LESMARK

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To: Clients and Friends of LesMark Capital
From: Mark Hill
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Re: Lease Accounting Standards Update – Commercial Real Estate

Back in August of 2013 we issued a lease accounting update summarizing the Financial Accounting Standards Board's ("FASB") ongoing efforts to overhaul the existing lease accounting standards. Earlier this year, and after a decade of joint deliberations with the International Accounting Standards Board ("IASB") and various industry constituents, the FASB issued Accounting Standards Update ("ASU") 2016-02, basically an amendment detailing codification changes to the various existing lease accounting pronouncements, beginning with FAS13. As expected, the FASB has finally reclassified all leases as either finance or operating (no "capital lease" designation), requiring both to be recognized on the balance sheet. ASU 2016-02 is limited to leases on property, plant and equipment ("PP&E") and provides for exemptions on intangible and biological assets, mineral rights, inventory, assets under construction and certain leases with a term of 12 months or less ("short-term leases").

Key elements and changes of the ASU include:

- A lease is defined as a contract that conveys the right to control the use of PP&E for a period of time in exchange for consideration. The lessee is deemed in control if it directs the use of the asset and retains substantially all its economic benefits.
- Leases classified as finance by lessee and sales-type by lessor generally follow the old FAS13 Section 7 capital lease criteria, although the triggers aren't as specific. All other leases are classified as operating by lessee and either operating or direct finance by lessor.
- Leases will be recognized by the lessee as a liability on balance sheet in an amount equal to the present value of the future lease payments, offset by a right-of-use ("ROU") asset. Lease accounting for lessors will not significantly change.
- The lessee's ROU asset will be amortized on a straight line basis for operating leases. For finance leases, the lessee will also need to book interest expense on the outstanding lease liability.
- Short-term leases will continue to avoid balance sheet classification, provided there are no lease extension or purchase options the lessee is likely to exercise.

These new lease accounting standards will take effect beginning in 2019, giving reporting entities three more years to plan for and implement the changes. As mentioned in our 2013 lease accounting update, although the new ASU will certainly help to standardize the bookkeeping for PP&E lease contracts, most real estate tenants will be required to capitalize all existing operating leases, which will certainly gross up the balance sheet and could negatively impact debt ratios and performance metrics. Again, the existing underlying lease contracts and economics are not going to change, just the way in which we have chosen to present the data. It remains to be seen how the new ASU effects how companies make decisions on renting vs. owning real estate in the future.

Link to FASB ASU 2016-02:
http://www.fasb.org/jsp/FASB/Document_C/DocumentPage?cid=1176167901010&acceptedDisclaimer=true