The New Lease Accounting Standard
What Real Estate Companies Should Know

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Speakers

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Topic 842 - Leases

A contract, or part of a contract, that conveys the right to control the use of identified property, plant or equipment (an identified asset) for a period of time in exchange for consideration.

A contract is (or contains) a lease when two criteria are met:

(1) The contract explicitly or implicitly specifies the use of the **identifiable asset**

(2) The customer **controls** the use of the asset for that period of use.

Current Standard – Lessee (ASC 840)

Type of Lease	Balance Sheet	Income Statement	Statement of Cash Flows
Operating	N/A	Rent / Lease Expense – Straight Line Basis	Reduction of Net Income - Operating Activities
Capital	Fixed Asset Lease Liability – Present Value of Lease Payments	Amortization Expense and Interest Expense Impairment, if any	Principal Payment on Lease – Financing Activity Interest Expense – Operating Activity

New Standard- Lessee (ASC 842)

Type of Lease	Balance Sheet	Income Statement	Statement of Cash Flows
Operating	Right to Use Asset Lease Liability – Present Value of Lease Payments	Single Lease Expense Recognized on Straight Line Basis Variable Lease Payments Impairment, if any	Reduction of Net Income - Operating Activities
Financing	Right to Use Asset Lease Liability – Present Value of Lease Payments	Amortization Expense and Interest Expense Variable Lease Payments Impairment, if any	Principal Payment on Lease – Financing Activity Interest Expense – Operating Activity

Lease Classification

- A lease that meets any of these criteria is a finance lease:
  - Transfers ownership of underlying asset
  - Grants option to purchase underlying asset – lessee is reasonably certain to exercise
  - Major part of remaining economic life
  - PV of lease payments and any additional residual value guarantee by the lessee equals or exceeds substantially all or more of fair value of underlying asset
  - Underlying asset – specialized nature – No alternative use to lessor at end of lease
- A lease that meets none of these criteria is an operating lease

Measurement Basics

Lease Liability = Present Value of the Lease Payments Not Yet Paid

ROU Asset = Lease Liability + Initial Direct Costs + Prepaid Lease Payments − Lease Incentives Received

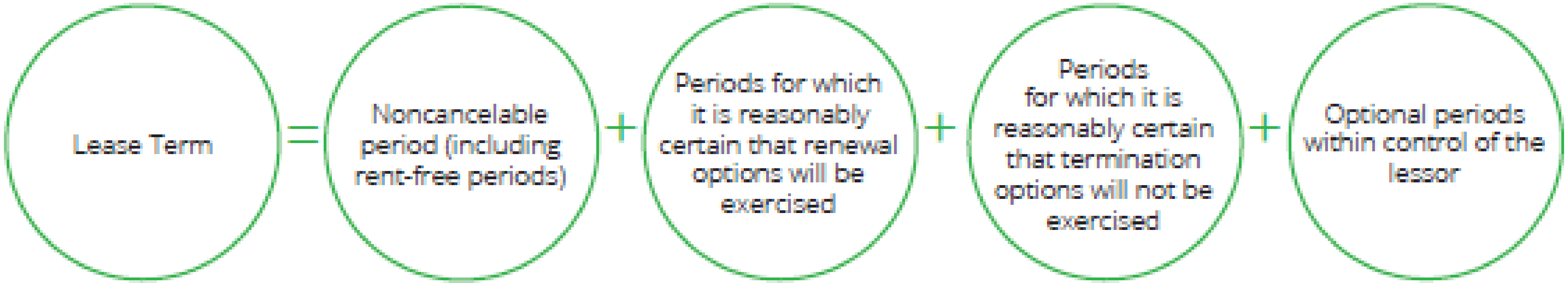
Steps for Companies (Lessees)

- Understand lease portfolio and determine which leases are in scope
- Identify a point person to head the transition (not your auditor)
- Consider the use of lease accounting software
- Identify potential departments that know about leases or any leased assets
  - Start an inventory
- Get a listing of all leased assets
  - Summarize key terms
  - Consider embedded leases

Lease Term

The non-cancellable period of the lease, together with all the following:

- Periods covered by an option to extend the lease if the lessee is reasonably certain to exercise that option
- Periods covered by an option to terminate the lease if the lessee is reasonably certain not to exercise that option
- Periods covered by an option to extend (or not to terminate) the lease in which exercise of the option is controlled by the lessor.



Transition Guidance

- ASC 842 offers relief from implementing the transition provisions by permitting an entity (lessee or lessor) to elect to not reassess:
  - Whether any expired or existing contract is or contains a lease
  - The lease classification of any expired or existing leases
  - Initial direct costs for any existing leases
- The above is referred to as the “practical expedient package” or “package of three”.
- Additionally, an entity is also allowed to use hindsight in evaluating the lease term (e.g. renewal, termination, and purchase options for existing leases) – the “hindsight practical expedient”.
- Also determine adoption approach – current year or comparative

Transition Guidance

- Comparatives Under 840 Option – date of initial application is the beginning of period of adoption of ASC 842 (i.e. 1/1/22 for nonpublic)
  - Keep ASC 840 in the prior comparative periods
  - Provide the disclosures required by ASC 840 for all periods that continue to be presented in accordance with ASC 840
  - Recognize the effects of applying ASC 842 (if any) as a cumulative-effect adjustment to retained earnings as of the effective date (1/1/22)
  - Do NOT:
    - Restate comparative periods for effects of applying ASC 842
    - Provide the disclosures required by ASC 842 for the prior period
    - Change how the transition requirements apply, only when the transition requirements apply

ASC 842 - Lease Classification (Lessor)

- Lessors classify leases based on ownership transfer and other factors:
  - Sales-type leases (financing lease for lessee)
  - Direct financing (similar to Capital Lease under ASC 840)
  - Operating leases
  - Lease classification determines how and when a lessor recognizes lease income and what assets and liabilities they record.
  - Most real estate leases from a lessor perspective are expected to be operating leases

Operating Leases (Lessor)

- Lessor retains control of the underlying asset, and underlying asset remains on the lessor’s balance sheet.
- Income is recognized on a straight-line basis unless another systematic basis is more appropriate.
- Initial direct costs deferred and expensed over the lease term in a manner consistent with income.
- Important change: Under ASC 842, any change in collectability of lease payments is an adjustment to lease income **NOT** bad debt expense.

Evaluating Collectability (Lessor)

- Collectability refers to the lessee’s ability and intent to pay substantially all of the lease payments and any guaranteed residual value.
- A lessor should assess a lessee’s ability to pay based on the lessee’s financial capacity and its intention to pay, considering all relevant facts and circumstances, including past experiences with that lessee or similar lessees. Collectability determinations must be made on a lease-by-lease basis.
- Collectability is probable — recognize income generally on a straight-line basis
- Collectability is not probable — income recognition can be no greater than lease payments and variable lease payments received. *Note, lessors are required to recognize the effect of a change in their assessment of whether the collectability of operating lease receivables is probable as an adjustment to lease income rather than as bad debt expense.*

ASU 2018-11: Targeted Improvements

Lessor non-separation practical expedient:

- Prior to ASU 2018-11 lessors were required to separate lease from non-lease components
- Under ASU 2018-11, lessors may elect not to separate lease and non-lease components if:
  - Those components are co-terminus and would have the same pattern of transfer to the lessee (typically, straight-line), and
  - The lease would be an operating lease if separated

  If the above criteria are met, the combined unit of account should be accounted for as either an operating lease or as a revenue contract, depending on which component is predominant (i.e., if the nonlease component(s) is predominant, account for the combined component under revenue recognition (ASC 606)). Tenant reimbursements for common area maintenance are also accounted for as variable lease payments and recorded in a single line item "rental revenue" on a company's income statement.

ASC 842 - Initial Direct Costs (IDCs)

The FASB decided that only incremental costs would qualify for capitalization. Costs would be incremental if they would not have been incurred absent the lease being obtained.

For operating leases, for which payments are deemed to be collectible, defer IDCs (capitalize) and recognize as expense over lease term on same basis as lease income

Included (Incremental)	Excluded (Not Incremental)
• Commissions (both internal and external) payable only upon successful execution of a lease • Certain payments made to existing tenant to incentivize them to terminate their lease	• Leasing department base salaries, bonuses, overhead unsuccessful efforts • Advertising, soliciting potential lessees, serving existing leases • Other origination efforts, costs incurred before lease is obtained, such as legal or tax advice, negotiating the lease, due diligence on potential tenants

Fewer costs will qualify for recognition as "initial direct costs" in a lease

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Thank you!