

NEW LEASE STANDARD

New Rules - Topic #4

2019 Update



Financial Analysis & Advisory

Measurement Matters – The NNN Operating Lease

The new FASB Financial Reporting Standard for leases - ASC 842 - was issued in 2016.

This installment in the “New Rules” series takes a brief look at the arithmetic for operating leases under the new standard.

Our example below shows the basic calculations required to record a NNN lease on the balance sheet as a right-of-use asset (“ROU”) and an operating lease liability.

Step 1 - Collect the Relevant Data

(Essential data to perform the calculations; example operating lease, 50,000 RSF)

DATA	KEY DETAILS		SOURCE	EXAMPLE
Critical Dates	Lease execution	Contract Date	Lease document	January 1, 2019
	Lease commencement	Date available for use	Lease document	January 1, 2019
	Possession (control)	Certificate of Occupancy	Client/Project Manager	January 1, 2019 Turnkey
Rent	Lease payment table	Monthly-lease term	Lease document	\$16.00 NNN 3% Escalations
LL- Incentives	Abatement	In lease payment table	Lease document	4 Months
	TI Allowance	Reduce ROU asset	Lease document	Turnkey
Exclusions	Base Year - (CAM & Services)	If full service, property tax and insurance remain in lease payment	Landlord	NNN
Discount Rate*	Incremental borrowing rate	Based on similar commitments	Client/Treasury	6%
Lease Term	Consider renewal term(s)	Economic incentive if reasonably certain	Client/Lease Document	4 Years

*use the incremental borrowing rate (IBR) if the implicit rate is not readily determinable

Step 2 - Create a Table to Perform the Calculations

1. Create a table of lease payments for the entire lease term (may include renewal period)
2. Determine the aggregate total of the rent obligation (this can be used to derive the annual straight line rent expense)
3. Calculate the present value of the lease payments
 - a. The table can be used to derive the opening ROU asset and lease liability (before any other adjustments, if required)
 - b. These ROU asset and lease liability results will generally be required for approval (adherence to standards and budgets)



Results:

Aggregate Rent for Calculation:
\$3,080,235

NPV - Opening ROU
Lease Asset & Lease Liability:
\$2,712,577

Annual NNN Rent Expense:
\$770,059

Month	A Payment	B Expense	C Interest	D Liability	E ROU Asset
			= (D - A) * IBR	= D - A + C	= E - B + C
0				\$2,712,577	\$2,712,577
1	\$0	\$64,172	\$13,563	\$2,726,140	\$2,661,968
2	\$0	\$64,172	\$13,631	\$2,739,770	\$2,611,427
3	\$0	\$64,172	\$13,699	\$2,753,469	\$2,560,955
4	\$0	\$64,172	\$13,767	\$2,767,237	\$2,510,550
5	\$66,667	\$64,172	\$13,503	\$2,714,073	\$2,459,882
6	\$66,667	\$64,172	\$13,237	\$2,660,843	\$2,408,947
7	\$66,667	\$64,172	\$12,970	\$2,606,946	\$2,357,745
8	\$66,667	\$64,172	\$12,701	\$2,552,981	\$2,306,275
9	\$66,667	\$64,172	\$12,432	\$2,498,746	\$2,254,535
10	\$66,667	\$64,172	\$12,160	\$2,444,240	\$2,202,524
11	\$66,667	\$64,172	\$11,888	\$2,389,461	\$2,150,240
12	\$66,667	\$64,172	\$11,614	\$2,334,408	\$2,097,683
13	\$68,667	\$64,172	\$11,329	\$2,277,070	\$2,044,840
14	\$68,667	\$64,172	\$11,042	\$2,219,446	\$1,991,710
15	\$68,667	\$64,172	\$10,754	\$2,161,533	\$1,938,293
16	\$68,667	\$64,172	\$10,464	\$2,103,330	\$1,884,586
17	\$68,667	\$64,172	\$10,173	\$2,044,837	\$1,830,587
18	\$68,667	\$64,172	\$9,881	\$1,986,051	\$1,776,297
19	\$68,667	\$64,172	\$9,587	\$1,926,972	\$1,721,712
20	\$68,667	\$64,172	\$9,292	\$1,867,596	\$1,666,832
21	\$68,667	\$64,172	\$8,995	\$1,807,924	\$1,611,655
22	\$68,667	\$64,172	\$8,696	\$1,747,954	\$1,556,180
23	\$68,667	\$64,172	\$8,396	\$1,687,684	\$1,500,405
24	\$68,667	\$64,172	\$8,095	\$1,627,112	\$1,444,328
25	\$70,727	\$64,172	\$7,782	\$1,564,168	\$1,387,938
26	\$70,727	\$64,172	\$7,467	\$1,500,908	\$1,331,234
27	\$70,727	\$64,172	\$7,151	\$1,437,332	\$1,274,213
28	\$70,727	\$64,172	\$6,833	\$1,373,439	\$1,216,875
29	\$70,727	\$64,172	\$6,514	\$1,309,226	\$1,159,217
30	\$70,727	\$64,172	\$6,192	\$1,244,691	\$1,101,238
31	\$70,727	\$64,172	\$5,870	\$1,179,835	\$1,042,936
32	\$70,727	\$64,172	\$5,546	\$1,114,653	\$984,310
33	\$70,727	\$64,172	\$5,220	\$1,049,146	\$925,358
34	\$70,727	\$64,172	\$4,892	\$983,312	\$866,079
35	\$70,727	\$64,172	\$4,563	\$917,148	\$806,470
36	\$70,727	\$64,172	\$4,232	\$850,653	\$746,531
37	\$72,848	\$64,172	\$3,889	\$781,694	\$686,248
38	\$72,848	\$64,172	\$3,544	\$712,390	\$625,621
39	\$72,848	\$64,172	\$3,198	\$642,739	\$564,647
40	\$72,848	\$64,172	\$2,849	\$572,740	\$503,325
41	\$72,848	\$64,172	\$2,499	\$502,391	\$441,653
42	\$72,848	\$64,172	\$2,148	\$431,690	\$379,629
43	\$72,848	\$64,172	\$1,794	\$360,636	\$317,251
44	\$72,848	\$64,172	\$1,439	\$289,226	\$254,519
45	\$72,848	\$64,172	\$1,082	\$217,460	\$191,429
46	\$72,848	\$64,172	\$723	\$145,335	\$127,981
47	\$72,848	\$64,172	\$362	\$72,848	\$64,172
48	\$72,848	\$64,172	\$0	\$0	\$0
SUM	\$3,080,235	\$3,080,235			
NPV	\$2,712,577				

Helpful Hints:

- Many lease transactions will require this measurement to secure approval.
- Create a **monthly** table of lease payments for accuracy (unless entity only requires a rough order of magnitude estimate).
- The lease payments used in the ROU asset calculation are the Lease Components of the contract.
 - For NNN leases, the lease component is the base rent
 - For Full Service leases, the lease component is the base rent less CAM (service components)
- TI Allowance will reduce the opening ROU asset, **but not the lease liability**.
- **Longer term leases** will trigger higher ROU asset and lease liability balances.
- Early agreement on targets will help with structuring an **optimal** lease agreement.
- ASC 842 applies to publicly traded companies (after 12/15/18) and many large private companies (after 12/15/19).
- The straight line expense pattern used in the example is applicable to the US only (illustrates an operating lease). All non-US jurisdictions use a **front-loaded** interest and amortization expense pattern (applied as finance lease).

In Summary

This example illustrates the most basic, straightforward lease accounting calculations arising from the new lease standard – as it is a NNN arrangement with fixed escalations. Other lease structures or indexed based escalations require different calculation techniques.

Given the variety of formulas involved, each company will need to develop their own key metrics for lease approval to evaluate impact to cash flow from operations, annual rent expense, EBITDA, P&L, EPS, asset balances and/or liability balances.



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