WILL THE LATEST FASB REGULATIONS FUEL EXPANSION OF THE CLOUD?

In 2016, the Financial Accounting Standards Board ("FASB") issued*, Leases (Topic 842),* requiring most leases of real estate and equipment to be reported on the balance sheet. This is a significant shift from the current lease accounting rules that allow for most leases to avoid balance sheet recognition. Prior to Topic 842, operating real estate and equipment leases were not required to be reported on the balance sheet. Rather, such leases were effectively a form of "off balance sheet" financing and only disclosed in the footnotes of the financial statements.

The current lease accounting treatment has been criticized for failing to provide a full picture of a corporate's financial obligations related to leasing activities. The lack of transparency and comparability led to the revisions of lease accounting rules and ultimately led to Topic 842.

Topic 842 will require all lease obligations in excess of 12 months to be reported on the balance sheet in the form of a lease liability and a right of use ("ROU") asset. The lease liability will be valued at the present value of lease payments discounted at the lessee's incremental borrowing rate or the rate implicit in the lease. The ROU asset will be equaled to the value lease liability adjusted for prepaid rent, initial direct costs or lease incentives.

Effective for reporting periods after 2018, the impact of the Topic 842 will be significant as there will be greater transparency into leasing activities. The balance sheets of certain organizations may also experience a significant increase in size, which may alter certain metrics for measuring financial performance:

- **Decrease in Liquidity.** The lease liability will have a current liability portion, while the ROU asset will not. This will negatively impact certain liquidity ratios such as the current and quick ratios as well as working capital.
- **Decrease in Return on Assets.** The addition of ROU Assets will increase total assets and as a result decrease return on assets for an equivalent level of net income.

CLOUD COMPUTING SERVICES

According to Gartner, Inc., worldwide public cloud will grow 18 percent in 2017 to total $246.8 billion, up from $209.2 billion in 2016. This high rate of growth is expected to continue through next year.

The growth is led by the migration of enterprises from owned and operated data centers to the Cloud. Corporate C-Suite leadership has reached the conclusion that owning and operating supporting IT infrastructure required an excessive amount of the company's financial resources, as well as results in higher operating expenses.

With many of the underlying software programs based on Cloud platforms (ie; Saleforce, Apple, social media), enterprises are accessing some via the Cloud directly, through aggregators or a hybrid solution. The expansion of Cloud providers is commoditizing data centers resulting in lower price points.

As a result, we are seeing retail colocation and smaller wholesale colocation rates trending lower to compete with Cloud services.

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Data Center Advisory Group

FASB LEASES TOPIC 842 IMPACT ON THE CLOUD

As enterprise leadership look at different IT solutions, capitalizing the underlying data center lease and equipment will be a major consideration.

In our opinion, a Cloud service contract, if structured properly, will be considered a service agreement because there will be no identifiable asset that the cloud user controls and directs the use. As a result, the cloud user would not be required to capitalize any components of the contractual payments and avoid balance sheet recognition of IT infrastructure costs associated with capturing and managing data.

Once the new FASB requirements are implemented, we believe enterprises will bypass wholesale/retail colocation in favor of a properly structured Cloud solution.

CLOSING COMMENTS

As enterprise leadership considers IT solutions, it is important to note that the IT landscape has evolved from physical bricks and mortar white space to geographically agnostic services. The new FASB reporting requirements will allow enterprises to implement IT solutions as a service, therefore minimizing balance sheet exposure. Although the new regulations won't go into effect until reporting periods after 2018, we strongly recommend evaluating the financial statement impact of cloud computing strategies with certified accounting professionals to ensure compliance.

ABOUT CUSHMAN & WAKEFIELD

Cushman & Wakefield is a leading global real estate services firm that helps clients transform the way people work, shop, and live. Our 43,000 employees in more than 60 countries help investors and occupiers optimize the value of their real estate by combining our global perspective and deep local knowledge with an impressive platform of real estate solutions. Cushman & Wakefield is among the largest commercial real estate services firms with revenue of $5 billion across core services of agency leasing, asset services, capital markets, facility services (C&W Services), global occupier services, investment & asset management (DTZ Investors), project & development services, tenant representation, and valuation & advisory. To learn more, visit www.cushmanwakefield.com or follow @CushWake on Twitter.

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We are the leader in the data center industry with a robust offering of enhanced services to support the enterprise-end user. Our track record managing data center requirements is robust and our industry experience relevant.

We can ensure that your business needs and objectives always come first, here or abroad. This is important as IT is critical to the enterprise and cannot be compromised.

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The Cushman & Wakefield National Financial Consulting Group (NFCG) is a component of the Global Occupier Services platform and offers the professional resources necessary to support financial analysis on a broad and deep technical basis for our clients. The NFCG provides technical financial analysis support to ensure the quality of financial measurement and evaluation through every stage of transaction.

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