NEW LOGISTICS OF LEASE REPORTING

New Rules - Topic #3

2019 Update

CUSHMAN & WAKEFIELD

Financial Analysis & Advisory

Considerations for Industrial Asset Leases

New Standards for financial reporting of lease obligations Topic 842 (FASB) and IFRS 16 (IASB) were issued in early 2016. These new rules will trigger widespread global change in transaction and portfolio management of commercial real estate leases upon adoption dates December 15, 2018 and January 1, 2019 for FASB and IASB, respectively. This installment in the "New Rules" series considers how new reporting requirements could impact industrial asset lease transactions and the associated approvals and documentation processes.

1. SIZE OF TRANSACTION

Many industrial leases encompass large spaces and, accordingly, are likely to receive scrutiny in the approval process. For example, a 200,000 RSF warehouse with a $6.00 NNN and a ten year term under the new standards will now create a ROU asset and lease liability of $10,000,000 to be recorded on the balance sheet of the lessee. Due to the materiality of the liability, such a transaction will likely receive increased scrutiny in planning or board approval cycles.

WHY DOES THIS MATTER?

- The ROU asset and lease liability that arise as a result of the lease obligation must be reported on the balance sheet of the business in the next financial reporting period (generally quarterly). Balance sheet ratios used in loan covenants, legal agreements or performance ratings will be impacted.
- **As a result, real estate, finance and accounting will have a vested interest in the calculation and documentation for new lease agreements.**

2. DEFINITION OF A LEASE

The new standard requires the separation of lease components and non-lease components (services) within agreements and contracts. Specifically, the definition of a lease encompasses arrangements where a tenant controls the use of an identified asset. As a result, storage and 3PL agreements should be reviewed closely to determine if a lease is embedded in the service arrangement.

WHY DOES THIS MATTER?

- Prior to ASC 842, many warehousing agreements were considered merely service arrangements. Specific provisions in these warehousing agreements may include an embedded lease and therefore will require an ROU asset and lease liability to be separated from the service portion of the agreement in compliance with the new standard.
- The definition of a lease has been changed from current (FASB) rules and will require a new understanding and interpretation.

3. STRUCTURING

Under ASC 842 (U.S. GAAP), there are two categories of leases: operating leases and finance leases (formerly capital), which will have different expense patterns. All leases will book assets and liabilities, but the expense pattern differs based on the lease type. An operating lease will have a straight-line expense pattern. A finance lease - any lease that covers most of the useful life or fair value of an asset - will trigger an interest amortization rent pattern and the booking of debt (or lease liability). Our graph illustrates these different expense patterns.

WHY DOES THIS MATTER?

- Topic 842 removes the 90% "bright line" rule and instead is based on principles (i.e. the essence of the transaction) rather than a strict 90% cut off, which means that 88% may also trigger this finance lease classification and recording. Companies will want to review and evaluate their internal policies in this area.

4. PAPERWORK

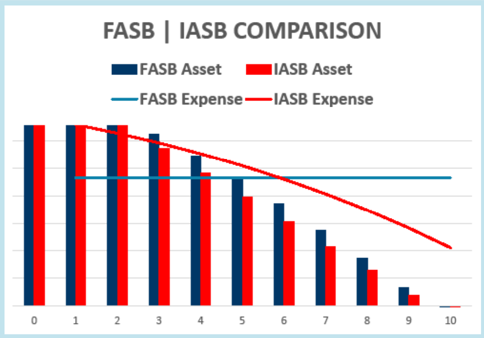
Diligence surrounding lease transactions will be heightened and more reliance will be placed on the completeness of the paper trail due to the change in financial reporting requirements.

WHY DOES THIS MATTER?

- Quarterly reporting means that there is less time to execute and circulate the lease documents through appropriate channels for recording, especially for deals that close near the end of quarters and for transactions that may be in remote jurisdictions.
- **The new reporting standard is both date and data driven – so dates of occupancy, commencement and rent escalation need to be in the lease documentation and supporting paperwork.**
- Additionally, base year amounts under full service or gross arrangements will need to be segregated, documented and itemized by component. Base year costs associated with goods and services will be excluded from lease payments and, in turn, the liability calculations.

5. GLOBAL

FASB (U.S. GAAP) and IASB (IFRS) have diverged with respect to expense reporting and asset balances during the term of the lease.



WHY DOES THIS MATTER?

- Global organizations face challenges in managing portfolios, as jurisdictions may require different recording rules. The corporate parent determines the ultimate recording – but some leases may be recorded and reported in separate jurisdictions under different calculation methods.
- Database integrity and portfolio functionality will be extremely important for multinationals.

6. TIMING & TRANSITION

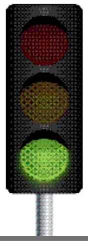
Issuance – Topic 842 issued February 25, 2016; IFRS 16 issued January 13, 2016

Adoption Date – Topic 842 (Fiscal years beginning after December 15, 2018); IFRS 16 (Fiscal years beginning after January 1, 2019) for publicly traded companies. One year later for private entities.

Early Adoption – Permitted (subject to revenue recognition standard compliance)

WHY DOES THIS MATTER?

- 2017 & 2018 have been extremely busy – initial transaction / education phase
- Identification, collection and update of databases for all leases (real estate, equipment, vehicles, etc) is underway and being finalized, as well as the selection of technology to support lease systems
- Business processes will require modification for new asset / liability obligations – review of agreements
- There is no grandfathering provision, so all leases currently in existence and new leases executed will require transition processes and calculations.



2019 “implementation” is the finish line.

Contact

RYAN RAWLS, CPA
(813) 424-3219
ryan.rawls@cushwake.com

MITCHELL RUSBARSKY, CPA
(213) 629-7319
mitchell.rusbarsky@cushwake.com

TESSA MELLINGER, CPA
(813) 424-3203
tessa.mellinger@cushwake.com

ERIK BRIDY, CPA
(858) 334-4023
erik.bridy@cushwake.com

Cushman & Wakefield, Inc.
www.cushmanwakefield.com