



Upcoming FASB/IASB Changes to Lease Accounting Standards

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Leasing is a source of finance. Based on this statement, it can be argued that reporting a lease on the income statement is problematic and that this is a form of “off balance sheet” reporting made famous by ENRON and other firms. Regardless of opinion, The United States Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) initiated a joint project to develop a new approach to lease accounting to ensure that assets and liabilities arising under leases are recognized in the statement of financial position as stated in the FASB Proposed Accounting Standards Update of Topic 840 dated August 17, 2010. The question is not if the changes will be approved (they will) but what changes the final version will include.

The purpose of this document is to summarize the current proposed changes, identify the possible impacts, and provide commercial real estate managers an action plan for going forward.

WHAT CHANGES ARE BEING PROPOSED?

In short, the proposed changes eliminate rent from the income statement and replace it as a balance sheet item. For the lessee, the asset is a “right of use” and the liability is the lease payment. For a lessor, the asset is the right to receive lease payments and the liability is either a performance obligation (performance obligation approach) or a reduction in the rights that are being provided to the lessee (derecognition approach).

FOR THE LESSEE:

A lessee would recognize an asset representing its right to use the leased asset for the term and a liability to make the lease payments. As an asset, the net present value (excluding operating expenses) is amortized on a straight line basis. As a liability, the net present value is amortized like a loan for the term of the lease using the cost of capital that a lessee would pay to borrow funds for a similar asset and term. This is known as the incremental borrowing rate.

FOR THE LESSOR:

A lessor would recognize an asset representing its right to receive lease payments and, depending on its exposure to risks or benefits associated with the underlying asset, would either

- Recognize a lease liability while continuing to recognize the underlying asset (a performance obligation approach) or;
- Derecognize the rights in the underlying asset that it transfers to the lessee and continue to recognize a residual asset representing its right to the underlying asset at the end of the lease term (a derecognition approach).

Attached is an example of a five year lease with annual payments to illustrate how the changes effect lease commitment over the term (See Exhibit A).

ASSETS AND LIABILITIES RECOGNIZED BY LESSEES AND LESSORS WOULD BE MEASURED ON A BASIS THAT:

- Assumes the longest possible lease term that is more likely than not to occur, taking into account the effect of any options to extend or terminate the lease.
- Uses an expected outcome technique to reflect the lease payments, including contingent rentals and expected payments under term option penalties and residual value guarantees, specified by the lease.
- Is updated when changes in facts or circumstances indicate that there would be a significant change in those assets or liabilities since the previous reporting period.

The changes will affect public companies and private companies that issue audited financial statements, have public debt, or are contemplating an IPO. Companies expected to be effected the most include retailers, financial services firms, airlines, and commercial banks. These industries will need to change their policies to capitalize billions on corporate balance sheets resulting in a substantial increase in assets & liabilities plus an increase in EBITDA.

OTHER HIGHLIGHTS

- The net charges (taxes, insurance, common area maintenance, utilities, janitorial, etc.) are treated as expenses as before so the base rent needs to exclude these charges. However, some are currently questioning whether or not taxes should be included in the base rent and brought over to the balance sheet. Many believe that this rule will encourage more triple net leases in the future.
- Tenant improvements-If there is a landlord allowance, the tenant will own them and depreciate tenant improvement charges in a straight-line fashion against rent over the term.
- Subleases fall under lessor accounting. Lease “right of use” assets are not taken as a deduction. Instead the lease and sublease are both capitalized similar to a normal lease.
- Footnotes related to leases will still be necessary.
- All leases will be impacted. Greater than one year will be capitalized. Less than one year MAY be capitalized.
- No Grandfathering; as soon as the amendment goes into effect, ALL leases will need to be converted on the financial statements. This means that most companies will need to go back and research all existing commitments.
- The lease shall include term through all renewal or termination options if exercising the options are “more likely than not” to occur.
- Guarantees must be capitalized.
- Percentage rents must be estimated and capitalized.

COSTS AND BENEFITS

Benefits

1. Create Greater Financial Transparency.
2. Complete and Comparable Financial Ratios.
3. Simpler method of accounting for leases.
4. Reduce ability to “engineer” results.
5. Financial statements more accurately reflect obligations.
6. Business units have more incentive to collaborate relating to how lease exposure impacts financials.

Costs

1. Straight-lining with interest expense creates front-ending of lease costs and a declining rent curve (see chart in Exhibit A).
2. FASB calls to revisit the assumptions “whenever it’s appropriate” at the same time that SOX says “execs are legally liable” to disclose the correct answer.
3. Too much effort to document –For every lease the discount rate must be adjusted; options and guarantees must be reviewed constantly. The estimates of lease term and lease payments have to be reviewed every time the lessee reports financial results-normally this is a monthly event.
4. Tenant has to disclose whether or not a renewal option will be “more likely than not to occur” which hurts negotiating leverage and allows “estimates”. In the future, many tenants will probably eliminate having a renewal option altogether.
5. The effort to segregate the costs of servicing the space (operating costs) and using the space (lease costs) is time consuming and ambiguous in some gross and modified gross leases.
6. The incremental borrowing rate may be difficult to determine as most banks do not provide 100% financing or offer fixed interest rates and level payments.

FINANCIAL RATIOS ARE IMPACTED DISPROPORTIONATELY

Subject to specific guidance from the Boards regarding the classification of an ‘interest bearing’ liability that is created by a lease contract, several leverage ratios can be negatively impacted. For example, if a lease contract gives rise to an identical amount of asset and liability, then the company’s equity position remains unchanged. However, if the liability were to be classified as debt under the proposed new standards, then the debt-to-equity ratio would artificially increase.

ENHANCED EBITDA (EARNINGS BEFORE INTEREST, TAXES, DEPRECIATION & AMORTIZATION)

EBITDA is a key financial benchmark that is significantly impacted by the proposed new standard. Creditors may use EBITDA as a metric to determine a company’s ability to service debt; employers may use it as an employment compensation benchmark; and investors may use it as a basis for company valuation. Since rent expense under current standards is included in EBITDA, its

reclassification into depreciation/amortization and interest expense would eliminate such rent expense from the EBITDA calculation.

THE AMENDMENT PROCESS

The amendment is being proposed jointly by FASB and IASB:

FASB- Since 1973, the Financial Accounting Standards Board (FASB) has been the designated organization in the private sector for establishing standards of financial accounting that govern the preparation of financial reports by nongovernmental entities. More information can be found at www.fasb.org.

IASB- The IASB is the independent standard-setting body of the IFRS Foundation, a not-for-profit private sector organization working in the public interest to, among other things, develop a single set of high quality, understandable, enforceable and globally accepted international financial reporting standards (IFRSs). More information can be found at www.ifrs.org.

The proposed changes have been discussed by both Boards for over a decade including a discussion paper that was completed by FASB on March 19, 2009. Many have thought that FASB would continue to adopt IASB standards. This may be the beginning of more standards where FASB and IASB align efforts.

ACTION	COMPLETION DATE
Statement of Financial Accounting Standards No. 13	November 1976
Discussion Paper	March 19, 2009
Exposure Draft	August 17, 2010
Exposure Draft Comments	December 15, 2010
Full new Standard Publication	Expected 2011
Effective Date of new Standard	FYE 2012/2013

The estimated date that the proposed changes go into effect is as early as January 2012 or as late as January 2013.

ACTION PLAN

Since the overwhelming opinion is that the amendments will be approved, commercial real estate managers, accountants, and CFOs need to begin leading a response to this change.

Two major steps are critical:

1. RESPOND WITH COMMENTS TO FASB 13 BY NO LATER THAN DECEMBER 15, 2010.

FASB is welcoming comments regarding the exposure draft until December 15, 2010. Comments will be seriously considered, especially from end-users. Comments directly from industry groups (Corenet Global, IAMC, IFMA, etc.) or form letters will carry less validity so it is important for each company to respond with their own statement prior to December 15, 2010. Attached please find a list of responses that were suggested at the September Corenet Global Summit in Phoenix, Arizona by Corenet Global's Capital Optimization Workforce that can easily be adapted into a letter response and/or inserted into the questionnaire that IASB has created on their web site at www.fasb.org in the lower right hand corner by selecting Leases-Questionnaire (See Exhibit B).

2. IMPLEMENT A TASK LIST FOR YOUR ORGANIZATION.

It is critical to collaborate with all aspects of the firm make sure all aspects of the company including finance/accounting, business unit management, tax, and lease administration. Copaken Brooks has a seasoned team of experts to help coordinate this list and provide support. **COPAKEN BROOKS HAS ALREADY PREPARED A DETAILED TASK LIST BUILT TO HELP COMMERCIAL REAL ESTATE MANAGERS LEAD EFFORTS TO BE PREPARED FOR THE CHANGES. CALL OR E-MAIL BILL EARLY FOR A COPY AT NO CHARGE.**

The FASB/IASB changes related to leasing will result in new operational challenges and a myriad of decisions related to increased leverage and profitability ratios in both a leased or owned real estate portfolio. CFOs will need to take a closer look at real estate. Instead of cost per square foot, CFOs will begin to apply ratios related to utilization and return on assets. The impact of these changes is less overwhelming than at first glance for three reasons. First, the changes are global. An increase in leverage due to FASB/IASB changes is less important to analysts when this increase is happening across the board in an industry. Second, the value of the underlying asset is not changing, but merely the way it is being measured is changing. Third, the business plan still drives the overall decision process. The idea that all leases will go away is absurd because leases can still provide a strong financing alternative and give business units flexibility. Although shorter lease terms may be more desired, leases will still need at least enough term to amortize tenant improvements.

The FASB/IASB changes are another opportunity for collaborative, dynamic commercial real estate managers to make a strategic impact. Copaken Brooks has a platform that is “built” specifically to help commercial real estate managers with multiple facilities. Whether the challenge is managing FASB/IASB changes, workplace strategy, mergers/acquisitions, or reduced occupancy costs, Copaken Brooks can provide the support commercial real estate managers need to meet these challenges and make an impact on the bottom line.

For more information, please contact:



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UPCOMING FASB/IASB CHANGES TO LEASE ACCOUNTING STANDARDS

**EXHIBIT A
LEASE EXAMPLE**

Assumptions:

Size:	10,000 SF
Rate:	\$10.00/SF
Escalations:	3.0%
Term:	Five (5) years
Cost of Capital:	Eight percent (8%)

Year	Annual Base Rent
1	\$100,000
2	\$103,000
3	\$106,090
4	\$109,273
5	\$112,551
TOTAL	\$530,914
NPV	\$418,150

Because the net present value in the table above is \$418,150, the asset and liability will reflect this amount. The asset will be amortized on a straight-line basis over the life of the lease. The liability will be treated like a loan with principal and interest components.

ASSETS	Current	Proposed
Current Assets	\$200,000	\$200,000
Total Net Property and Equipment	\$500,000	\$918,150*
Other Assets	1,000	1,000
Total Assets	\$701,000	\$1,119,150

*Net Property and Equipment (\$500,000) plus NPV of rent payments (\$418,150).

LIABILITIES	Current	Proposed
Current Liabilities	\$50,000	\$116,548
Long –Term Debt	\$600,000	\$600,000
Net Liability Under Lease	\$0	\$351,602
Total Liabilities	\$650,000	\$1,068,150
Stockholder’s Equity	\$51,000	\$51,000
Total Liabilities and Equity	\$701,000	\$1,119,150

Please note that the current liabilities increase by \$66,548 because the principal is paid down by this amount in the first year as shown below:

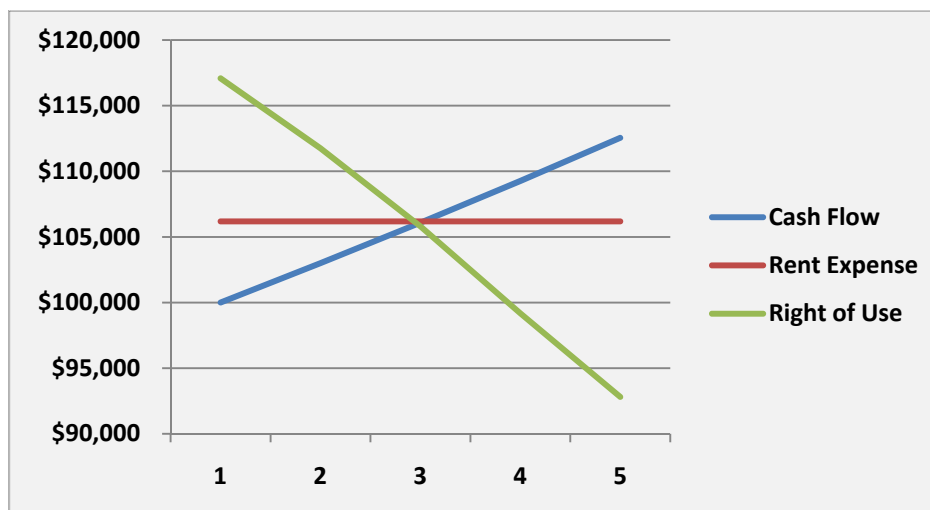
Lease Year	Annual Rent	Asset	Liability		Remaining Liability	Interest for Next Period
		Amortization NPV/# of Periods	Interest	Principal Annual Rent-Interest Expense	NPV (\$418,150) – Sum of Principal	Cost of Capital X Remaining Liability
1	\$100,000	\$83,630	\$33,452*	\$66,548	\$351,602	\$28,128
2	\$102,500	\$83,630	\$28,128	\$74,372	\$277,230	\$22,178
3	\$105,063	\$83,630	\$22,178	\$82,885	\$194,346	\$15,548
4	\$107,689	\$83,630	\$15,548	\$91,141	\$102,205	\$8,176
5	\$110,381	\$83,630	\$8,176	\$102,205	\$0	

*Net present value of the asset (\$418,150) multiplied by the cost of capital (.08)

The Net Liability Under Lease decreases the remaining liability after the first period's principal is paid down. Just like a loan, the interest burden is greater at the beginning of the term. This causes the lease commitment to be front-loaded as shown in the table and chart below:

Lease Year	Prior to Amendment		Post Amendment		
	Cash Flow	Rent Expense	Amortization	Interest Expense	Total
1	\$100,000	\$106,183	\$83,630	\$33,452	\$117,082
2	\$103,000	\$106,183	\$83,630	\$28,128	\$111,758
3	\$106,090	\$106,183	\$83,630	\$22,178	\$105,808
4	\$109,274	\$106,183	\$83,630	\$15,548	\$99,178
5	\$112,551	\$106,183	\$83,630	\$8,176	\$91,806
TOTAL	\$530,915	\$530,915	\$418,150	\$107,482	\$525,632*

*This number does not equal \$530,915 because amortization calculations were made using payment at the beginning of the month since rent is paid at the beginning of the month.



UPCOMING FASB/IASB CHANGES TO LEASE ACCOUNTING STANDARDS

EXHIBIT B

Suggested Comments to Proposed Lease Accounting Changes

Corenet Global Summit

September, 2010

The information below provides a suggested response to the Questions for Respondents that starts on Page 4 of FASB's Exposure Draft of Proposed Accounting Standards Update of Topic 840 dated August 17, 2010. This information can be used to answer IFSB's questionnaire on leases that can be accessed in the bottom right corner of the landing page to FASB's web site, www.fasb.org. The information can also be used to draft a letter with comments directly to FASB at the following address (preferably via e-mail in pdf format):

Technical Director

Financial Accounting Standards Board

401 Merritt 7

P.O. Box 5116

Norwalk, Connecticut 06856-5116

Telephone: (203) 847-0700

E-mail: director@fasb.org

It is important to include a subject line that refers to "Topic 840".

Questionnaire Question 1-Concerning the best way to recognize the right-of-use asset and interest on the liability to make lease payments:

Although our firm agrees that lessees should recognize lease liabilities and assets on the balance sheet, the proposed methodology of calculating lease payments creates "front-ending", exacerbated in longer leases (including option terms). This is distorting, and does not reflect actual financial performance.

A better approach would be to calculate lease payments using an "interest-adjusted" approach similar to straight-line "loan amortization", whereby the total lease payments in principal (in this case depreciation) and interest are flat over the term. At the beginning of term, interest is proportionately high and depreciation is low, which then reverses over the term, resulting in a zero balance.

Questionnaire Question 6-Concerning contracts that contain service components and lease components:

It should be made clear that operating expenses in real estate leasing are NOT a service Component.

Questionnaire Question 8-Concerning whether or not the longest possible term is more likely than not to occur and whether or not to include options :

Renewal or extension options in real estate leasing are typically used as a protection from landlord abuses. They are typically not in fact exercised, but serve as a basis for negotiation.

Accordingly, renewal or extension options in real estate leases should not be included in term, unless bargain in nature.

Alternatively, the marketplace activity of securing multiple renewal options in real estate leasing would create the greatest distortion under the proposed accounting changes; simply limiting the inclusion of renewal options to a maximum of five (5) years would mitigate the distortion.

Questionnaire Question 9-Concerning lease payments:

None of contingent rentals, term option penalties, or residual value guarantees should be included. None are a part of the intended lease obligation or asset at inception, but arise over time as a consequence of operating decisions.

To the extent the Boards are concerned about abuses, (i) these elements should be identified and addressed in disclosure footnotes, and (ii) a reporting company's auditor should be responsible for identifying "out of balance" lease agreements.

Questionnaire Question 10-Concerning Reassessment:

There should be no re-measurement unless there is a contractual change. There should be no impairment of the right-of-use asset.

Questionnaire Question 15-Concerning Disclosure:

Although, there should be greater disclosure than under current standards, the desired benefits of transparency and comparability can be better achieved, at a lower cost with less complexity, and less subjectivity, by adopting the methodologies of the major credit rating agencies, i.e., establishing the likely liabilities and assets and multiplying by a standard factor(s), to be determined by the auditor.

Questionnaire Question 17-Concerning the Benefits related to the Costs:

The proposed changes would result in a tremendous administrative burden and cost for lessees; the desired benefits of transparency and comparability can be achieved with much less effort and costs, as reflected in the comments herein.

Questionnaire Question 18-Concerning any other comments (the Incremental Borrowing Rate):

Lessee's incremental borrowing rate is not the best choice for consistently measuring leases, as differences in credit quality create significantly different results for the same activity, directly counter to the desire for comparability. Better to use an independent index, such as "200% of the 10-year Treasury rate", or a rate published by FASB/IASB. Additionally, whatever rate is used should not be reassessed during the term of a given lease.

Sources:

1. "Financial Accounting Series Exposure Draft, Proposed Accounting Standards Update", Financial Accounting Standards Board of the Financial Accounting Foundation, August 17, 2010.
2. "Statement of Financial Accounting Standards Number 13, Accounting for Leases", Financial Accounting Standards Board of the Financial Accounting Foundation, November 1976.
3. Conversation with Margaret Acker, Copaken Brooks, October 18, 2010.
4. Conversation with Troy Marquis, Copaken Brooks, November 2, 2010.
5. Conversation with Marce E. Betesh and with Louis J. Ferro, CPA, KBA Lease Services, on October 18, 2010.
6. "The Impact on Corporate Real Estate of Lease Accounting Changes under GAAP", Marc E. Betesh, Esq., MCR.h, KBA Lease Services, September 15, 2010 and
7. Corenet Global Summit Breakout Session, Phoenix Arizona, September 21, 2010; "The Future of FAS 13-How the Proposed Changes will Affect Your Leased Portfolio Strategy", Richard Podos, Lance, LLC, and Russell Howell, Johnson Controls.
8. "Major Changes Proposed to Lease Accounting Rules", Professional Standards Group, Mayer Hoffman, McCann, PC, MHM Messenger, September, 2010.
7. IAMC Forum Session, Hot Springs, Virginia, October 2010; "Corporate Lease Accounting, A looking into Pending Changes", Karen DeMarinis as Moderator and Bret Hardy, Colliers International, as Panelist.
8. Conversation with Amie Sweeney, CPA, Grubb & Ellis, on October 15, 2010.
9. "The Mechanics of the Changes", Amie D. Sweeney, CPA, Grubb & Ellis.
10. "Action Plan to Prepare for the New Lease Accounting Standard", William Bosco, Tririga, August 2010.
11. "Proposed Changes to Current Lease Accounting Standards: FASB and IASB", Newmark Knight Frank Financial Services, June, 2010.