LEASE ACCOUNTING UPDATE

ARE YOU READY FOR THE NEW LEASE ACCOUNTING STANDARDS?

FREQUENTLY ASKED QUESTIONS: A LESSEE'S PERSPECTIVE

The new lease accounting standards issued by the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB), collectively the "Boards," require virtually all leases be recorded on a company's balance sheet as both a Right-of-Use (ROU) asset and a lease liability. This is a significant departure from prior lease accounting requirements where most real estate leases were "off-balance sheet."

The FASB and the IASB have issued separate standards and, while they are very similar, there are key differences between the two standards.

For calendar-year companies following IASB, the effective date is January 1, 2019. The new FASB standard has an effective date of January 1, 2019, for public companies and January 1, 2020, for private companies on a calendar year.

To provide a refresher on the changes to lease accounting—and to help you understand the key technical aspects of these new standards to determine the possible financial impact of potential occupancy decisions—CBRE's Global Task Force on Lease Accounting has prepared a Frequently Asked Questions (FAQ) document.

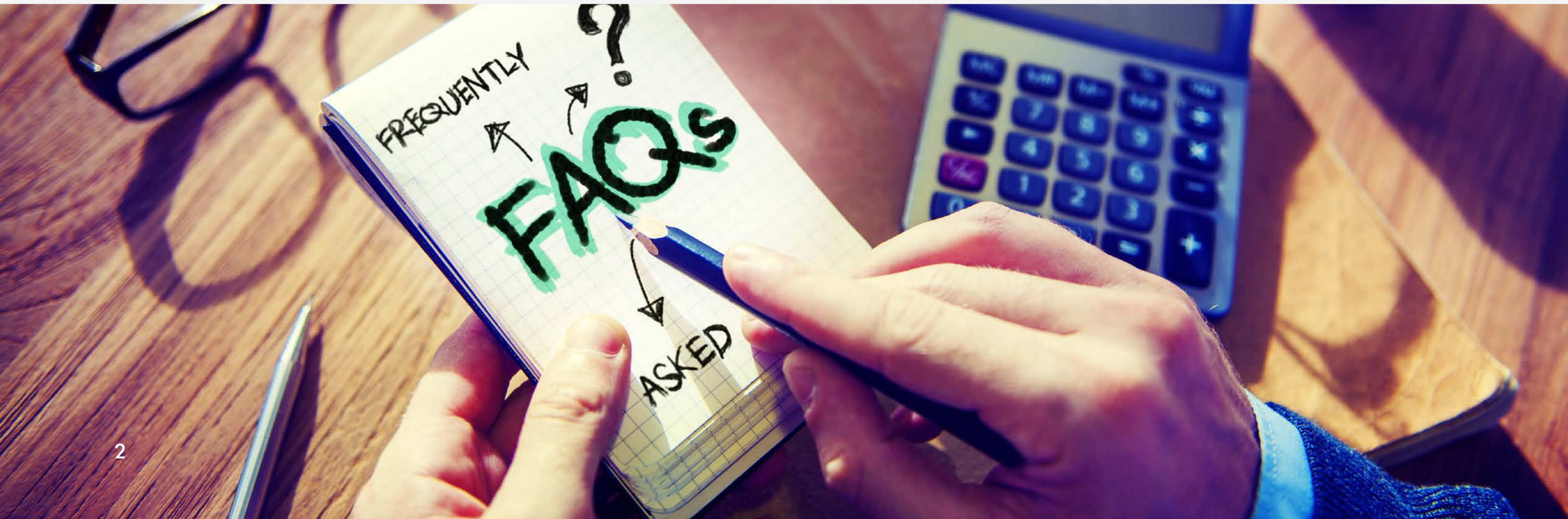
Note: *A company's effective date for the new lease accounting standards is determined based on its year-end and whether they report under U.S. Generally Accepted Accounting Principles (GAAP) or International Financial Reporting Standards (IFRS). While this FAQ makes mention of the "prior" or "previous" lease accounting standards in reference to ASC-840 and IFRS 17, it is important to note that many companies, especially non-public companies that follow U.S. GAAP, have not yet reached their effective date. In this situation, the aforementioned standards would more appropriately be referred to as the "current" or "existing" lease accounting standards.*

EXECUTIVE SUMMARY

- Leases of 12 months or less are excluded from the requirements of both standards (IASB and FASB). In addition, the IASB standard allows for a "low value" exception.
- The IASB requires all leases be classified as Finance Leases.
- The FASB has a dual approach to lease classification with two types of leases: Finance Leases and Operating Leases.
- Under the new standards, Finance Leases are accounted for in the same manner as Capital Leases with a front-end-loaded expense pattern.
- Operating Leases under the new FASB standard will continue to have a straight-line Rent Expense.
- All leases—Finance and Operating—will be recorded on the balance sheet as a ROU asset and a lease liability.
- The ROU asset and lease liability are generally determined based upon the present value of the lease payments over the primary term of the lease.
- Renewal options are only included in the determination of the ROU asset and lease liability if they are "reasonably certain" of being exercised.
- The liability associated with an Operating Lease (FASB only) **IS NOT CONSIDERED DEBT**, while the liability of a Finance Lease **IS CONSIDERED DEBT**.
- The P&L impact of the new FASB standard will be minimal, while the IASB standard will result in the straight-line Rent Expense of former Operating Leases being replaced with the front-end-loaded expense pattern of Finance Leases.

FREQUENTLY ASKED QUESTIONS

To directly access a specific question, please click on the question below:



1. Why were changes made to lease accounting?

The primary goals of the new lease accounting standards are to provide greater transparency and comparability for users of financial statements by recognizing both the liability and the asset associated with a lease on the lessee's balance sheet. This is in contrast to prior lease accounting where only Capital Leases (FASB) and Finance Leases (IASB), which represented only a small portion of the universe of real estate leases, were required to be recorded on the lessee's balance sheet.

2. Are there separate standards for the FASB and the IASB?

Yes. The Boards did not reach consensus on a uniform standard. The FASB, which regulates accounting for companies reporting under U.S. GAAP, and the IASB, which regulates accounting for companies reporting under IFRS, each issued their own standard. While the standards are similar in many ways, there are key differences, which are addressed in this FAQ.

3. Must all companies follow the new standards?

Those companies reporting under U.S. GAAP or IFRS are required to follow their respective new standard.

4. What are the effective dates for the new standards?

FASB – Accounting Standards Codification (ASC) 842

- The effective date for public companies that report on a calendar-year basis is January 1, 2019.
- For all other public companies, the effective date will be their first fiscal year beginning after December 15, 2018.
- The effective date for private companies that report on a calendar-year basis is January 1, 2020.
- For all other private companies, the effective date will be their first fiscal year beginning after December 15, 2019.

IASB – IFRS 16

- The effective date for all companies is the beginning date for annual reporting periods occurring on or after January 1, 2019.

5. What leases will be impacted by these changes?

The new standards impact ALL leases, not just real estate leases. The only exceptions, at the option of the lessee, relate to:

- "Short-term" leases—Defined as leases with a lease term of 12 months or less. This is an exception for both the FASB and the IASB.
- "Low-value" leases—This exception is only available under the IASB standard. The exception is based on the value of the asset as if "new" regardless of whether the asset being leased is new or used.

6. Are there any additional exceptions made?

It is likely both the FASB and the IASB will allow for additional exceptions. These decisions will be based on what is generally referred to as capitalization thresholds, which essentially refers to a level of materiality. This threshold is typically established by a company and then agreed to by its auditors and will vary by company.

7. Are leases in place on the effective date exempt from the new standards?

No. Leases in place on the effective date are subject to the transition requirements of the applicable new standard. They are not allowed to continue to be accounted for under the prior lease accounting requirements. While the variety and complexity of the transition requirements preclude an in-depth review of the topic in this paper, from a "big picture" perspective, leases in place on the effective date will be recorded on the balance sheet based on the present value of the lease payments to be made from the effective date to the end of the lease term. The actual amount recorded will be subject to the specific guidance provided by each Board.

8. Are the types of leases the same for both the FASB and the IASB?

No. This is the greatest area of divergence between the Boards:

- The FASB continues to embrace a dual approach to lease classification, consistent with prior lease accounting. In accordance with the new standard, a lease will be classified as either an Operating Lease or a Finance Lease.
    - As Operating Leases exist in prior lease accounting, this may cause confusion. It is important to know that while the name is the same, the balance sheet treatment of an Operating Lease under the new standard is different than under prior lease accounting. This will be discussed in more detail in question 9.

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- A Finance Lease is simply a new name for what was known as a Capital Lease. The financial treatment of the Finance Lease, both from a balance sheet and P&L perspective, will essentially be the same as the prior treatment for a Capital Lease.

- The IASB is changing from a dual approach to lease classification to a single approach and is requiring all leases be classified as Finance Leases for lessees. The financial treatment of these leases will be the same as prior Finance Leases pursuant to the IASB.

9. What is the difference between the two lease types?

Finance Leases under the new accounting standards are essentially the same as Capital Leases (FASB) and Finance Leases (IASB) under the previous standards:

- They are recorded on the balance sheet as a ROU asset and a lease liability.

- From a P&L perspective, the expense recognition pattern is similar to previous lease accounting for Capital Leases (FASB) and Finance Leases (IASB).

- Rent payments for a Finance Lease are not classified as Rent Expense. Rather, the payment is bifurcated between: 1) Interest Expense and Amortization Expense for the new FASB standard and 2) Interest Expense and Depreciation Expense for the new IASB standard.

- Because Interest and Amortization or Depreciation Expense are reported below Earnings Before Interest, Taxes, Depreciation and Amortization (EBITDA), this lease type results in improved EBITDA when compared to an Operating Lease and its associated Rent Expense.

- However, since the Interest Expense is determined using the Effective Interest Method (i.e., similar to a mortgage where the interest component of the payment is greater in the early years of the lease), this lease type has a front-end-loaded expense pattern.

- The liability associated with a Finance Lease is **CONSIDERED DEBT**.

While Operating Leases under the new FASB standard will have a P&L treatment similar to prior Operating Leases, they will now be recorded on a company's balance sheet as well.

- From a P&L perspective, the financial impact of an Operating Lease under the new FASB standard is essentially the same as under previous lease accounting. In both instances, Rent Expense is recognized on a straight-line basis over the term of the lease.

- The primary difference between a new Operating Lease and an Operating Lease under the prior standard, is that under the new standard the lessee will have to record both a ROU asset and a lease liability on their balance sheet.

- It is important to note that the liability associated with an Operating Lease is **NOT CONSIDERED DEBT** and, therefore, does not impact debt-related financial ratios.

10. Are both Operating Leases and Finance Leases, as defined in the new standards, recorded on the balance sheet?

Yes. The only exceptions, as noted previously, are short-term leases (12 months or less) or "low-value" leases (IASB only).

11. How are the different lease types determined?

For lessees reporting under IFRS, there is only one lease type, a Finance Lease. As a result, there is no criterion required for determining the lease type. If it is determined to be a lease, then it is a Finance Lease.

For companies following U.S. GAAP, the classification process will be like that of previous lease accounting. Surprisingly, while the FASB has said from day one the new standard will eliminate the "bright line" tests, they have indicated the "bright line" tests may be used as "Safe Harbor" tests under the new standard to determine whether a lease is an Operating Lease or a Finance Lease.

"Bright line" tests refer to two of the four tests in prior U.S. GAAP where specific percentages are referenced. There are now five tests under ASC 842 to determine lease classification; the first four are similar to those in prior U.S. GAAP. If the answer to any of the questions that follows is "yes," the lease is a Finance Lease. Otherwise it is an Operating Lease.

- Does the lease transfer ownership of the underlying asset to the lessee at the end of the lease term?

- Does the lease grant the lessee the option to purchase the underlying asset that the lessee is reasonably certain to exercise (a.k.a. bargain-purchase option)?

- Is the lease term for a major part of the remaining economic life of the underlying asset (Note: Safe Harbor test allows "75%" to be substituted for "a major part")?

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- Is the present value of the sum of the lease payments, and any residual value guaranteed by the lessee that is not otherwise included in the lease payments, substantially all of the fair value of the underlying asset (Note: Safe Harbor test allows "equal to or greater than 90%" to be substituted for "substantially all")?

- Is the underlying asset of such a specialized nature that it is expected to have no alternative use to the lessor at the end of the lease term?

In other words, a lease classified as an Operating Lease under prior lease accounting will likely be classified as an Operating Lease under the new standard. Likewise, what was considered a Capital Lease will likely be classified as the renamed Finance Lease.

12. In simple terms, what amount is recorded on a company's balance sheet as a ROU asset and lease liability for a lease entered into after the effective date?

From a big-picture perspective, the amount recorded on the balance sheet is the present value of the rent to be paid over the term of the lease.

13. What is the accounting definition of the "term of the lease?"

- For accounting purposes, the term of a lease must take into account any renewal or termination options that are "reasonably certain" of being exercised. While this is consistent with the previous requirement of both Boards relative to Finance and Capital Leases, it is a new concept for most people. Because this is a very subjective attribute, with both Boards noting this is considered a "high threshold" to meet, it will be challenging to accurately assess if an option is reasonably certain of being exercised at lease commencement. A company will want to obtain a clear understanding from their auditors as to how this concept should be implemented.

- The existence of any one factor does not make an option period "reasonably certain." For instance, a below-market rent for a renewal option does not by itself trigger an option to be reasonably certain. It is a factor to consider, but not the only factor.

- There are several factors to consider in determining whether an "economic incentive" exists making an option "reasonably certain" of being exercised. These include, but are not limited to, the amount of tenant improvements in the space, the costs to relocate, interruption to the company's business should they relocate, etc.

14. When are you to determine if an option is "reasonably certain?"

- For leases entered into after the effective date, the determination is to be made on the lease commencement date.

- Both the FASB and the IASB define the lease commencement date as "The date on which a lessor makes an underlying asset available for use by a lessee."

- It seems somewhat unlikely that a "reasonably certain" option will be triggered at lease commencement. However, the more challenging and burdensome aspect of the new standard is that a lessee must continue to monitor leases with options to assess whether there has been a "significant event or a significant change in circumstances that is **within the control of the lessee** that directly affects whether the lessee is reasonably certain to exercise or not to exercise an option to extend or terminate the lease or to purchase the underlying asset."

- If a renewal or termination option becomes "reasonably certain" subsequent to the initial capitalization, the lessee must adjust the balance of the ROU asset and lease liability taking into account the revised term of the lease.

- If it is determined a termination option is "reasonably certain" of being exercised, the term of the lease will be reduced for accounting purposes and any termination fee is capitalized along with the remaining lease payments.

- It will be up to each company and its auditors to decide what leases are to be monitored and how often they are to be reviewed to determine if a "significant change" has taken place that causes the "reasonably certain" threshold to be triggered.

15. What are the technical steps taken to determine the amounts recorded on a company's balance sheet for leases commencing after the effective date?

The amounts initially recorded on the balance sheet as a ROU asset and lease liability are determined based on the following:

- The present value of the rent payments to be made over the term of the lease.

- The lease term is to be adjusted for any renewal/ termination options that are "reasonably certain" of being exercised (see FAQ #13 for further discussion).

- Any portion of the rent attributable to the reimbursement of "non-lease components" (e.g., utilities, CAM, maintenance) can be carved out of the rent being paid to arrive at a "net rent." This net rent is the amount used in the present value calculation.
    - As the Boards consider real estate taxes and insurance to be "costs of ownership," any amount included in the rent for reimbursing the landlord for real estate taxes and insurance CANNOT be excluded from the rent.
    - However, if a lease is a net lease, meaning all expenses are either paid directly by, or reimbursed by, the lessee, then taxes and insurance can be excluded from the rent amount.
    - For a more detailed discussion and explanation of this topic please see FAQ #17.
    - **Note:** As a "practical expedient" a lessee may elect, by class of underlying asset, not to separate non-lease components from lease components (FASB & IASB).
- The discount rate used to calculate the present value of the rent is the implicit interest rate in the lease. However, for most real estate leases this will not be known, nor can it be calculated with any level of certainty by the lessee.
- When the implicit rate in the lease is not known, the lessee is to use their incremental borrowing rate (IBR).
    - The FASB defines IBR as "The rate of interest that a lessee would have to pay to borrow on a collateralized basis over a similar term an amount equal to the lease payments in a similar economic environment."
    - The IASB defines IBR as "The rate of interest that a lessee would have to pay to borrow over a similar term, and with similar security, the funds necessary to obtain an asset of a similar asset value to the right-of-use asset in a similar economic environment."

From a big-picture perspective, it might be easiest to think of the amount recorded on the balance sheet for both the ROU asset and lease liability as the same; however, this is not generally going to be the case.

- Naturally, the IBR will vary by company and will vary over time for each company.
- **Note:** The IBR is not to be confused with a lessee's Weighted Average Cost of Capital.

Technically, the amount derived from the preceding steps determines the amount of the lease liability to be recorded on the balance sheet. This is the starting point for determining the ROU asset, which is then adjusted based on the following (if applicable):

- Increase for any Initial Direct Costs incurred (FASB & IASB)—see FAQ #20.
- Increase for any prepaid rent (FASB & IASB).
    - As most real estate leases require rent for the month be paid at the beginning of the month, this is a form of prepaid rent and will technically require an adjustment to arrive at the amount to be initially recorded as the ROU asset. (**Note:** If rent is paid at the beginning of the month, this amount should not be included in the present value calculation. Rather, you would add the first month's "prepaid" rent to the present value.)
- Increase for any costs to restore the underlying asset to the condition required by the terms of the lease (**IASB only**).
- Decrease for any lease incentives received (i.e., tenant improvement allowances, moving allowances, etc.) (FASB & IASB).

16. What happens to the amounts initially recorded on the balance sheet as a ROU asset and a lease liability?

- Over the term of the lease, the outstanding balance of the ROU asset and lease liability are amortized (i.e., decline).
- How the ROU asset and lease liability are amortized varies and depends on whether the lease is an Operating Lease or a Finance Lease.
- At the end of the lease term, both the ROU asset and lease liability will have a zero balance.

17. If the rent paid includes the reimbursement of expenses to the landlord, can these expenses be excluded from the rent amount prior to performing the present value calculation?

Lease payments will likely be comprised of a "lease component" and a "non-lease component." As it relates to a real estate lease, the lease component is the amount that can be identified solely as the amount of rent paid to lease the space, also known as the "net rent."

The non-lease component of a rent payment is associated with reimbursing the landlord for operating expenses, such as common area maintenance, utilities, janitorial services, building security, etc. (**excluding** real estate taxes and insurance).

The new standard allows a lessee, at their option, to carve out from the gross rent payment any amount reimbursing the landlord for non-lease components for purposes of determining the amount to be used in the calculation of the lease liability and ROU asset.

The FASB believes both real estate taxes and insurance are costs of ownership. Therefore, they are not considered "non-lease components" and as a result cannot be excluded from lease payments under that clause in the standard. However, the standard does allow for "variable lease payments (VLPs)" to be excluded from rent. The most common form of a VLP in real estate leases is percentage/turnover rent. Many retail leases contain percentage rent, which is calculated as a percentage of sales over a set amount. Because of the inherent variability of a VLP, it does not have to be estimated and included in the capitalization calculation. While not specifically stated in the new standard, but interpreted by the large accounting firms, if a lease is a "double net" or "triple-net" lease then real estate taxes and insurance are considered VLPs. As a result, they can be excluded, along with non-lease components, from the calculation of the lease liability and the ROU asset.

18. Is percentage/turnover rent included in the calculation of the ROU asset and lease liability?

No. This is considered a VLP and VLPs are excluded from the calculation.

19. How are CPI increases, or other increases based on an index or rate, accounted for?

Future CPI increases, or increases based on an index or rate, are not taken into account in the initial calculation of the ROU asset and lease liability for either the new FASB or IASB standard.

For companies reporting under U.S. GAAP, the incremental increase in rent associated with a CPI increase will simply be recorded as additional Rent Expense when incurred. These increases will not require a re-measurement of the ROU asset and lease liability.

For companies reporting under IFRS, an increase in rent associated with an increase in CPI, or any other index or rate, will require the ROU asset and lease liability to be re-measured at the time of the increase.

20. What are Initial Direct Costs and how are they accounted for?

"Initial Direct Costs" associated with a lease must be included in the amount of the ROU asset. An Initial Direct Cost is defined as an incremental cost that would not have been incurred if the lease had not been executed (e.g., commissions, payments made to an existing tenant to incentivize that tenant to terminate its lease, etc.).

21. What is the P&L impact resulting from the new standards?

As a result of the FASB's decision to continue with a dual lease classification, companies reporting under U.S. GAAP will have minimal, if any, impact to their P&L as a result of the new standard.

- Operating Leases afforded straight-line Rent Expense under prior lease accounting will likely be classified as Operating Leases under the new standard and will continue to be accounted for on a straight-line Rent Expense basis.
- Leases previously considered Capital Leases will likely be classified as Finance Leases under the new standard and will continue to result in both Interest Expense and Amortization Expense as they are considered a form of debt.

For companies reporting under IFRS, there will be a P&L impact for any companies who previously had Operating Leases as Operating Leases no longer exist. All leases are Finance Leases under the new standard. As a result, Operating Leases with straight-line Rent Expense will be converted to Finance Leases with the front-end-loaded expense pattern consisting of Interest Expense and Depreciation Expense.

- A shift to all Finance Leases will increase a company's EBITDA as Rent Expense is eliminated (which is considered in the determination of EBITDA) and replaced with Interest and Depreciation Expense (which are not included in the calculation of EBITDA).
- While this will increase a company's EBITDA, the front-end-loaded expense pattern of a Finance Lease will adversely impact the company's bottom line in the early years of a lease.

22. Could the new standards result in debt covenants being violated?

For companies following U.S. GAAP, this concern should be mitigated to a great extent as the FASB has specifically stated the liability associated with an Operating Lease under the new standard will be considered an "operating obligation" and **NOT DEBT**. The liability associated with a Finance Lease is considered debt, which is consistent with previous Capital Lease treatment.

For companies following IFRS, the new standard could cause some concerns over debt covenants as all leases will be Finance Leases and the lease liability will be considered debt.

The potential impact should be determined by the company and communicated to any of the company's lenders with existing debt covenants that could be impacted to ensure no surprises arise.

Whether a company reports under U.S. GAAP or IFRS, they are well advised to communicate the financial impact of the new standard to their lenders to ensure no concerns surface as a result of the changes. As all lenders are aware of the upcoming changes, these discussions should not be a surprise to them unless the order of magnitude of the changes is at an unexpected level.

23. Where do we go from here?

Because the new standards address ALL leases, it is impossible to address "all things" leases in the new standards. As a result, there are still many questions to be answered regarding how to account for certain items and transactions. It is anticipated that in 2019 and beyond, there will be many clarifications and issues addressed by the FASB and IASB and/or the large accounting firms. As a result, companies with effective dates subsequent to the clarifications will reap the greatest benefit.

The epic journey of the new lease accounting standards that formally started in 2010 with the issuance of the initial FASB and IASB Exposure Drafts is entering a new phase. We now find ourselves at "Day Two" of the new standard that will bring to light both the intended and unintended consequences of the new standards. Speculation of the impact of the new standards will begin to dissipate, while the actual impact to a company's financial statements and go-forward strategic considerations will begin to crystalize.

For further information on this topic visit the websites of the FASB, IASB and the CBRE Global Task Force on Lease Accounting.

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CBRE'S LEASE ACCOUNTING CALCULATOR

As an industry leader, CBRE is focused on assisting our clients in understanding the potential financial impact of entering into a lease based on the new lease accounting standards. To further this goal, CBRE has developed a web-based Lease Accounting Calculator to allow you to prepare a high-level lease analysis based on either the current or previous FASB or IASB standards. For an overview of the tool and to access the Calculator **please click on the calculator image below.**