Arazzo Solutions, LLC

Learning Series: Lease Accounting Changes for Non-accountants

Why is moving leases to the Balance Sheet such a big deal?

Arazzo Solutions, LLC **April 26, 2017** Volume 2

What's all the Hubbub About?

Deb Vallo, Arazzo Solutions, Principal

You've probably heard some pretty large numbers being tossed around when analysts are trying to project the impact of the new lease accounting guidelines on companies' balance sheets. The most common estimate is that about $3 trillion (USD) will be added to the collective balance sheets of organizations globally.

This Learning Series is intended to simplify the vast amount of information relating to the latest FASB/IASB lease accounting guidelines. Our goal is to boil down these standards to make them easily understood by CRE professionals who are not accountants by trade. We want to help you understand the concepts and the lingo (with a bit of humor) without having to be a CPA, while also enabling you to hold your own with the newly extended group of stakeholders and executives. We hope you enjoy this series and we look forward to your feedback.

This is due to the new FASB (ASC 842) and IASB (IFRS 16) guidelines which require operating leases to be reflected on the balance sheet, whereas previously they were recorded on the P&L (see Buzz Words) and tucked into the footnotes (capital leases – now called finance leases – have always been recorded on the balance sheet). the effects should not be underestimated.

Under the new rules, a lease is recorded on the balance sheet in two ways. First as a Right of Use (ROU) asset because the lease gives you the right to use the underlying asset. Second as a lease liability which is your company's obligation to make lease payments over the term of the lease. The liability is calculated at the present value of those payments (i.e., the value of future payments in today's dollars). The ROU asset is

Buzz Words to Know

Balance Sheet: Assets + Liabilities = Owner's Equity

Profit & Loss (P&L) Statement (aka **Income Statement):** Revenue – Expenses = Net Income

Right of Use (ROU) Asset: The right to use the asset during the lease term

Lease Liability: The obligation to make lease payments over lease term

Present Value (PV): The current worth of a future sum of money

Operating Lease: (Only applicable for ASC 842) Being moved to balance sheet

Finance Lease: Has always been recorded on balance sheet (for IFRS 16, all leases are considered finance leases) the amount of the lease liability with other things added in, like prepayments and initial direct costs.

So, what's the big picture impact to your organization? Is it just a lot of painful data gathering and accounting calculations that will no longer have a significant effect after the first year or so?

Unfortunately, it's not that innocuous. There can be a significant impact on your company's operating results and financial ratios. This movement of operating leases may make your organization look bigger than it is because there will be a significant increase in assets and liabilities, but not an increase in net worth. That has the follow-on effect of making organizations appear to rely on a lot of debt to run their business. That's a red flag to investors.

Your organization also has debt covenants with lending institutions when borrowing money. With the shift of leases to the balance sheet changing ratios, companies may find themselves in violation of their debt covenants, thereby making it harder (if not impossible) to borrow more funds in the future.

For public companies, it's all about presenting the organization in the most appealing light to investors and keeping stock prices up. As we discussed in Volume 1 of this Learning Series, the guidelines were changed to increase the transparency when accounting for leases, which helps investors' analysis. But at least initially, the impact of the changes to a company's financial standing and presentation will have to be closely monitored by the CFO and team with an eye to minimizing impacts whenever possible.

Your CRE team will play a significant part in this effort. It will be imperative that you closely track things that can trigger a re-measurement (i.e., a recalculation of the ROU asset and lease liability). Open lines of communication between CRE and Finance / Treasury are key to managing this successfully.

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Feel free to share this paper with your friends and co-workers. Below are the upcoming papers in this series.

Upcoming Papers in this Learning Series

Volume 1: Why did FASB and IASB change the guidelines?

Volume 2: Why is moving leases to the Balance Sheet such a big deal? (CURRENT ISSUE)

Volume 3: How do the accounting changes impact my CRE team?

Volume 4: What are the key requirements of FASB ASC 842?

Volume 5: What are the key requirements of IASB IFRS 16?

Volume 6: What are the differences between ASC 842 and IFRS 16?

Volume 7: What comes first – the chicken or the egg?

Volume 8: What do I need to consider when evaluating software systems?

Volume 9: What potential impacts will there be to leasing space?

***Arazzo Solutions, LLC** is a boutique professional services firm focused on the Commercial and Corporate Real Estate (CRE) industry. Having more than a combined 45 years of CRE experience, our team has a unique combination of expertise in lease administration, lease accounting, project management, and IWMS (Integrated Workplace Management System) support.*

We are here to augment your internal CRE teams, assist you with ASC 842 and IFRS 16 compliance, including required data points, data management and governance, evaluation of systems, and best practices, and act as your advocate to manage IWMS vendors. Whether you have seasonal demands or need assistance year-round, we can help you meet your responsibilities and deadlines without the need to hire additional employees.

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Charlene McNeil, Principal
214-773-4836
charlene.mcneil@arazzosolutions.com

Deb Vallo, Principal
214-405-4316
deb.vallo@arazzosolutions.com