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Practical considerations for lease accounting

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On the heels of a transformative and challenging revenue recognition standard, FASB's new lease accounting standard presents a potential tsunami of changes to the financial statements of public and private companies.

In February 2016, FASB issued new lease accounting guidance in Accounting Standards Update (ASU) No. 2016-02, *Leases* (Topic 842). This new guidance was initiated as a joint project with the International Accounting Standards Board to simplify lease accounting and improve the quality and comparability of financial information for users. The IASB also issued guidance in IFRS 16 during January 2016.

This new guidance eliminates the historical concept of off-balance-sheet treatment for "operating leases" for lessees for the vast majority of lease contracts. Under ASU No. 2016-02 (Topic 842) and IFRS 16, at inception, a lessee is required to classify all leases with a term of more than one year as either finance or operating leases, with both classifications resulting in the recognition of a defined "right of-use" asset and a lease liability on the balance sheet.

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These lease accounting changes are substantial and will require in many cases a significant investment of time and effort. These practical considerations can help entities as they implement the new standard:

- A defined strategy and timeline will help an organization comply with the standard in time to meet the implementation deadline. Good project management and planning is paramount.

- More time and effort will be required than most companies anticipate. This is partly because many leases are drafted in varying forms, since there is no industry standard. Most lease documents are dictated by the landlords or equipment lessors. Additionally, large companies are constantly leasing, renewing, and exiting current leases, so an accurate leased property inventory is critical.

- Real-estate-related leases are typically more complicated than equipment leases and may require real estate leasing expertise to implement and maintain.

- Various sales tax and local taxes need to be addressed. Organizations should keep their tax experts involved throughout implementation.

- Entities will need to identify all expenses that will be considered initial direct costs so they know what needs to be tracked.

- Global entities often have leases involving a variety of foreign currencies, creating another challenge for implementation. For leases denominated in a foreign currency in which the entity has multiple leases, the remeasurement exchange rate for the each of these right-of-use assets may be difficult to determine due to the need to use the exchange rate at the commencement of each lease. Preparers will need to trace the exchange rate back to the rate used at the time of lease commencement.

- Measurement metrics depend on the country of origin. Acceptable definitions for square footage measurements also vary from market to market. Depending on the market, square footage measurements may be defined based on space that is useable, rentable, rentable with a loss factor, rentable with a core factor, rentable based on drip line, or rentable based on ANSI-BOMA standards. For U.S.-based companies, preparers will need to convert the metric system to the imperial system to facilitate consistency and comparability throughout their leased property portfolio.

- Lease payments need to be analyzed and accounted for based on the goods and services they secure. For example, it is fairly simple to account for a lease that covers rent while the tenant is responsible for all maintenance, tax, insurance, and utilities. When those extras are included in the lease payment, the lease liability and right-of-use asset will increase. Parking costs and allocations will need to be considered. Many times, parking costs are factored into the base rent, which does not allow for expensing them separately. As part of the base rent, parking costs increase the lease liability.

- Security deposits will continue to be accounted for as other assets.

- In leases with biannual (twice yearly) payment increases, lessors and lessees may wish to agree to switch to annual leases for ease of accounting. Where biannual increases exist, the lessees will need to remeasure twice a year instead of once. While this doesn't directly affect the lease accounting, it will affect the comparability of leases and related economies.

- Renewal options and their related structure, including relocation rights and termination rights, can have a profound effect on the balance sheet liability. For example, if a tenant has a five-year lease that it is reasonably certain the tenant will renew for an additional five years below fair market value, this would be considered a 10-year lease under the new standard.

- If upon initial capitalization of a lease it is determined that it is not reasonably certain that the entity will exercise the option to renew the lease, the entity will not include the renewal term in the capitalized term. However, if upon reassessment in a subsequent reporting period it is determined that it is reasonably certain that the entity will exercise its option to renew the lease, the entity will include the computation of the renewal period for the asset and liability at that time.

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