

## VALUATION & ADVISORY

# REAL ESTATE PERSPECTIVE ON **NEW LEASE ACCOUNTING STANDARDS**

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## INTRODUCTION

The Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) 2016-02, Leases (Topic 842) on February 25, 2016, which replaces the U.S. generally accepted accounting principles (GAAP) detailed in Topic 840, Leases, of the FASB's Accounting Standards Codification (ASC), as the new lease guidance for lessors and lessees. The ASU, along with IFRS 16 Leases, is a joint effort at convergence by the FASB and the International Accounting Standards Board (IASB) to promote consistency and improve the transparency of financial reporting by requiring companies to recognize lease assets and liabilities on their balance sheets.

Many of the requirements in Topic 842 are the same as those of IFRS 16. The key differences between the two relate to certain aspects of the lessee accounting model. Whereas Topic 842 distinguishes between finance and operating leases in financial statements, IFRS 16 requires all leases to be accounted for in a manner consistent with the Topic 842 approach for finance leases. Consequently, operating leases will be accounted for differently under GAAP than under IFRS and will have a different effect on statements of comprehensive income and cash flows under IFRS 16.

## EFFECTIVE DATES

ASU 2016-02 becomes effective for public business entities, certain not-for-profits and certain employee benefit plans for annual periods (including interim periods) beginning after December 15, 2018. For all other entities, it is effective for annual periods beginning after December 15, 2019.

## DEFINITION OF A LEASE

Under the new guidance, a lease is "a contract, or part of a contract, that conveys the right to control the use of identified

property, plant, or equipment (an identified asset) for a period of time in exchange for consideration."

At the start of a contract, the parties to the contract should determine whether it is a lease by assessing (a) whether there is an identified asset and (b) whether the contract conveys substantially all of the economic benefits achievable from the asset in exchange for consideration over a period of time. The parties must also consider whether the supplier of the identified asset has a substantive substitution right. It should be noted that the new standard does not require lessees to apply the guidance to short-term leases. The short-term lease exception is applicable in those instances where the lease term is less than 12 months and does not include an option to purchase the underlying asset that the lessee is reasonably certain to exercise.

In determining the lease term, the following should be considered:

- the non-cancelable period of the lease,
- any renewal options that the lessee is reasonably certain of exercising,
- any periods covered by a termination option that the lessee is reasonably certain it will not exercise and
- any periods from an option to extend (or not terminate) the lease that are controlled by the lessor.

"Reasonably certain" is characterized by circumstances in which there is an economic incentive to continue. Such circumstances would include:

- the pricing of an option that is below market,
- lease termination cost avoidance,
- significant leasehold improvements that would be impaired and
- business interruption.

## LEASE V NONLEASE COMPONENTS

The new lease guidance requires that lessees apply criteria to

determine whether a contract that contains a lease includes one or more lease components that should be accounted for separately. In addition, in cases of contracts that include both lease and nonlease components (e.g., maintenance services), lessees may choose by class of underlying asset to either (a) not separate lease components from nonlease components, in which case each separate lease component and its related nonlease components are accounted for together as a lease component, or (b) separate lease components from nonlease components by allocating the contract consideration to the components based on their relative standalone prices.

Under the latter approach, the consideration allocated to the nonlease components is not considered when measuring the lease liability and right-of-use asset. A right-of-use asset represents a lessee's right to use an underlying asset for the lease term, and it can be a physically distinct portion of a single asset.

Lessors must also apply criteria to determine whether a contract that contains a lease includes one or more lease components that should be accounted for separately. As is the case for lessees, lessors must also separate the lease and nonlease components. The contract consideration is allocated to the lease and nonlease components using the new revenue recognition guidance.

ASC 842 also grants lessors the right, via the use of a practical expedient, to elect, by class of underlying asset, to not separate lease and non-lease components if the non-lease components are accounted for in accordance with the new revenue standard and the following criteria are met:

- the lease component and the associated non-lease components have the same timing and pattern of transfer; and
- the lease component, if accounted for separately, would be classified as an operating lease.

Under this option, if a lessor determines that the non-lease component or components are the predominant components in the contract, it is required to account for the combined component in accordance with ASC 606, Revenue from Contracts with Customers. Otherwise, the lessor is required to account for the combined component as an operating lease in accordance with ASC 842.

If a lessor elects to apply the practical expedient for an underlying asset class, it is required to apply the expedient to all qualifying leases in that class. Lessors are also required to apply the practical expedient consistently to all non-lease components that are eligible to be combined with lease components.

## LESSEE CLASSIFICATION

Subsequent to the initial recognition of leased assets and liabilities, certain leases may have different accounting treatment.

The primary distinction between each is in the resulting income statement recognition.

- Finance leases require a lessee to apply a financing model in which the expense resulting from the lease declines during the lease term.
- Operating leases result in lease expense being recognized on a straight-line basis.

The most significant change in the new lease guidance requires lessees to recognize right-of-use assets and lease liabilities for all leases other than those that meet the definition of short-term leases.

For short-term leases, lessees may elect an accounting policy by class of underlying asset (e.g., office space, equipment lease, etc.), under which these right-of-use assets and liabilities are not recognized on their balance sheets, and the lease payments are instead expensed on a straight-line basis over the lease term. This change will result in lessees recognizing right-of-use assets and lease liabilities for most leases currently accounted for as operating leases under legacy U.S. GAAP.

## LESSOR CLASSIFICATION

Lessors are also required to classify leases. Sales-type and direct financing leases are recognized by a lessor as lease receivables with interest income that is typically front-loaded (i.e., income per period declines during the lease term).

The distinction between a sales-type and direct financing lease is that in a sales-type lease, the lessee obtains control of the underlying asset and the lessor recognizes selling profit and sales revenue upon lease commencement.

The lease income of operating leases is recognized on a straight-line basis, and the underlying leased asset remains on the lessor's balance sheet and can continue to be depreciated.

## LEASE CLASSIFICATION

Entities will be required to classify each separate lease component at the commencement date of the contract and cannot modify the classification unless the contract is modified and not accounted for as a separate contract. In addition, lessees must reassess the lease classification if there is a change in the lease term, or there is an expectation that the lessee is reasonably certain to exercise a purchase option.

Although ASC 840 and ASC 842 include some of the same and similar terms for lease types for lessees and lessors, the lease testing process is not the same, which may result in different lease classifications under the two standards.

Lease classification is dictated by five criteria. In accordance

with ASC 842-10-25-2, a lessee shall classify a lease as a finance lease, and a lessor shall classify a lease as a sales-type lease, when the lease meets any of the following criteria:

- The lease transfers ownership of the underlying asset to the lessee by the end of the lease term.
- The lease grants the lessee an option to purchase the underlying asset that the lessee is reasonably certain to exercise.
- The lease term is for the major part of the remaining economic life of the underlying asset, except in cases where the commencement date falls at or near the end of the economic life of the underlying asset.
- The present value of the sum of the lease payments and any residual value guaranteed by the lessee that is not already reflected in the lease payments equals or exceeds substantially all of the fair value of the underlying asset.
- The underlying asset is of such a specialized nature that it is expected to have no alternative use to the lessor at the end of the lease term.

ASC 842 eliminates the “bright line” percentage tests for lease classification of ASC 840 (i.e., 75% of economic life and 90% of fair value) and further modifies the classification criteria to be used by lessors. Despite the elimination of ASC 840’s bright lines, companies will need to take a judicious and consistent approach to the lease classification process. It is likely that many lessees will continue to apply the 75% and 90% thresholds to facilitate the classification of leases as operating leases. The motivations of lessors may be different, which could lead to the adoption of the more principle-based approach to classifying leases, enabling them to continue classifying leases as sale-type leases. Lessors that take this approach, however, will be required to apply the same policy to any agreements in which it is the lessee, possibly resulting in the classification of its leases as finance leases.

Assuming none of the foregoing criteria are met, lessees must classify the lease as an operating lease, and lessors must classify the lease as a direct financing lease or an operating lease. A lessor shall classify the lease as an operating lease unless both of the following criteria are met, in which case the lessor shall classify the lease as a direct financing lease:

- The present value of the sum of the lease payments and any residual value guaranteed by the lessee that is not already reflected in the lease payments equals or exceeds substantially all of the fair value of the underlying asset.
- It is probable that the lessor will collect the lease payments plus any amount necessary to satisfy a residual value guarantee.

## FAIR VALUE OF THE LEASED ASSET

The lease payments criterion requires a lessee and lessor to compare the present value of lease payments and any residual

value guaranteed by the lessee to the fair value of the underlying asset, which is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. However, it will not always be realistic (i.e., fair value can be estimated without undue cost or effort) for an entity to determine the fair value of an underlying asset, specifically a real estate asset, as will be the case for most lessees. In such cases, the ASU indicates that the lease classification should be made without consideration of the lease payments criterion.

## DISCOUNT RATE FOR THE LEASE

Lease asset and liability valuations will be greatly impacted by the discount rate assumptions of companies (lessors and lessees), which will make it critical that careful judgment and a consistent process be applied in their development.

Lessees and lessors should discount lease payments at the lease commencement date using the interest rate implicit in the lease (“IRIIL”). Which can be expressed as the rate in which:

**AGGREGATE VALUE OF LEASE PAYMENTS**

**Aggregate Value of Lease Payments**

**+**

**PV of Residual Value**

**=**

**Current FV of Asset less any Investment Tax Credits**

**+**

**Lessor's Deferred Initial Direct Costs**

From the lessor’s position, the accessibility to these data points is relatively straightforward. From the lessee’s position, the necessary information to determine the IRIIL may be less readily available but may be ascertainable when leasing vehicles or equipment. Situations where the determination of the IRIIL may be impractical or impossible will be common for lessees of real property. This impracticality arises from the fact that lessees will rarely have the intel related to the asset’s residual value and the lessor’s deferred initial direct cost, which are both inputs in determining the IRIIL.

When the inputs are not readily available and the IRIIL is not determinable, the lessee must use its incremental borrowing rate (“IBR”) for the purposes of classifying the lease and measuring the right-of-use asset and lease liability. Under ASC 842, the IBR is 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, although it should be noted that the standard does not dictate the nature of the assets collateralizing the borrowing, only that it be fully collateralized.

The process of determining the IBR should be transparent and well documented, and companies need to be prepared to update their rates as warranted by changes to lease terms and in the economic environment. Although the process of determining the IBR will be similar for different leases, a one-size-fits-all approach will not be acceptable.

In its development of an IBR, the lessee will need to consider a reference rate, financing spread adjustments and lease specific adjustments, which are influenced by the key factors of lessee entity, currency, economic environment, term, asset type and level of indebtedness.

- The reference rate, which will be influenced by the currency type, economic environment and term, may be government bonds or LIBOR rates reflecting a risk-free rate and should be aligned with the term of the lease.
- Financing spread adjustments, which are affected by term, level of indebtedness, lessee entity and economic environment, should be relevant as of the lease commencement date or date of application and reflect spreads for debt with a term consistent with the lease term.
- Lease-specific adjustments, which are affected by asset type, should consider the nature of the collateral (i.e., location, quality, income growth potential, desirability, etc.), input from banks/lenders, available market data and property yields as a check of the reasonableness of the calculated IBR.

Public data should be considered when available. Absent specific reference data, a degree of judgment or estimation may be required to estimate the various components of the IBR.

As an alternative to determining the IBR, ASC 842 does provide a practical expedient to private companies by allowing them to use a risk-free rate to determine lease classification. This process is easier, but more of the company's leases may be classified as finance leases because the risk-free rate will be lower than the IBR, making the present value of the lease payments used in the classification process greater.

The difference between the rates used by lessors and lessees (IRIIL v. IBR) to classify a lease will result in situations where a lessor may classify a lease as a sales-type lease and a lessee may classify it as an operating lease. Such distinctions would be a direct result of the IRIIL usually being lower than a lessee's IBR.

It should also be noted that one of the key differences between the practical expedients offered by ASC 842 and IFRS 16 is that companies are allowed under IFRS 16 to apply a single discount rate to a portfolio of leases with reasonably similar characteristics; thus, leases with similar security, terms and economic environments may be judged reasonably similar.

ASC 842 and IFRS 16 also reflect different definitions for the IBR. Under IFRS 16, it is the rate of interest that a lessee would have to pay to borrow over a similar term, and with a similar security, the funds necessary to obtain an asset of a similar value to the right-of-use asset in a similar economic environment. The distinction is that ASC 842, which references borrowing on a collateralized basis, is not specific to the collateral affecting the IBR.

## CONCLUSION

ASC 842 satisfies the original objective of the project, which was to replace ASC 840. Lessees will be now required to recognize an asset and liability for substantially all leases. Under the new guidance, the user community and regulators will have access to the information necessary to understand a reporting entity's leasing activities.

Although there are some changes to the lease classification criteria, ASC 842 retains the majority of the criteria from ASC 840. As a result, the number of leases classified as finance leases by lessees may not increase under ASC 842, but more consideration will need to be given to the classification and treatment of leases.

Newmark Knight Frank Valuation & Advisory's Financial Reporting group, a premier provider of financial reporting services, is well positioned to help companies make the transition under ASC 842. Our professionals bring a comprehensive awareness of financial reporting standards coupled with property-specific insights to deliver strategic guidance to multi-national corporations, public and private REITs, private equity groups and funds.

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