Separation Anxiety:

Lease and Non-Lease Components

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Pros and Cons of the Lease and Non-Lease Component Practical Expedient

Under the new standards, when reporting a lease, companies have the option of choosing whether or not to separate out lease and non-lease components by asset class. There are pros and cons associated with each option.

The main benefit of electing the expedient to not separate the components is that it will greatly reduce the burden of maintaining compliance. While at first glance it may seem simple to allocate the costs listed in the contract to the separate components, in actuality it's more complex. Under the new standard, allocation is not based on the cash paid for a component, but rather on the standalone observable price. Tracking down the standalone observable price is challenging, and for some asset classes, it may not be worth the effort. In those cases, there's a strong argument for electing the expedient. However, there are also some drawbacks, including:

Capitalizing More on the Balance Sheet

The value of both the lease components and the non-lease components will need to be reported on-balance sheet, so companies will see their assets and liabilities increase more than they already would have under the new standard.

Potentially Triggering a Finance Lease

One of the criteria for a finance lease is that the present value of the lease (plus guaranteed residual value) is greater than "substantially all of the fair market value" of the asset on lease. Including non-lease components in the calculation of present value could push the lease over the threshold. If the classification changes from operating to finance, the income statement may also be impacted.

Potentially Triggering an Impairment

If the value of the right-of-use asset recorded on the balance sheet is greater than the market value of the right-of-use asset, it could trigger an impairment. Including non-lease components on the balance sheet may be enough to push the recorded value of the asset over its market value.

Many companies will likely choose to take the expedient for some of their asset classes, but not all. For those that will be separating their components for at least some of their asset classes, there are a few key things to understand about allocating to lease and non-lease components under the new standards, including how to define the components, how allocation changes for different lease types, and how to value the components.

Three Components to a Real Estate Lease

The costs that may be included in a lease tend to fall into three different categories, a lease component, which transfers the right to use the underlying asset, a non-lease component, which transfers a good or service that is not required for use of the underlying asset, and costs that are not considered components because they do not transfer a good or service. Some common costs you may see on a real estate lease are:

THE COMPONENT	WHAT IT IS	EXAMPLES	COMPONENT TYPE	WHY
PAYMENT FOR USE OF THE ASSET	This is any payment for the right to use the asset on lease.	Base/variable rent for usable space of the building Base/variable rent for use of parking spaces	Lease Component	Transfers right to use the underlying asset, a good or service, to the lessee.
COMMON AREA MAINTENANCE (CAM) CHARGES	These cover the lessee's share of maintaining shared space and utilities.	HVAC Lobby space Landscaping Utilities	Non-Lease Component	Transfers a good or service that is not related to the underlying asset to the lessee.
OTHER SERVICES CHARGES	These cover any services the landlord provides to the lessee.	Janitorial for tenant's space Security for tenant	Non-Lease Component	Transfers a service that is not related to the right to use the underlying asset to the lessee.
TAXES	Landlords are required to pay taxes on real estate properties.	Property taxes	Not a Component	The landlord is required to pay taxes, so the payment from the tenant is a reimbursement, not a transfer of good or service.
INSURANCE	Landlords are required to have insurance to cover their properties.	Property damage insurance	Not a Component	The landlord is required to pay for insurance, so the payment from the tenant is a reimbursement, not a transfer of good or service.

The Deal Structure

There are many ways real estate leases can be structured. On one extreme, the contract may be a gross lease where all costs are bundled into a single, fixed, monthly rent payment. On the other extreme are triple net leases, which split off the components into separate line items that can vary month-to-month. There are many other permutations of real estate leases in between these two extremes, each of which offer different combinations of the five costs with different types of fixed and variable pricing. Under the two extremes, lease and non-lease components, as well as the costs that do not qualify as components, are generally broken out in the follow way:

LEASE TYPE	STRUCTURE	INCLUDED IN LEASE COMPONENT	INCLUDED IN NON-LEASE COMPONENT
GROSS LEASE	Bundled Charges	Payment for right-of-use asset	CAM
			Other Services
		Taxes	
		Insurance	
NET LEASE	Separate Charges	Payment for right-of-use asset	CAM
			Other Services

The key to knowing where taxes and insurance will fall is understanding that they are not really goods or services and therefore not a component of the lease. In general, these costs are then not allocated to the lease or non-lease components. When those costs are presented separately, as in a net lease, they should not be allocated to either the lease or non-lease component, and so will be accounted for separately. However, if these costs are already bundled into the fixed monthly payment, as in a gross lease, they need not be separated.

The Valuation

The biggest challenge for accountants will be determining the consideration for the lease and non-lease components. Under ASC 842 and IFRS 16, the costs outlined in the leasing contract and monthly invoices are not necessarily the values that need to be recorded in journal entries. Instead, companies will have to determine what is called the "standalone observable price," also known as the fair market value (FMV), for each lease and non-lease component. An example gross lease scenario is depicted below:

	CONTRACTUAL OBLIGATIONS	STANDALONE OBSERVABLE PRICES
PAYMENT FOR ASSET	$2000	$2300
CAMS	$200	$225
OTHER SERVICES	$100	$100
TAXES & INSURANCE	$300	$275
TOTAL	**$2600**	**$2900**

Sample Calculation

In the above example, the tenant would need to use the column on the right to weight the components in the middle column accurately. Simply cross multiply and divide.

The total of the actual value of the components is still $2600, but the weight given to the each component now reflects the weight of the standalone observable price for that component.

LEASE COMPONENT

$$\frac{(\$2300 + \$275)}{\$2900} * \$2600 = \mathbf{\$2309}$$

NON-LEASE COMPONENT

$$\frac{(\$225 + \$100)}{\$2900} * \$2600 = \mathbf{\$291}$$

Considerations

To prepare for the new lease accounting standards, companies will need consider the following questions:

1 What types of real estate lease structures does your company have? Are costs bundled together into one fixed payment or separated out? Are there variable or unknown costs? Are costs for utilities and services paid through the landlord or directly to the utilities and service companies?

2 Will you separate lease and non-lease components for some or all asset classes?

3 How will you determine the standalone observable price for each component?

4 What documentation will be required for audit purposes to demonstrate that the standalone observable price was used rather than the contract value?

5 Does your real estate administration software store both the contract value and standalone observable price for each component?

6 Can your lease accounting software calculate the consideration for lease and non-lease components or will you need a manual workaround in a spreadsheet?

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