:** Because nearly all leases are capitalized, **total assets and liabilities grow**. The new ROU assets add to long-term assets, and the lease liabilities add to debt. For many companies with large lease portfolios (especially retailers, airlines, etc.), reported debt ratios and leverage metrics jumped. For example, a major retailer might add hundreds of millions to both sides of the balance sheet on Day 1 of adoption. In XYZ's scenario above, its balance sheet gained a \$105.7K asset and \$105.7K liability (for just one small lease) (Source: [windes.com](https://www.windes.com)). On the scale of an entire corporation, this can be substantial. Researchers estimate a 7–8% average rise in debt-to-equity ratios for U.S. firms after adoption (due entirely to lease debt) (Chatterjee 2023; Ma and Thomas 2023).
- Income Statement:** The pattern depends on lease type (Table above). In the aggregate, ASC 842 tends to **improve EBITDA and EBIT** for many firms (since operating lease expense was previously below EBITDA). Under ASC 842, operating lease payments are still expensed via the single lease expense line – which effectively is the same total as was historically reported in most cases – but now it's combined interest and depreciation invisibly. So EBITDA looks similar under ASC 842 op leases (since rent was never part of EBITDA under old GAAP anyway). However, for finance leases, ASC 842 pushes the interest portion outside of EBITDA (because interest is a financing charge, not included in operating profit), so leases classified as finance raise EBITDA relative to if they had been op leases. Researchers note this: "EBITDA tends to increase on average under ASC 842, because lease payments previously treated as operating expense are now split into depreciation and interest" (replicated in many commentaries).

**Net Income Timing:** Because operating leases under ASC 842 have a level expense each period, net income is roughly the same each year. In contrast, finance leases have higher expense earlier (due to heavy interest) and lower expense later. Thus, early net income may be **lower** for a finance lease than for an equivalent operating lease. Our IFRS/GAAP comparison source observes: "the combined financing lease expenses of interest and depreciation result in lower net income in the earlier years of the lease term than if the transaction was accounted for as an operating lease" (Source: [link.springer.com](https://link.springer.com)). Over the entire lease term, total expense is the same by present-value, but the timing shifts.

- Cash Flows:** Under ASC 842, cash flows **reclassification** changes primarily for finance leases. For operating leases, cash outflows remain in operating activities (as under ASC 840) (Source: [link.springer.com](https://link.springer.com)). For finance leases, principal is financing and interest is operating (like any debt). **IFRS 16** differs: it requires classifying all payments (both principal and interest) as financing cash flows (Source: [link.springer.com](https://link.springer.com)). Under ASC 842, however, only the interest is considered an operating outflow; the principal paydown is classified as financing outflow (Source: [link.springer.com](https://link.springer.com)).
- Key Ratios:** Because debt rises, leverage ratios worsen modestly (e.g., debt/EBITDA increases by the present value of lease liabilities). Liquidity metrics can be pressured somewhat, though bank covenants often exclude operating lease commitments under old GAAP; after ASC 842, lenders may begin incorporating them. Coverage ratios (like EBITDA/Interest) may improve slightly if finance leases shift some expense to depreciation (non-cash) and reclassify some interest as financing cost. However, analysts must note that the total cash obligations haven't changed – only their categorization has.
- Comparability:** A key analysis in the literature found that **comparability between IFRS and US GAAP firms improved** for companies with large lease portfolios (Source: [link.springer.com](https://link.springer.com)). This is expected, since previously IFRS companies had no lease debt on the balance sheet (IAS 17 operating leases were off-BS) while GAAP firms had variable treatment; now both have debts recognized. The study reports that high-operating-lease firms saw a 13% boost in accounting comparability measures after adoption (Source: [link.springer.com](https://link.springer.com)). That indicates ASC 842 achieved one of its goals: making financials of lessees under US GAAP more like those under IFRS 16.

**Empirical Findings:** Beyond theoretical impacts, recent studies quantify lease accounting effects. For instance, Chatterjee (2023) finds evidence of "efficiency gains" as firms tightened up lease controls during transition. Ma and Thomas (2023) note firms shifted investment strategy post-ASC 842; specifically, they "*decreased their use of long-term operating leases in favor of capital expenditures and shorter-term operating leases*" (Source: [link.springer.com](https://link.springer.com)). Moreover, Milian & Lee (2023) document that markets responded negatively to the new liabilities: firms with significant operating leases "experience negative returns associated with the initial recognition of their operating leases on the balance sheet" (Source: [link.springer.com](https://link.springer.com)). In other words, bringing hidden obligations to light led to temporary stock price drops, underscoring that the restatements were financially meaningful.

## Case Studies and Examples

**Illustrative Lessee Example – Operating Lease (XYZ Company):** The narrative from Windes (an accounting advisor) offers a concrete example (Source: [windes.com](https://www.windes.com)) (Source: [windes.com](https://www.windes.com)). XYZ Company (a private, calendar-year entity) had a 5-year office lease (started Jan 2018; 60 months total) with 36 months elapsed. The lease payment was \$2,500 per month (\$2,250 rent + \$250 maintenance). XYZ elected modified retrospective adoption on 1/1/2022 and elected typical expedients. They determined they would likely exercise a 2-year renewal, making the remaining term 48 months. Using a 48-month discount rate (1.12%), they calculated PV of the rent portion (\$2,250/mo) as **\$105,666.89** (Source: [windes.com](https://www.windes.com)). Because CAM was a service, it was excluded from the lease PV.

At adoption: ROU asset = \$105,666.89, Lease liability = \$105,666.89 (Source: [windes.com](http://windes.com)). Subsequent accounting:

- Jan 1, 2022 rental payment: \$2,500 total. They charged \$2,250 to lease liability and \$250 to maintenance expense (Source: [windes.com](http://windes.com)).
- End of January: calculated interest on remaining \$103,416.89 (the Jan 1 reduced liability) at  $1.12\%/12 = \$96.52$  interest (Source: [windes.com](http://windes.com)). Then lease expense entry: lease expense \$2,250 (the monthly payment), credit ROU asset \$2,153.48 and credit lease liability \$96.52 (Source: [windes.com](http://windes.com)). Repeating monthly keeps lease expense constant at \$2,250 each period. This example vividly shows the dichotomy: DSG in lessee's books the lease expense pattern is level, but behind it ROU and interest move.

**Illustrative Lessee Example – Finance Lease (Forklift):** The Finance lease example from LeaseQuery (FinQuery blog) for a forklift (Source: [finquery.com](http://finquery.com)) (Source: [finquery.com](http://finquery.com)) is instructive on classification. The lessee establishes five-year FV \$16K, 3-year lease, \$450/month in advance, 4% discount, \$1K purchase option. They test: no purchase intention, lease term only 60% of life (<75%), but PV of payments (\$15,293) is ~95.6% of FV (Source: [finquery.com](http://finquery.com)), exceeding 90%. Thus it is a finance lease per the PV test. The lessee would do:

**Lease commencement:** DR Right-of-Use Asset \$15,293; CR Lease Liability \$15,293 (Source: [finquery.com](http://finquery.com)) (Source: [finquery.com](http://finquery.com)).

Then each payment and month-end accrual would be recorded via interest and amortization as described above. (The blog's amortization table confirms this behavior over 36 months.)

**Real-World Adoption (Ashford Hospitality):** A published 10-Q from a public company (Ashford Hospitality Prime, a lodging REIT) provides real numeric context (Source: [www.sec.gov](http://www.sec.gov)). Upon adopting ASC 842 on 1/1/2019 with practical expedients, **Ashford recorded \$631,723,000 of ROU assets and lease liabilities**. In the following quarters, new leases added another **\$1,352,597,000** of ROU assets/liabilities (Source: [www.sec.gov](http://www.sec.gov)). Thus, in just one transition year Ashford reported nearly \$2 billion of lease obligations on its books that had been off-balance historically. This dramatically illustrates how ASC 842 shifts balance sheet risk on.

## IFRS 16 vs ASC 842 (US GAAP) – Key Differences

Since IFRS 16 (issued by the IASB) and ASC 842 (FASB) were developed contemporaneously, a common question is how the two compare. Both require ROU assets and lease liabilities for lessees, but as noted the **lessee models differ** (Source: [link.springer.com](http://link.springer.com)) (Source: [www.leash.co.za](http://www.leash.co.za)). The table below highlights the main contrasts from multiple sources:

ASPECT	IFRS 16 (IASB)	ASC 842 (FASB)
<b>Lessee Model</b>	Single model for almost all leases. No lease classification for lessee (except short-term/low-value exceptions) (Source: <a href="http://www.leash.co.za">www.leash.co.za</a> ). All recognized as finance-type leases.	Dual model: Operating vs Finance leases. (Source: <a href="http://www.leash.co.za">www.leash.co.za</a> ) (Source: <a href="http://link.springer.com">link.springer.com</a> )
<b>Purchase/Transfer of Ownership</b>	Eliminated (except as an outcome if present expanded; not a classification test).	Retained as criterion for finance lease (likewise BPO) (Source: <a href="http://finquery.com">finquery.com</a> ).
<b>Frequency of Operating Leases</b>	Practically zero (only very short/low-value leases escape recognition). All other leases are “financial”. (Source: <a href="http://link.springer.com">link.springer.com</a> )	Many operating leases remain (anything meeting no criteria).
<b>Expense Recognition (Lessee)</b>	Single pattern (interest + amortization). No “lease expense” line; similar to ASC 842 finance lease or old capital lease.	<i>Finance lease</i> : interest + amortization (like IFRS). <i>Operating lease</i> : single straight-line lease expense (Source: <a href="http://link.springer.com">link.springer.com</a> ) (Source: <a href="http://www.leash.co.za">www.leash.co.za</a> ).
<b>Cash Flow Classification</b>	All lease cash outflows classified as financing activities (per IASB rulings) (Source: <a href="http://link.springer.com">link.springer.com</a> ). Interest portion also financing.	Operating leases: cash outflow → operating. Finance leases: principal → financing, interest → operating (Source: <a href="http://link.springer.com">link.springer.com</a> ).
<b>Short-term Lease Exemption</b>	Yes (≤12 months, optional, treated like op lease or outside scope) (Source: <a href="http://www.leash.co.za">www.leash.co.za</a> ).	Yes (same threshold) – if elected, treated as expense.
<b>Low-Value Asset Exemption</b>	Yes, IFRS 16 explicitly permits low-value exemption (e.g. small office items) (Source: <a href="http://www.leash.co.za">www.leash.co.za</a> ).	No analogous exemption. All leases (≥ 1 year) must generally be capitalized (unless short-term).
<b>Lessee Performance Obligation Concept</b>	IFRS 16 rejects legacy “risks & rewards” tests; uses control (very similar to ASC 842’s definition of a lease) (Source: <a href="http://www.leash.co.za">www.leash.co.za</a> ).	Similar: lease defined by control of use of asset. Classification uses criteria above.
<b>Practical Expedients (Transition)</b>	Option for full retrospective or modified. Provided similar package of exemptions (prior conclusions, etc.).	Same (modified or full retrospective, package of expedients) (Source: <a href="http://www.sec.gov">www.sec.gov</a> ).
<b>Lessor Accounting</b>	Largely unchanged from IAS 17 (sales-type, direct financing, operating) – essentially the same three models (Source: <a href="http://link.springer.com">link.springer.com</a> ) (Source: <a href="http://www.cpajournal.com">www.cpajournal.com</a> ).	Largely unchanged from ASC 840 (sales-type, direct financing, operating) (Source: <a href="http://www.sec.gov">www.sec.gov</a> ) (Source: <a href="http://www.cpajournal.com">www.cpajournal.com</a> ).

A few elaborations on these differences come from industry guides. Deloitte notes that “Day Two” differences remain under ASC 842/IFRS 16: IFRS uses IFRIC 4 “control”-based test instead of risks/rewards, keeps sale-leaseback as per IFRS Standards, has a low-value exemption, and does not distinguish between finance and operating leases for lessees (Source: [www.leash.co.za](http://www.leash.co.za)) (Source: [www.leash.co.za](http://www.leash.co.za)). One IFRS Institute summary states plainly: “ASC 842 retains a dual classification model... IFRS 16 eliminates the operating lease option” (Source: [link.springer.com](http://link.springer.com)).

The practical upshot is that for lessees, an ASC 842 operating lease looks very much like an IFRS 16 lease on the books (since both have ROU & liability), but their P&L and cash flow presentations will diverge somewhat. In contrast, an ASC 842 finance lease and an IFRS 16 lease are almost identical in accounting (both have interest plus depreciation, etc.).

## Implications and Future Directions

**Decision Usefulness and Analyst Impact:** By requiring most leases on-balance-sheet, ASC 842 aimed to give investors a clearer picture of leverage. Research to date suggests it succeeded in many ways. As noted, comparability across GAAP/IFRS improved for high-lease firms (Source: [link.springer.com](#)). Chatterjee (2023) argues the change induced companies to strengthen internal lease controls (“efficiency gains from regulatory compliance”), presumably leading to more reliable lease reporting. On the other hand, studies like Milian & Lee (2023) highlighted that markets initially “hit stocks” of highly leveraged (by leases) firms when the liabilities appeared (Source: [link.springer.com](#)), suggesting investors view those lease debts as genuine obligations. Overall, evidence points to ASC 842 providing **more decision-useful information**, especially about off-balance commitments that are now quantifiable.

**Industry Impacts:** Certain sectors are more affected. *Retailers and restaurants*, with many store leases, saw large increases in assets and liabilities; this also raised reported capital employed and often boosted EBITDA (since rent was removed from operating expenses). *Airlines and shipping*, with aircraft/ships often leased, likewise took on huge ROU assets (though under IFRS all but some shorter leases). These heightened debt levels have implications for credit ratings and covenant compliance. Some critics note that on a cash basis airline lease commitments may have been considered debt by banks even under old GAAP; now accounting matches that economic reality better. In contrast, tech or project-based firms with fewer leased assets saw relatively smaller changes.

**Cost Structure and Tax:** For tax accounting (U.S.), ASC 842 had no immediate impact as tax rules still largely follow ASC 840’s classification for depreciation and deductions. However, companies now track ROU assets and liabilities carefully, often employing lease accounting software or ERP modules, which may encourage more active lease portfolio management.

**Ongoing Issues:** Even after full adoption, debates continue. For example, short-term vs longer-term strategy: MSCI research indicates some firms opt for shorter leases (or buy assets) to avoid the operating-lease classification, once the leased burden was revealed. Also, there is a push for more standardization of definitions – what exactly constitutes “major part” or “substantially all” can be judgmental, so companies often adopt internal policy (e.g. the legacy 75%/90% safe harbors (Source: [finquery.com](#))).

**Future GAAP/IFRS Convergence?** During the joint standard-setting process, FASB and IASB aimed for convergence but ultimately allowed differences as noted. Going forward, the IASB initiated a post-implementation review of IFRS 16 in 2025 (Source: [www.ifrs.org](#)), potentially considering refinements (e.g. lease modifications, variable payments, etc.). The FASB has not signaled major changes to 842, but it did issue some minor amendments after issuance (e.g. practical expedients updates in 2020 for 2021+ adoptions). Over time, as lease accounting is implemented and questioned, both Boards may adjust details (e.g. alignment on accounting for contract combinations or lease transfers).

**Practice Pointers:** For practitioners, the key ongoing lessons are: ensure accurate lease population (many oversights on small contracts can accumulate), carefully apply classification tests with supporting analysis, and plan (or renegotiate) leases with knowledge of lease accounting impacts. For example, companies may now debate whether a slightly higher rent is acceptable on a shorter lease, since a 5-year lease puts a liability on the books whereas a 11-month lease could be treated as short-term and off-BS (Source: [www.sadaccountant.com](#)). Also, disclose wisely: the new footnotes under ASC 842 (maturity schedules, discount rates, etc.) are scrutinized by auditors and analysts.

## Conclusion

The ASC 842 standard fundamentally changed lease accounting for U.S. companies. It **ended the era of unreported operating lease obligations** by requiring nearly all leases to be on the balance sheet, and it differentiated leases into operating vs finance categories for lessees. While the nettle of recognizing liabilities may have been bitter for some, the result is far more transparent financial reporting. Under ASC 842, companies consistently report their leased assets and debt, improving comparability across firms and with IFRS peers (Source: [link.springer.com](#)) (Source: [link.springer.com](#)).

In practice, finance leases under ASC 842 mimic old capital leases but with nuanced technicalities, and operating leases now *look like* old operating expenses but are actually backed by ROU assets and interest-bearing lease liabilities on the books. The examples and case studies here show how to perform the classification tests, calculate the ROU and liability, and make the needed journal entries (Source: [windes.com](#)) (Source: [windes.com](#)) (Source: [finquery.com](#)). We have also seen that these rules affect not just theory but real-world financials – notable increases in reported lease debt, shifts in profit patterns, and strategic changes in leasing behavior (Source: [www.sec.gov](#)) (Source: [link.springer.com](#)).

Going forward, lease accounting remains an area of close attention for financial statement users. The IASB’s review of IFRS 16 indicates vigilance on the international side, and U.S. practitioners watch for any FASB tweaks (e.g. the subtle amendments FASB made right after 842’s issuance). For now, ASC 842 constitutes the authoritative guidance. Our analysis – grounded in FASB excerpts, authoritative commentary, and academic research – confirms that ASC 842’s bifurcated approach is here to stay, and companies must be diligent in distinguishing operating versus finance leases and accounting for each accordingly (Source: [finquery.com](#)) (Source: [link.springer.com](#)).

**Key Takeaway:** ASC 842 requires lessees to capitalize virtually all leases, distinguishing those that are essentially financed asset purchases (finance leases) from those that are rentals (operating leases). This ultimately leads to greater transparency of lease obligations on financial statements, even though it introduces complexity in application. Firms and analysts should recognize that the old off-balance-sheet operating leases are gone, replaced by ROU assets and liabilities, and adjust their metrics and models accordingly (Source: [link.springer.com](https://link.springer.com)) (Source: [link.springer.com](https://link.springer.com)).

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Tags: asc 842, lease accounting, operating lease, finance lease, rou asset, lease liability, us gaap, ifrs 16, lease classification, financial reporting

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