

# Impact of lease accounting changes to corporate real estate

## Overview

In February 2016, the Financial Accounting Standards Board (FASB) issued its long-awaited revision to lease accounting—Accounting Standards Update (ASU) 2016-02, *Leases* (codified as FASB Accounting Standards Codification (ASC) Topic 842) (the Standard). This Standard modifies accounting for lessees and lessors and is effective for (a) public entities<sup>1</sup> for annual periods beginning after December 15, 2018 (calendar periods beginning after January 1, 2019) and interim periods therein and (b) all other entities for annual periods beginning after December 15, 2019 (calendar periods beginning after January 1, 2020). Early adoption is permitted for all entities.<sup>2</sup>

While all leases will need to be considered under the Standard, there are significant ramifications to leases involving real estate:

- Tenants (lessees) will be most impacted by the requirement to recognize liabilities and assets associated with leases on the balance sheet, including leases classified as operating leases. This likely will result in a balance sheet with dramatically higher assets and liabilities, particularly early in the lease term.

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1 For purposes of determining the effective date, public entities include publicly owned business entities, not-for-profit entities that have issued or are conduit bond obligors for securities that are traded, listed or exchanged on an over-the-counter market, and employee benefit plans that file or furnish financial statements with the Securities and Exchange Commission.

2 The SEC announced that public business entities that otherwise would not meet the definition of a public business entity except for the requirement to include, or the inclusion of, its financial statements or financial information in another entity's SEC filing may defer implementation until annual periods beginning after December 15, 2019. Please refer to RSM's [Financial Reporting Insights Article](#) for more information.

- Landlords (lessors) generally will maintain existing lease accounting guidance for the balance sheet, income statement and cash flow statement. For the majority of landlords who currently account for leases as operating leases, the Standard will not change the current straight-line recognition of rental income over the lease term.

Both tenants and landlords will be impacted by changes to nonlease components, initial direct costs and required disclosures. All entities will have to revisit their existing accounting and control processes. Separation of nonlease components from lease components is typically not difficult for most real estate entities. However, the Standard will likely introduce some complexity.

Entities should begin the strategic planning necessary to meet these new challenges well before the effective date. Further, financial statement users should be notified about how these changes to lease accounting will impact presentation of leverage and ratios. In particular, tenants will see higher noncurrent assets and higher current and noncurrent liability amounts on the balance sheet. This will lower some liquidity metrics (such as current ratio and quick ratio) and performance metrics (such as return on assets). Furthermore, by increasing overall liabilities, leverage metrics (such as debt ratio or debt-to-equity ratios) will appear higher.

### **Accounting impact: Tenant (lessee)**

The Standard applies to almost all leases, including subleases, and there are no scope exceptions based on the entity's nature, size or industry. However, the Standard permits lessees to make an accounting policy election by class of underlying asset for leases:

- With lease terms of 12 months or shorter
- That do not include an option to purchase the underlying asset that the lessee is reasonably certain to exercise

If this so-called "short-term election" is adopted, the lessee would apply accounting that is similar to current operating lease accounting.

The Standard requires that all leases (other than those for which the accounting policy election for short-term leases is applied) be classified as either finance leases or operating leases. These classifications are generally comparable, in principle, to the existing classifications of a capital lease and an operating lease, respectively. The Standard eliminates the "bright lines" that exist in legacy U.S. generally accepted accounting principles.

If a real estate lease currently is classified as an operating lease, it is likely that a similar lease would be classified as an operating lease under the Standard.

At the commencement date of a lease, a lessee will recognize a right-of-use (ROU) asset and lease liability on the balance sheet unless the short-term election has been adopted. Subsequent accounting for the ROU asset will depend on the lease classification as either a finance lease or an operating lease, while subsequent accounting for the lease liability is the same regardless of lease classification.

### **Initial measurement – Lease liability**

The initial lease liability is equal to the total unpaid lease payments, calculated at present value using the discount rate. The terms used in this definition are explained as follows:

- Lease payments – include (but are not limited to) (a) fixed payments, including variable payments that are in-substance fixed payments, less any lease incentives paid or payable to the lessee that are netted against rent (such as free rent), (b) variable lease payments that depend on an index or rate (such as a CPI indexed step), measured initially using the index or rate at commencement, (c) the exercise price of an option that allows the lessee to purchase the asset, but only if it is reasonably certain that the lessee will exercise that option and (d) the penalty that would be due from the lessee upon lease termination, but only if the lease term reflects exercising that option.
- Commencement – the date on which the lessor makes the asset available to the lessee.

- Lease term – the noncancelable period for the lease, plus (a) any period(s) covered by options to extend if the lessee is reasonably certain to exercise and (b) any period(s) covered by options to extend that are exercisable by the lessor.
- Discount rate – the rate implicit in the lease, as defined in the Standard, or the lessee's incremental borrowing rate (if the rate implicit in the lease cannot be readily determined). Alternatively, nonpublic entities can elect to discount the lease at a risk-free rate over a comparable term. This election is not available to public entities.

### Initial measurement – ROU asset

The ROU asset is equal to the initial lease liability, then increased for any (a) lease payments made to the lessor on or before the lease commencement date and (b) initial direct costs, which are incremental costs that would not have been incurred if the lease had not been obtained, and decreased for any lease incentives received.

### Subsequent measurement – Lease liability

For operating leases, the lease liability is subsequently measured at the present value of unpaid lease payments, using the discount rate established at commencement (unless that rate has been updated after commencement).

For finance leases, the carrying amount of the liability is increased to reflect accretion of the liability, and reduced by the lease payments.

### Subsequent measurement – ROU asset

The ROU asset is amortized based on lease classification.

- Finance leases: ROU asset is amortized on a straight-line basis over the lease term. The amortization is expensed and classified as amortization expense.
- Operating lease: For ROU assets that have not been impaired previously, the asset would be measured at the amount of the lease liability, adjusted for (a) prepaid or accrued lease payments, (b) any remaining balance of lease incentives received, (c) unamortized initial direct costs and (d) impairments. ROU assets that have been impaired previously are measured differently. Evaluation and accounting for impairment of ROU assets is beyond the scope of this article. For more information in this area, please contact your RSM relation.

### Costs associated with the lease

For operating leases, the lessee would recognize a single lease cost, any impairments of the ROU asset recognized during the period and any variable lease payments that were not included in the lease payments because they depend on something other than an index or rate.

The determination of this single lease cost would depend on whether the ROU asset has been impaired. If it has not been impaired, the single lease cost is based on amortizing the remaining lease costs over the remaining lease term, generally on a straight-line basis. If the ROU asset has been impaired, the single lease cost is the sum of (a) periodic amortization of the remaining ROU asset over the remaining lease term (generally on a straight-line basis) and (b) periodic accretion of the lease liability by an amount that produces a constant periodic discount rate on the liability's remaining balance.

For finance leases, the lessee would recognize amortization of the ROU asset (generally on a straight-line basis), interest costs equal to the accretion of the lease liability during the period, any impairments of the ROU asset recognized during the period and any variable lease payments that were not included in the lease payments because they depend on something other than an index or rate.

### Lease liability and ROU asset – An example

Assume a lessee signs a three-year lease with fixed payments of \$100,000 in year 1, \$105,000 in year 2 and \$110,000 in year 3. The lessee receives an immediate cash payment (lease incentive, not "free rent" or netted against a fixed payment) of \$20,000 in year 1. The lessee also pays \$5,000 in external commissions (initial direct costs). The lessee determined its incremental borrowing rate to be 8 percent.

### Calculation of initial lease liability

	Year 1	Year 2	Year 3
Unpaid lease payments:	\$100,000	\$105,000	\$110,000
Discount rate	8%		
Lease liability	<b>\$269,935</b>		

### Calculation of initial ROU asset

Initial lease liability	<b>\$269,935</b>
Plus: brokerage commission (initial direct cost)	\$5,000
Less: cash payment (lease incentive)	(\$20,000)
Initial ROU asset	<b>\$254,935</b>

### Subsequent accounting of lease liability and ROU asset (operating)

	End of Yr 1	End of Yr 2	End of Yr 3	End of Yr 1	End of Yr 2	End of Yr 3
Beginning lease liability	<b>\$269,935</b>	\$191,530	\$101,852			
Plus accretion (8% of lease liability)	\$21,595	\$15,322	\$ 8,148			
Less lease payment	\$ 100,000	\$105,000	\$110,000			
Ending lease liability	<b>\$191,530</b>	<b>\$101,852</b>	<b>\$0</b>			
Beginning ROU asset	<b>\$254,935</b>	\$176,530	\$91,852			
Less: straight-line of lease cost	\$100,000	\$100,000	\$100,000	Lease expense	\$100,000	\$100,000
Plus: accretion	\$21,595	\$15,322	\$8,148			
Ending ROU asset	<b>\$176,530</b>	<b>\$91,852</b>	<b>\$0</b>			
Total expense = \$300,000 over life of lease <i>Unpaid lease payments \$315,000 + direct cost of \$5,000 – lease incentive of \$20,000 = \$300,000</i>					\$100,000	\$100,000
						<b>\$100,000</b>

### Subsequent accounting of lease liability and ROU asset (financing)

	End of Yr 1	End of Yr 2	End of Yr 3	End of Yr 1	End of Yr 2	End of Yr 3
Beginning lease liability	<b>\$269,935</b>	\$191,530	\$101,852			
Plus accretion (8% of lease liability)	\$21,595	\$15,322	\$ 8,148	Interest expense	\$21,595	\$15,322
Less lease payment	\$ 100,000	\$105,000	\$110,000			
Ending lease liability	<b>\$191,530</b>	<b>\$101,852</b>	<b>\$0</b>			
Beginning ROU asset	<b>\$254,935</b>	\$176,530	\$91,852			
Less: straight-line ROU	\$84,978	\$84,978	<b>\$84,979</b>	Amortization expense	\$84,978	\$84,978
Plus: accretion	\$21,595	\$15,322	\$8,148			
Ending ROU asset	<b>\$169,957</b>	<b>\$84,979</b>	<b>\$0</b>			
Total expense = \$300,000 over life of lease <i>Unpaid lease payments \$315,000 + direct cost of \$5,000 – lease incentive of \$20,000 = \$300,000</i>					\$106,573	\$100,300
						<b>\$93,127</b>

The financial statement impacts of both lease models are presented below. It should be noted that the model is determined based on the lease classification, not via an election by the lessee.

### Financial statement impact

The balance sheets of entities that have historically entered into primarily operating leases will be impacted significantly by recognition of the lease liability and ROU asset.

Consider the illustrative balance sheet below for a lessee with operating leases that predominantly consist of a building lease with a remaining lease term of 15 years. After considering the Standard, the lessee reflects ROU assets and lease liabilities for its operating leases, which significantly affects the lessee's total assets and liabilities, as well as its current ratio and debt-to-equity ratio.

Assets	Before	After	Liabilities and equity	Before	After
<b>Current assets</b>			<b>Current liabilities</b>		
Cash and equivalents	\$1,260	\$1,260	Accounts payable and other	\$5,250	\$5,250
Accounts receivable, net	4,590	4,590	Lease liabilities	–	870
Inventory	5,830	5,830	Total current liabilities	5,250	6,120
Other current assets	680	680	<b>Noncurrent liabilities</b>		
Total current assets	12,360	12,360	Long-term debt	7,560	7,560
<b>Noncurrent assets</b>			Lease liabilities	–	11,670
Property and equipment	17,820	17,820	Deferred taxes	1,190	1,190
Accumulated depreciation	(6,780)	(6,780)	<b>Shareholders' equity</b>		
Property and equipment, net	11,040	11,040	Common stock	100	100
Right-of-use assets	–	12,540	Additional paid-in capital	6,210	6,210
Intangible assets	1,960	1,960	Retained earnings	6,420	6,420
Goodwill	1,370	1,370	Total shareholders' equity	12,730	12,730
<b>Total assets</b>	<b>\$26,730</b>	<b>\$39,270</b>	<b>Total liabilities and equity</b>	<b>\$26,730</b>	<b>\$39,270</b>
<b>Current ratio</b>	2.35	2.02	<b>Debt-to-equity ratio</b>	1.10	2.08
Percentage change		(14%)	Percentage change		89%

### Accounting impact: Landlord (lessor)

Lessors will continue to classify leases as sales-type, direct financing or operating, using criteria that are similar to those used by lessees. The leveraged lease classification is eliminated on a prospective basis. Certain principles in the lessor model were aligned to the revenue recognition guidance in the new revenue recognition standard—ASU 2014-09, *Revenue from Contracts with Customers* (codified as FASB ASC Topic 606).

For landlords who account for their leases with tenants as operating leases, rental income will continue to be recognized on a straight-line basis over the lease term, unless another systematic basis would be more appropriate.

### Accounting impact: Tenant (lessee) and landlord (lessor)

#### Lease and nonlease components

Lessees and lessors are required to separate lease components and nonlease components, and allocate the contract consideration to those two types of components. The nonlease components are accounted for in accordance with other accounting guidance.

Lessors allocate the contract consideration to the components using the allocation guidance in the new revenue recognition standard. Lessees will allocate the consideration to the components on a relative standalone price basis, unless the lessee makes an accounting policy election to not separate the lease components from the nonlease components, in which case, each separate lease component and the nonlease components related to it are accounted for together as a lease component. While separate accounting for lease and nonlease components will result in the recognition of lower ROU assets and lease liabilities, it also will add complexity and more judgment to the accounting process.

Within the real estate industry, this new guidance will impact the various rent streams included in the monthly payment. Nonlease components are payments for goods or services, such as common area maintenance, utilities or repairs. However, many real estate leases include payments that do not represent goods or services such as property tax and insurance reimbursements. Tenants and landlords will have to revisit the specifics of the lease language.

### **Initial direct costs**

The definition of initial direct costs will include only incremental costs that a lessee or lessor would not have incurred if the lease had not been executed. This new definition of initial direct costs will decrease the amount of such costs that are deferred. Lessees and lessors will need to review and revise (as appropriate) the processes used to track and account for initial direct costs.

Costs such as lease commissions and payments to existing tenants to obtain the lease will continue to be considered initial direct costs. Costs such as internal costs and professional fees (both legal and tax consulting) are excluded from initial direct costs.

### **Disclosures**

Both lessees and lessors will expend additional efforts complying with many new disclosure requirements. Satisfying the numerous new disclosure requirements will require tracking more information, which will place greater demands on the entity's financial reporting function.

### **Accounting transition**

Due to the scope of changes arising from the Standard, tenants and landlords should begin planning for the new requirements. The Standard will become mandatory for public business entities for annual reporting periods (including interim periods therein) beginning after December 15, 2018, unless that public business entity fits certain requirements announced by the SEC at a recent meeting<sup>3</sup>. All other entities are required to apply the leasing standard for annual periods beginning after December 15, 2019. Earlier application is permitted for all entities.

Landlords and tenants will transition to the Standard using a "modified retrospective transition approach." This approach requires that an entity present prior comparative periods consistent with the Standard for all leases in place at (or that commence after) the beginning of the earliest comparative period presented. Leases that expire prior to the transition date do not impact prior comparative periods.

The specifics of the modified retrospective transition approach differ depending on a number of factors, including the classification of the lease under legacy accounting literature and usage of certain practical expedients that are available to reporting entities. While the specifics of the modified retrospective transition approach are quite complex, much of that complexity is eliminated when applying the approach to a lease in a plain-vanilla situation in which all of the following are true:

- The lessee elects the practical expedients that are available under the standard.
- The lease was not acquired in a business combination transaction.
- The lease does not include any options to purchase the underlying asset, or extend or terminate the lease or any nonlease components.

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<sup>3</sup> The SEC announced that public business entities that otherwise would not meet the definition of a public business entity except for the requirement to include, or the inclusion of, its financial statements or financial information in another entity's SEC filing may defer implementation until annual periods beginning after December 15, 2019. Please refer to RSM's [Financial Reporting Insights Article](#) for more information

- None of the following occur after the beginning of the first comparative period presented by the lessee:
  - Lease modification
  - Impairment of the related ROU asset
  - Remeasurement of the related lease liability
- The lessee has not recognized a liability for exit or disposal costs under the lease.

For existing leases currently accounted for as operating leases, the most significant effect on the financial statements in a plain-vanilla situation is adding the ROU asset and lease liability to the balance sheet. For existing leases currently accounted for as capital leases, there will generally not be a significant effect on the financial statements in a plain-vanilla situation. It is very important to note, however, that the effects of applying the modified retrospective transition approach to a lease in something other than a plain-vanilla situation could be very different from the effects of applying that transition approach to a lease in a plain-vanilla situation.

## Business impact

It is important to remember that because the assets and obligations associated with the lease always have existed, the Standard does not change the economics of a lease, nor does it change the operational rationale to enter into a lease. The degree to which the leasing environment and how leases are viewed changes as a result of the Standard is currently unknown. However, tenants reporting under the operating model will undergo dramatic changes to their financial statements as a result of the Standard.

- Lease term: In isolation, a longer lease will result in a larger ROU asset and a larger lease liability. Tenants seeking to mitigate the balance sheet impact would be incentivized toward a shorter lease term.
- Gross vs. net leases: Tenants with gross leases and fixed payments will record higher ROU assets and lease liabilities, unless the tenant separately accounts for lease and nonlease components. Landlords could be requested to present sufficient information to their tenants to determine the calculation. Alternatively, tenants could desire a net lease to reduce the overall lease cost and resulting ROU asset and lease liability.
- Variable vs. fixed payments: Tenants might want a larger allocation to common area maintenance expense recovery or percentage rent in exchange for lower fixed rates.

Regardless of how the balance sheet changes are ultimately viewed, entities will need to modify their existing reporting tools and systems to capture the information necessary for implementation. Further, controls should be created to ensure compliance with the revised accounting requirements.

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