Arazzo Solutions, LLC

Learning Series: Lease Accounting Changes for Non-accountants

What are the key requirements of FASB ASC 842?

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US GAAP Requirements for ASC 842

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Sounds like a pretty dry topic, doesn't it? And you'd be right. But it's important for your CRE team to understand the high-level requirements for U.S. leases. As discussed in previous papers in this learning series, the group of stake-holders is greatly expanded due to the accounting changes, which means you're going to be expected to understand the lingo so you can communicate effectively with Finance and others.

We'll try to keep this as light as possible to preserve everyone's sanity (and patience). So let's look at the highlights of ASC 842 that governs leases in the U.S.

The first step for U.S. GAAP is to classify leases as Operating or Finance. They're handled slightly differently, but we won't explore that here for fear of the snores it would induce. Remember from volume 2 of this learning series, finance leases have always been recorded on the balance sheet, so we're focusing on operating leases in this series.

There are two parts to moving the lease to the balance sheet: the lease liability (the obligation to pay rent) and the Right of Use (ROU) asset (aptly named since the lease gives you the right to use the space). The lease liability

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.

Buzz Words to Know

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

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

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

Initial Direct Costs (IDC): Costs incurred which are directly related to executing a lease and are only paid if the lease is signed (e.g., broker commissions); legal fees are not an IDC since they are incurred whether or not the lease is actually signed

Landlord Allowances: Funds the landlord provides to the tenant, including allowances for tenant improvements, moving, cable & wiring, architectural, etc.

is calculated first since it's the basis of the ROU asset value.

The lease liability is the present value (PV) of the lease payments for the term of the lease (i.e., rent charges). Also included are other charges like renewal or termination options that are deemed "reasonably certain" (see volume 3 of this series for more information on this term) and variable lease payments based on an index (e.g., CPI) or a rate (e.g., $.50 psf per year). Other items may also be included based on assumptions from your CFO and auditors.

Gross leases are handled a little differently, which means they require more work by the CRE team. The part of the gross rent amount that pertains to services (e.g., OPEX) should be deducted before calculating the lease liability (based on auditor's recommendations), which means figuring out the base year portion for each gross lease. An added effort that you don't have to do for triple net leases.

The lease liability is then used as the basis of the ROU asset calculation. Added to this amount are things like prepayments of rent, restoration costs, and initial direct costs (IDC). Landlord allowances are deducted from the ROU asset. (see Buzz Words)

The next step is to create the capitalization schedule, but we'll leave that to the Finance team to manage. The important information for your CRE team is the data points needed for the lease liability and ROU asset calculations. You manage the lease data, so Finance will come to you for these data points at a minimum: lease term, rent amounts, renewal/termination options (and estimated values relating to these options), base year amounts, landlord allowances, and IDC. Having complete and accurate data at your fingertips is going to be key to managing the extra load on your CRE resources.

Global companies will need to understand both ASC 842 and IFRS 16. The IFRS 16 guidelines are the topic of our next white paper.

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

Papers in this Learning Series (Past, Present, & Future)

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

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

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

Volume 4: What are the key requirements of FASB ASC 842? (CURRENT ISSUE)

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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