

NEW LEASE STANDARD

New Rules - Topic #1

2019 Update



Financial Analysis & Advisory

'A Lease by Any Other Name...'

FASB's new lease standard Topic 842 issued on February 25, 2016 includes a new lease definition that converges with IASB's IFRS 16 issued on January 13, 2016. Both standards focus on an identified asset and the right to control the use of that asset.

ONE OF THE KEY CRITERIA OF 842 IS THE DEFINITION OF A LEASE.

FASB and IASB deliberated for years to create a broader definition of a lease that is inclusive of all leases involving property, plant or equipment.

What is the definition of a lease?

A CONTRACT THAT CONVEYS THE RIGHT-OF-USE ASSET FOR A PERIOD OF TIME IN EXCHANGE FOR CONSIDERATION

- A contract must depend on the use of an "identified" asset
- Tenant to enjoy the right to control the use of the asset during the time period
- Landlord cannot have a "substantive substitution right"

WHY DOES THIS MATTER?

Because lease arrangements will be added to the balance sheet and service arrangements will continue to be expensed as they are incurred. And some arrangements are a little bit of both. Full service lease structures are a good example of a lease agreement that has embedded services. Only the lease component is segregated, measured and recorded under the proposed new standard to derive the balance sheet impact.

At the heart of the matter is the delineation between identifying a contract that is essentially a service (which might have an incidental asset) versus a contract that is a lease (which might be bundled with services). In short, one of the challenges for entities will be to properly account for contractual arrangements that incorporate both asset and service components.

Impact to Occupiers of Commercial Real Estate

The best way to assist with interpretation of what a lease is, is to look at examples that may arise regularly in commercial real estate arrangements.

RIGHT TO USE ASSET

Only payments made for the “right to use” an asset are considered lease payments used to measure the asset (Right-of-Use asset and Lease Liability) under the new standards:

- A full-service office lease has both “right to use” and “services” elements (“services” are considered Non-Lease Components and therefore segregated from lease payments).
- The net lease payments - after removing “services” (e.g. CAM expenses) - represent the Lease Component used to measure the ROU asset and lease liability.
- Property taxes and Insurance represent Not-a-Component of the lease (i.e. a reimbursement) and are not segregated from payments (of a full service lease).

IDENTIFIED ASSET

For Occupiers to recognize a Right-Of-Use asset associated with a lease, Landlords cannot easily and readily substitute it for another asset.

- For example, unreserved parking spaces provided as part of a pool (50 spaces anywhere in the parking structure) is not identified (physically distinct) and therefore does not meet the new definition of a lease. In contrast, reserved parking does satisfy the definition of a lease as the asset is identified and controlled by the tenant.

RIGHT TO CONTROL

This will be the most difficult area of interpretation for many companies where service arrangements and integrated assets will have to be evaluated carefully to determine if there is a lease embedded in the agreement.

- Warehouse / Third Party Logistic arrangements are very diverse in terms of structure, responsibilities and control. Accordingly, the new standard interprets a lease arrangement in an instance where the customer designs the asset or directs the asset to be designed in such a way that predetermines how or for what purpose an asset will be used. A third party arrangement where the customer defines the design of the premises for specialized inventories is likely to have an embedded lease where previously the arrangement had no lease.

In Summary

The wording and guidance of Topic 842 is expected to have a wide-ranging impact on lease accounting for US registrants leading up to and after its adoption date of December 15, 2018. The new definition of a lease and the emphasis on expanded guidance gives us some clarity on the magnitude of the shift ahead.

Cushman & Wakefield’s Financial Analysis & Advisory will continue to monitor transition to the new standards and prepare updates to assist our business audience with timely information related to commercial real estate.



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