A LOOK AT THE NEW LEASE ACCOUNTING STANDARDS OF FASB

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Highlights

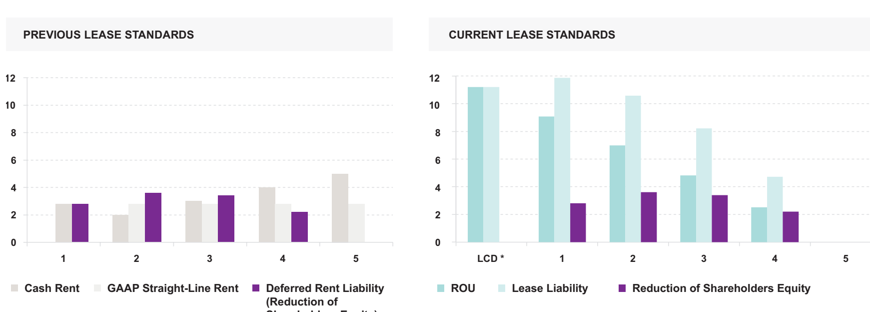
- Most leases are now recorded on a company's balance sheet both as an asset (right-of-use asset or ROU) and as a liability (lease liability).
- The finance lease and operating lease classifications have been retained; accordingly, the P&L treatment is almost identical to previous lease standards, even though the lease classification criteria are different
- Measurement of balance sheet recognition is based on the present value of lease payments, which are determined by evaluating the following criteria: lease and non-lease components, variable lease payments and initial direct costs
- Sale-leaseback is now subject to the sale recognition criteria pursuant to ASC 606 and ASC 842.
- Sublease profit or loss is recognized subject to whether the sublessor is relieved of the primary obligation and the lease classification of the sublease.

Factors to consider that could temper initial concerns.

The subsequent measurements of the ROU asset and Lease Liability under ASC 842 create a negative impact on the shareholder value when the carrying amount of liability is greater than the carrying amount of the asset in a given period. However, in the previous standards, the cumulative deferred rent resulting from the difference between the cash rent and the straight-line rent created a similar impact on the shareholder value. Therefore, ASC 842 did not really cause an incremental impact on the shareholder value. In addition, rating agencies have already reflected the balance sheet impact of the company's lease obligations in their analyses.

Therefore, if the new standards have a neutral impact on the shareholder value and the rating agencies' current analysis methodology already recognized the

Why Impact of ASC 842 to Shareholder Value is Neutral *Chart 1*



balance sheet impact of leases, then signing short-term leases and foregoing renewal options to mitigate the balance sheet impact no longer makes practical sense. Accordingly, companies may continue to sign leases with terms that are consistent with their operational imperatives.

THE AMENDMENTS IN THIS UPDATE WILL TAKE EFFECT FOR FISCAL YEARS BEGINNING AFTER DECEMBER 15, 2018 FOR PUBLIC BUSINESS ENTITIES.

Background

In February 2016, Financial Accounting Standards Board (FASB) finally issued an amendment to Accounting Standards Codification (ASC) by creating Topic 842—Lease update. Similarly, the International Accounting Standards Board (IASB) issued their version of the update called IFRS 16.

These updates were the result of a joint initiative by both boards to increase transparency and comparability among organizations, by recognizing lease assets and lease liabilities on the balance sheet and disclosing key information about leasing arrangements. While the original joint initiative included the convergence of FASB/IASB lease accounting standards, the final, updated versions of both boards still contain provisions with distinct differences.

It should be noted that this paper intends to merely present FASB Topic 842 with respect to real estate property and primarily from the lessee's perspective.

Timing

The amendments in this update will take effect for fiscal years beginning after December 15, 2018 for public business entities. For all non-public entities, it will take effect for fiscal years beginning after December 15, 2019.

Early application of the amendments in this update is permitted for all entities.

Transition

For leases that commenced prior to the effective date, lessees and lessors shall recognize and measure leases at lease commencement date or at a later date prior to the effective date. Further, they may elect to apply all or none of the practical expedients, which allow an entity to forego reassessing expired or existing leases, based on the following:

- Whether they are lease contracts by themselves or a component of a contract;
- The lease classifications (i.e. operating or capital lease);
- Initial direct costs (for any existing leases).

An entity may elect another practical expedient option, independently or in conjunction with the practical expedients listed previously and use hindsight in determining the lease term (i.e. when considering lessee options to extend or terminate the lease and to purchase the underlying asset) and assessing impairment of the entities ROU asset.

An entity that elects to apply the practical expedients will, in effect, continue to account for all leases that commenced before the effective date, in accordance with previous GAAP lease classification and lease term, unless the lease is modified.

Illustration of Early Transition of Existing Operating Lease Under Previous Standards to New FASB *Chart 2*

		CASH	P&L		LEASE LIABILITY				ROU ASSET			
Lease Year	Calendar Year	**EXISTING LEASE** Net Rent Lease Payments (Cash)	**EXISTING LEASE** Straight-Line Rent (Previous standards)	**EXISTING LEASE** Straight-Line Rent (New standards)	Y/B Balance	Effective Interest	Lease Component Cash Amount	Y/E Lease Liability Balance **112,461.69**	Liability Balance	**PREPAID/(ACCRUED) RENT** (annual)	(cumulative)	Y/E ROU Asset Balance **$112,461.69**
1	2016	*a.* 31,000	*b.* 32,200	*c.*	*d.*	*(d.x6%) = e.*	*(a.) = f.*	*(d.+ e. -f.) = g.*	*(g.) = h.*	*(a.- c.) = i.*	*j.* (1,200)	*(h.-j.) = k.*
Early application date									112,462		(1,200)	111,262 **
2	2017	31,000	32,200	32,500	112,462	6,748	(31,000)	88,209	88,209	(1,500)	(1,500)	86,709
3	2018	33,000	32,200	32,500	88,209	5,293	(33,000)	60,502	60,502	500	(1,000)	59,502
4	2019	33,000	32,200	32,500	60,502	3,630	(33,000)	31,132	31,132	500	(500)	30,632
5	2020	33,000	32,200	32,500	31,132	1,868	(33,000)	0	0	500	0	0
		130,000	128,800	130,000								
NPV-6% IBR		**112,462**										

** ROU is recorded net of existing deferred rent liability

> LESSEES SHALL RECOGNIZE A RIGHT-OF-USE ASSET AND A LEASE LIABILITY... EXISTING OPERATING LEASE (BASED ON THE PRESENT VALUE OF THE REMAINING MINIMUM RENTAL PAYMENTS, AS TRACKED AND DISCLOSED UNDER PREVIOUS GAAP) ... EXISTING CAPITAL LEASES (BASED ON CARRYING AMOUNT OF THE LEASE ASSET AND THE CAPITAL LEASE OBLIGATION)

With respect to expired or existing operating leases, lessees shall recognize a right-of-use asset and a lease liability based on the present value of the remaining minimum rental payments, as tracked and disclosed under previous GAAP. For expired or existing capital leases, lessees shall recognize right-of-use asset and a lease liability at the carrying amount of the lease asset and the capital lease obligation.

The transition guidance in Topic 842 also provides specific guidance for sale and leaseback transactions, build-to-suit leases, leveraged leases and amounts previously recognized in accordance with the business combinations guidance for leases.

Balance Sheet Recognition

Lessees are now required to recognize most leases (except those with less than 12 months of term) on the balance sheet as both an asset (for the lessee's right to use the underlying property) and also as a liability (for the lessee's obligation to pay rent); these are referred to as a Right-to-Use (ROU) asset and Lease Liability, respectively. The accounting for a ROU asset varies based on the lease classification (i.e. operating or finance lease), while accounting for a Lease Liability, which is similar to the capital lease accounting under the previous standards, will be the same for both lease classifications.

Illustration of Finance Lease Accounting *Chart 3*

	CASH			P&L		ROU	LEASE LIABILITY
Year	Net Rent	Purchase Option *	Lease Payments	ROU Amort. Exp	Interest	294,222	294,222
	a.	b.	(a.+b.) = c.	d.	e.	(Bal. - d.) = f.	(Bal. + e.-c.) = g.
1	-		-	58,844	17,653	235,378	311,876
2	20,000		20,000	58,844	18,713	176,533	310,588
3	21,000		21,000	58,844	18,635	117,689	308,224
4	22,000		22,000	58,844	18,493	58,844	304,717
5	23,000	300,000	323,000	58,844	18,283	-	-
	86,000		386,000	294,222	91,778		
	NPV-6% IBR		294,222				

* Assume that it is reasonably certain that the option will be exercised

Lease Classification

Finance Lease

A lessee shall classify a lease at lease commencement (as opposed to lease inception, which was the practice under the previous standards), as a finance lease when the lease meets any of the following criteria:

- Ownership is transferred to the lessee by the end of the lease term.
- Lessee is reasonably certain to exercise its purchase option.
- Lease term is for the major part of the remaining economic life; this criterion shall not be used if the commencement date falls at or near the end of the economic life.
- The present value of the sum of the lease payments and the residual value guaranteed by the lessee equals to or exceeds substantially all of the fair value of the underlying asset.
- Lessor has no alternative use at the end of the lease term, due to the specialized nature of the asset.

Operating Lease

A lease is classified as an operating lease when none of the criterion referenced above is met.

While ASC 840's bright lines (i.e. 75% economic life; 90% of fair value and last 25% of economic life) were eliminated, the ASC 842 implementation guidance references those bright line rules as alternatives when establishing a threshold for the economic life and fair value of the underlying asset. Since fair value test is based on lease payments that may include fixed costs (e.g., real estate taxes and insurance), leases should provide for a rent structure that excludes those fixed costs to avoid overstating the present value of the lease when comparing such with the fair value of the underlying asset.

Components of a Lease

Determining whether an element in a lease contract is a lease or a nonlease

Illustration of Operating Lease Accounting

Chart 4

	CASH						P&L
Year	Fixed Rental Payment	INCENTIVES Free Rent	INCENTIVES Work Allow.	Total Cash Payments	Lease Payment (Cash) ROU ASSET	Lease Payment (Cash) LEASE LIABILITY	Straight-Line Rent
	a.	b.	c.	(a.- b.- c) = d.	(d.) = e.	(a.- b.) = f.	g.
1	10,000	(3,000)	(7,000)	-	-	7,000	10,000
2	11,000	-	-	11,000	11,000	11,000	10,000
3	12,000	-	-	12,000	12,000	12,000	10,000
4	13,000	-	-	13,000	13,000	13,000	10,000
5	14,000	-	-	14,000	14,000	14,000	10,000
	60,000	(3,000)	(7,000)	**50,000**	50,000	57,000	50,000
NPV-6% IBR	50,058	(2,830)	(7,000)	40,228	**40,228**	**47,228**	

	LEASE LIABILITY				ROU ASSET			
Year	Y/B Balance	Effective Interest	Lease Payment (Cash) Lease Liability	Y/E Balance **$47,228.00**	Y/B Balance	PREPAID/(ACCRUED) RENT (annual)	PREPAID/(ACCRUED) RENT (cumulative)	Y/E Balance **$40,228.00**
	h.	(h.x6%) = i.	(f.) = j.	(h.+i. -j.) = k.	(k.)= l.	(e.-g.) = m.	n.	(k.-n.) = o.
					47,228 *			
1	47,228	2,834	(7,000)	43,062	43,062	(10,000)	(10,000)	33,062
2	43,062	2,584	(11,000)	34,645	34,645	1,000	(9,000)	25,645
3	34,645	2,079	(12,000)	24,724	24,724	2,000	(7,000)	17,724
4	24,724	1,483	(13,000)	13,208	13,208	3,000	(4,000)	9,208
5	13,208	792	(14,000)	-	-	4,000	-	-

* Reflects when work allowance amount is received.

FROM A BALANCE SHEET PERSPECTIVE, THE ACCOUNTING FOR A ROU ASSET VARIES BASED ON THE LEASE CLASSIFICATION (I.E. OPERATING OR FINANCE LEASE), WHILE ACCOUNTING FOR A LEASE LIABILITY WILL BE THE SAME FOR BOTH LEASE CLASSIFICATIONS

component depends on whether the activity transfers certain goods or services.

Nonlease components are those activities that transfer goods or services (e.g., CAM, cleaning, utilities, R&M, etc.), while the lease component refers to the right to use the building.

Land is also considered a separate lease component unless the accounting effect is immaterial.

Real estate taxes and building insurance costs do not constitute payments for goods or services; accordingly, they are deemed a lease component. However, from a practical standpoint, lessees may elect to separately pay real estate taxes and building insurance and as such those payments would be considered variable lease payments that do not depend on an index or a rate. Therefore; they would have to be separated from a lease component.

For practical expediency, Lessee may elect, as an accounting policy, to consider a single lease component instead of separating the lease into several components.

Lease Payments

Upon commencement of the lease, the lease payments shall consist of the following payments relating to the use of the underlying asset during the lease term:

- Fixed payments, including in substance fixed payments, less any lease incentives paid or payable to the lessee.
- Variable lease payments that depend on an index or a rate (such as the Consumer Price Index or a market interest rate), initially measured using the index or rate at the commencement date.
- The exercise price of an option to purchase the underlying asset—provided the lessee is reasonably certain to exercise said option.
- Payments for penalties for terminating the lease if the lease term reflects the lessee exercising an option to terminate the lease.
- Fees paid by the lessee to the owners of a special-purpose entity for structuring the transaction. However, such fees shall not be included in the fair value of the underlying asset).
- For a lessee only, amounts probable of being owed by the lessee under residual value guarantees.

Variable lease payments other than those mentioned above; any guarantee by the lessee of the lessor's debt; and amounts allocated to nonlease components are not considered lease payments. While a variable lease payment based on the Consumer Price Index (CPI)—as referenced in the above list is considered a lease payment, the common use of CPI as a rate of change (not the index itself) excludes such payment from being considered a lease payment.

Initial Measurement of ROU and Lease Liability

At the commencement date, a lessee shall measure the lease liability at the present value of the lease payments not yet paid over the noncancellable term, including renewal or purchase options that are deemed reasonably certain to be exercised. The discount rate is the

IF THE TRANSFER IS A SALE, SELLER-LESSEE RECOGNIZES THE TRANSACTION PRICE ---- AND DERECOGNIZES THE CARRYING AMOUNT OF THE UNDERLYING ASSET. ANY GAIN (ADJUSTED FOR THE AMOUNT CLASSIFIED AS PREPAYMENT OF RENT) OR LOSS IS RECOGNIZED IMMEDIATELY. ... ACCOUNT FOR THE CORRESPONDING LEASE IN ACCORDANCE WITH ASC 842

rate implicit in the lease if it is readily determinable. Otherwise, the lessee can use its incremental borrowing rate that is available at lease commencement. For entities that are not public, a risk-free discount rate comparable to the lease term is permitted as an accounting policy election for all leases.

Lease term may include renewal options, and lease payments may include purchase options, if they are reasonably certain to be exercised.

The measurement of the ROU shall consist of all of the following:

- The amount of the initial measurement of the lease liability.
- Any lease payments made to the lessor at or before the commencement date, less any lease incentives received.
- Any initial direct costs incurred by the lessee (e.g., commissions and lease buy out costs). Legal, marketing, downtime and consulting are expenses that will be incurred regardless of whether the lease is obtained or not; accordingly, they are not considered initial directs costs.

Subsequent Measurement

Finance Lease

After the commencement date, a lessee shall measure both of the following:

- The lease liability by increasing the carrying amount to reflect interest on the lease liability and reducing the carrying amount to reflect the lease payments made during the period. The lessee shall determine the interest on the lease liability in each period during the lease term as the amount that produces a constant periodic discount rate on the remaining balance of the liability, taking into consideration the reassessment requirements.
- The right-of-use asset at cost less any accumulated amortization and any accumulated impairment losses, and also taking into consideration the reassessment requirements.

A lessee shall recognize amortization of the right-of-use asset and interest on the lease liability for a finance lease.

Operating Lease

After the commencement date, a lessee shall measure both of the following:

- The lease liability based on the present value of the lease payments not yet paid, discounted using the rate that was established at the lease commencement date (unless the rate has been updated after the commencement date in accordance with the subsequent measurement of lease payments, in which case the updated rate shall be used).
- The right-of-use asset at the amount of the lease liability, adjusted for the following, unless the right-of-use asset has been previously impaired, in which case the right-of-use asset is measured after the impairment from the disposal of long-lived assets (e.g., sublease):
    - ◊ Prepaid or accrued lease payments.
    - ◊ The remaining balance of any lease incentives received, which is the amount of the gross lease incentives received net of amounts recognized previously as part of the single lease cost.
    - ◊ Unamortized initial direct costs.
    - ◊ Impairment of the right-of-use asset.

Sale-leaseback

In a sale-leaseback transaction both the seller-lessee and the buyer-lessor need to evaluate the sale under ASC 606 guidelines (i.e., whether the seller has transferred the control to the buyer) and ASC 842. If the transfer is a sale, seller-lessee recognizes the transaction price when buyer-lessor obtains control of the asset and derecognizes the carrying amount of the underlying asset. Any gain (adjusted for the amount classified as prepayment of rent) or loss is recognized immediately. Both seller-lessee and buyer-lessor would account for the corresponding lease in accordance with

IF THE TRANSFER IS NOT A SALE, SELLER-LESSEE SHALL RECOGNIZE THE AMOUNT RECEIVED AS A FINANCIAL LIABILITY IN ACCORDANCE TO OTHER US GAAP. CONVERSELY, THE BUYER-LESSOR ACCOUNTS FOR THE AMOUNT PAID AS A LOAN RECEIVABLE.

ASC 842. However, buyer-lessor will account for the purchase of the asset based on ASC 360.

ASC 842 requires a fair value assessment of the sale-leaseback transaction. If the sale price is greater than the fair value, the difference between the two is treated as prepayment of rent. If the sale price is lower than the fair value, the difference will be considered as additional financing provided by the buyer-lessor to the seller-lessee.

If the transfer is not a sale, seller-lessee shall recognize the amount received as a financial liability in accordance to other US GAAP. Conversely, the buyer-lessor accounts for the amount paid as a loan receivable.

Subleases

Recognition of sublease losses is based on whether the original lessee (sublessor) is relieved of the primary obligation, as well as the lease classification of the sublease given the underlying asset (i.e., not the ROU asset).

Sublessor is not relieved of primary obligation

If both head lease and sublease are operating leases, ASC 360 (long-lived asset impairment) provision will govern the treatment of an impairment resulting from a sublease loss. Remeasurement of ROU and Lease Liability is not required for sublease profit.

If head lease is an operating lease, but the sublease is a sales-type or direct financing lease, the sublessor needs to derecognize the original right-of-use asset at sublease commencement and account for the original lease liability similar to lessee’s finance lease accounting. Net investment in the sublease needs to be recognized and provisions of ASC 310 (impairment of the net investment in the lease) would apply if a sublease loss or impairment exists.

If both the head lease and the sublease are sales-type or direct financing leases, the accounting is the same as detailed previously, and the sublessor needs to derecognize the original right-of-use asset at sublease commencement. Net investment in the sublease needs to be recognized and provisions in ASC 310 (impairment of the net investment in the lease) would apply if a sublease loss or impairment exists.

Since ASC 842 did not provide clear guidance when a sublease is a sales-type, there is a view that a sublease profit—or, in this case, selling profit—is recognized upon the sublease commencement date, while a selling loss is recognized at the sublease inception date (i.e., sublease document execution).

For sublease lease classification and net investment measurement, the rate implicit in the lease should be used or, if it is not readily determined, the discount rate established for the original head lease.

Sublessor is relieved of primary obligation

If the sublessor is relieved of primary obligation, the transaction is considered a termination and, as such, both the ROU asset and lease liability will be derecognized and the difference, coupled with termination payment, will be recognized in the P&L.

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