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Real Estate Spotlight

A Walk-Through of the FASB's New Leases Standard

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The Bottom Line

- On February 25, 2016, the FASB issued its new leases standard, ASU 2016-02.[1] The standard marks the end of the Board's nearly decade-long deliberations with the IASB to address concerns about the current lease accounting requirements.
- The new standard introduces a model that brings most leases onto a lessee's balance sheet. This could significantly change the accounting by real estate lessees, whose leases are typically not included on the balance sheet because they are classified as operating leases under current U.S. GAAP. The new standard retains much of the current lessor model but aligns certain of its underlying principles with those of the new revenue recognition standard (ASC 606[2]).
- The new leases standard will significantly affect lessees and lessors in the real estate industry, including their considerations related to nonlease components, nonlevel rents, initial direct costs, and accounting for sale-leaseback transactions. In addition, real estate lessors will need to understand the ASU's broader implementation implications for lessees as well as the potential for changes in tenant behaviors.
- The new guidance is effective for public business entities for annual periods beginning after December 15, 2018 (i.e., calendar periods beginning after January 1, 2019), and interim periods therein. For all other entities, the ASU is effective for annual periods beginning after December 15, 2019 (i.e., calendar periods beginning on January 1, 2020), and interim periods thereafter. Early adoption is permitted for all entities irrespective of whether such entities elect to early adopt the new revenue standard.

1 FASB Accounting Standards Update No. 2016-02, *Leases.*
2 FASB Accounting Standards Codification Topic 606, *Revenue From Contracts With Customers.*

Beyond the Bottom Line

This *Real Estate Spotlight* provides insight into aspects of the new leases standard that are particularly relevant to lessees and lessors in the real estate industry. For a comprehensive overview of the new leases standard, see Deloitte's March 1, 2016, *Heads Up*.

Lessee Accounting

The new standard requires lessees to adopt a right-of-use (ROU) asset approach that brings substantially all leases, with the exception of short-term leases (i.e., those with a lease term of less than 12 months), onto the balance sheet. Under this approach, a lessee records an ROU asset representing its right to use the underlying property during the lease term and a corresponding lease liability (in a manner similar to the current approach for capital leases) regardless of the lease classification. The subsequent accounting for the ROU asset depends on the classification of the lease as either a finance lease or an operating lease (referred to as the "dual-model approach").

A lessee will determine the classification of a lease by using classification criteria that are similar to those under IAS 17.[3] For leases that are considered finance leases, the lessee recognizes interest expense and amortization of the ROU asset in a manner similar to a financed purchase arrangement, which will typically result in greater total expense during the early years of the lease. For leases that are considered operating leases, the lessee will also recognize an ROU asset and lease liability, but will recognize total lease expense on a straight-line basis.

The IASB decided on a different approach for a lessee's subsequent accounting of the ROU asset. Under the IASB's approach, all leases are accounted for as a financed purchase arrangement in a manner consistent with the FASB's guidance on finance leases.

Editor's Note: Under the FASB's dual-model approach, a lease is classified as a finance lease if any of the following criteria are met at the commencement of the lease:

- "The lease transfers ownership of the underlying asset to the lessee by the end of the lease term."
- "The lease grants the lessee an option to purchase the underlying asset that the lessee is reasonably certain to exercise."
- "The lease term is for the major part of the remaining economic life of the underlying asset."[4]
- "The present value of the sum of the lease payments and any residual value guaranteed by the lessee . . . equals or exceeds substantially all of the fair value of the underlying asset."
- "The underlying asset is of such a specialized nature that it is expected to have no alternative use to the lessor at the end of the lease term."

Although the classification criteria are similar to those under current U.S. GAAP, there are some differences that will apply to the real estate industry. First, the ASU requires entities to account for land and other elements separately unless the effects of not doing so are immaterial. Under current U.S. GAAP, the lease classification of land is evaluated separately from the building if its fair value at lease inception is 25 percent or more of the fair value of the leased property and the lease does not meet either the criterion related to transfer of ownership or the bargain purchase option criterion. This change may result in more bifurcation of real estate leases into separate land and building elements that are required to be evaluated separately for lease classification purposes and accounted for separately.

[3] International Accounting Standard 17, *Leases*.

[4] The ASU provides an exception to this lease classification criterion for leases that commence "at or near the end" of the underlying asset's economic life. The ASU indicates that a lease that commences in the final 25 percent of an asset's economic life is "at or near the end" of the underlying asset's economic life.

Editor's Note (continued): Second, the ASU eliminates the bright-line rules under the ASC 840[5] lease classification requirements — namely, whether the lease term is for 75 percent or more of the economic life of the asset or whether the present value of the lease payments (including any guaranteed residual value) is at least 90 percent of the fair value of the leased asset. While removal of the bright-line test could reduce structuring opportunities, the ASU's implementation guidance indicates that entities may use thresholds similar to those they use today in determining lease classification. Therefore, practice may not be significantly altered as a result of this change.

Lessor Accounting

Although initially the boards contemplated overhauling lessor accounting, they agreed to largely retain the current lessor accounting model. The ASU modifies the current U.S. GAAP lease classification criteria and aligns certain of the underlying principles in the lessor model with the new revenue recognition standard. Specifically, to qualify as a sales-type lease (in which a lessor recognizes profit up front), the arrangement must meet the requirements of a sale under the new revenue recognition guidance. On the other hand, if the transaction does not qualify as a sales-type lease, the transaction would be accounted for (1) as a direct financing lease with any profit deferred and recognized as interest income over the lease term or (2) an operating lease.

Editor's Note: The inability to recognize profit up front on a transaction because the arrangement would not be a sale under the new revenue recognition guidance will probably not significantly affect real estate lessors since such lessors typically do not enter into sales-type leases.

The ASU requires the lessor to account for rental income from operating leases on a straight-line basis unless another systematic basis would be more appropriate. However, to the extent that step rents are used to reflect or compensate the lessor for anticipated market rentals or market conditions, the lessor is required to recognize rental income on a systematic basis other than straight-line.

Editor's Note: Under the ASU, a lessor is only required to recognize rental income on a straight-line basis when payments are uneven for reasons other than to reflect or compensate for market rentals or market conditions (e.g., when there is significant front loading or back loading of payments or when there are rent-free periods in a lease). This may have a significant effect on a lessor's recognition of revenue for operating leases related to real estate since many such leases contain step rents that are intended to reflect expected increases in market rents over the lease term.

Lease and Nonlease Components

Lessees and lessors are required to separate lease components and nonlease components (e.g., any services provided) in an arrangement and allocate the total transaction price to the individual components. Lessors would perform the allocation in accordance with the guidance in the new revenue recognition standard, and lessees would do so on a relative stand-alone-price basis (by using observable stand-alone prices or, if the prices are not observable, estimated stand-alone prices). However, lessees are permitted to elect, as an accounting policy by class of underlying asset, not to separate lease components from nonlease components and instead account for the entire contract as a single lease component.

[5] FASB Accounting Standards Codification Topic 840, *Leases.*

Editor's Note: When evaluating whether an activity should be considered part of a lease component or a separate nonlease component, an entity should consider whether the activity transfers a separate good or service to the lessee. For example, maintenance services (including common-area maintenance services) and utilities paid for by the lessor but consumed by the lessee would be separate nonlease components because the tenant would have been required to otherwise contract for these services separately. However, payments for property taxes or insurance would most likely be considered part of the lease component because they do not transfer a separate good or service to the tenant. This treatment could have the effect of increasing a lessee's lease liability since it would include amounts that are currently considered executory costs. From a practical standpoint, however, such amounts are frequently variable and therefore would not be included in the measurement of the lease liability, as discussed below. See Example 12 in ASC 842-10-55-141 through 55-145[6] for three cases that illustrate the evaluation of whether such costs are considered a lease component.

Variable Lease Payments

In its initial measurement of the lease liability and ROU asset (lessee) or the net investment in the lease (lessor), an entity would only include variable lease payments if such payments are tied to an index or a rate. However, the entity would not include variable lease payments that are based on usage or performance of the asset. A lessee would recognize any variable payments not included in the original lease obligation as an expense in the period the obligation is incurred.[7] A lessor would recognize variable lease payments not included in the original net investment in the lease in the period a change occurs in the facts and circumstances on which the variable lease payments are based (e.g., "when the lessee's sales on which the amount of the variable payment depends occur"). Even if a variable lease payment is virtually certain (e.g., contingent upon a retail store's achievement of a nominal sales volume), the payment would not be included in the calculation of a lessee's lease obligation and ROU asset or a lessor's net investment in the lease.

Example — Variable Lease Payments

On January 1, 20Y1, Company A leased a building for five years, payable in annual lease payments of $100,000 at the beginning of each year. The lease is classified as an operating lease and contains a provision that on December 31 of each year, the lease payments will be adjusted by the change in the CPI for the preceding 12 months. At lease commencement, the CPI is 112. The implicit rate in the lease is not known, and A's incremental borrowing rate is 7 percent. Any initial direct costs and lease incentives are ignored in this example.

Determining the Lease Payments

At lease commencement, A makes its first annual payment of $100,000. In addition, A records a lease liability of $338,721 (the present value of the total remaining lease payments discounted at the incremental borrowing rate) and an ROU asset of $438,721 (the total of the lease liability plus the prepaid rent of $100,000). In measuring these amounts, A did not take into consideration the CPI in effect at lease commencement because the rent increase is based on a change in an index as opposed to the index itself.

On December 31, 20Y1 (the lease payment reset date), the CPI has changed to 126, representing a 12.5 percent increase (i.e., calculated as [(126 − 112) ÷ 112]). Accordingly, A's lease payment in year 2 would be $112,500, comprising the fixed amount of $100,000 and the variable amount of $12,500 (calculated as the change in CPI multiplied by the fixed amount). Further, because A was not required to remeasure its lease liability for any other reason (e.g., a modification), there would be no adjustment to the liability to reflect changes in the CPI. That is, incremental amounts that will be paid in the future because of changes in the CPI would also be recognized as variable lease payments in the period the amounts are paid.

Had the rental increases been based on an index (as opposed to a change in an index), the current — or spot — value of the index would have been used to measure the initial lease liability and ROU asset. Changes in the index over the lease term would result in variable lease payments and would not require revision of the lease liability or ROU asset unless the lease is reassessed for other reasons.

[6] FASB Accounting Standards Codification Topic 842, *Leases*, was added by ASU 2016-02.

[7] The period in which the obligation is "incurred" refers to the period when it becomes probable that the specified target that triggers the variable lease payments will be achieved.

Initial Direct Costs

Under the new standard, a lessee includes initial direct costs in the initial measurement of the ROU asset. A lessor's accounting for initial direct costs is similar to that under current U.S. GAAP. That is, for direct financing leases, a lessor defers all initial direct costs and includes them in the initial measurement of the lease receivable. Similarly, for operating leases, a lessor defers the initial direct costs and amortizes them as expenses over the lease term. For sales-type leases, initial direct costs are expensed up front unless the transaction does not result in a profit or loss.

However, the new standard has changed the definition of initial direct costs to align with the definition of incremental cost in the new revenue recognition guidance. Initial direct costs for both lessees and lessors now include only those costs that are incremental to the arrangement and would not have been incurred if the lease had not been obtained.

Editor's Note: The change in the definition of initial direct costs will affect many real estate entities. Costs such as commissions (whether paid to employees or third-party brokers) and payments made to existing tenants to obtain the lease will continue to be considered initial direct costs. By contrast, costs such as allocated internal costs and costs to negotiate and arrange the lease agreement (e.g., professional fees such as those paid for legal and tax advice) are excluded from this definition. This is likely to result in changes in practice for many real estate lessors, which currently capitalize such costs.

Sale-Leaseback Accounting

The FASB also aligned sale-leaseback accounting with the underlying principles in the new revenue recognition standard. Under the new leases guidance, the seller-lessee in a sale-leaseback transaction must evaluate the transfer of the underlying asset (sale) in accordance with ASC 606 to determine whether the transfer qualifies as a sale (i.e., whether control has been transferred to the buyer). The existence of a leaseback by itself would not indicate that control has not been transferred (i.e., it would not preclude the transaction from qualifying as a sale) unless the leaseback is classified as a finance lease. In addition, if the arrangement includes an option for the seller-lessee to repurchase the asset, the transaction would not qualify as a sale unless (1) the option is priced at the fair value of the asset on the date of exercise and (2) alternative assets exist that are substantially the same as the transferred asset and are readily available in the marketplace.

If the transaction does not qualify as a sale, the seller-lessee and buyer-lessor would account for it as a financing arrangement (i.e., the buyer-lessor would account for its payment as a financial asset and the seller-lessee would record a financial liability).

Editor's Note: Sale-leaseback transactions involving real estate that include a purchase option are not expected to meet the criteria to qualify as a sale, regardless of whether the purchase option is at fair value. Each real estate property is unique and not readily available in the marketplace because of various factors such as location and specified use; therefore, the existence of a purchase option on the real estate, whether it is at fair value or not, is evidence that the real estate is not readily available in the marketplace. Accordingly, in a manner similar to current U.S. GAAP, any purchase options on real estate will preclude sale-leaseback accounting for the seller-lessee.

The new standard will also affect the evaluation of sale-leaseback transactions by the buyer-lessor. Under current U.S. GAAP, the buyer-lessor accounts for its purchase and subsequent lease without regard to the seller-lessee's accounting for the transaction. Under the ASU, the buyer-lessor's and seller-lessee's accounting must be symmetrical. Accordingly, the buyer-lessor must assess whether the seller-lessee has achieved a sale under ASC 606 before it can determine its accounting for the purchase of the real estate assets.

Business Impact and Implementation Considerations

The new lease accounting requirements could change how real estate entities do business and could affect tenant behaviors. For example:

- Since the ASU will result in increased leverage on the balance sheet, tenants may want to negotiate shorter-term leases or leases that include more variable lease payments. Such negotiations could result in increased operating costs for both lessees and lessors.
- An increase in shorter-term leases could also result in higher rental rates and, therefore, additional operating costs. This could also affect (1) the lessor's ability to obtain financing, (2) the financing costs on the property, (3) and the fair value of the lessor's property.
- Because most leases will be on the tenants' balance sheets, tenants may be more motivated to consider whether to lease or purchase a property, particularly those that currently enter into long-term, triple-net leases.
- Bringing leases onto the balance sheet will result in increased leverage and affects an entity's key metrics. Real estate entities that are also lessees under lease agreements (e.g., a land lease for one of the real estate entity's properties) should consider whether the increased leverage could result in debt covenant violations or potentially affect lending decisions.
- The new guidance may complicate a tenant's internal approval of new leases or lease modifications since different individuals may need to closely consider the effects on the financial statements. Under current U.S. GAAP, a tenant's decision to enter into an operating lease may not necessarily receive much opposition or challenge from management. However, operating leases potentially will now be scrutinized as much as out-right purchases because of their effect on the balance sheet. In addition, in its decisions related to leases, an entity may need to involve personnel from a number of departments, such as accounting, corporate reporting, treasury, legal, operations, tax, and information technology.

For a discussion of additional implementation considerations, including those related to the application of judgment and estimation, data management, changes to information technology systems, changes to internal controls and the business process environment, debt covenants, and income taxes, see Appendix F in Deloitte's March 1, 2016, *Heads Up*.

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