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New lease accounting standards are evolving: Is there a scary monster under the bed and will it really affect lease versus buy or other CRE decisions?

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ABSTRACT

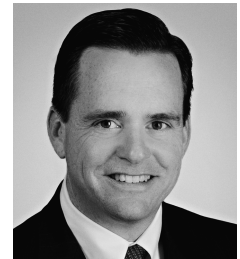
The new lease accounting standards will change some business practices, but not the ones most have previously imagined. Why? What has changed? Very recently, the accounting boards (FASB and IASB) made significant changes to the proposals they originally released in August 2010. These changes served to alter the impact the original

proposals were expected to have on CRE business practices and strategy. Thankfully, both for CRE and its counterparts in corporate finance, the changes adopted over just the past few months mean some of the most controversial aspects of the new lease accounting standards have been moderated so that they will not have as material an impact as originally envisioned. While all leases will still be capitalised with a front-loaded impact on the tenant's profit and loss, the revisions to how renewal options and contingent rents are to be accounted for, among other important changes, result in a smaller impact on the corporate balance sheet and income statement — provided CRE professionals understand the newly revised proposals. Importantly, the revised proposals mean CRE's lease versus buy decisions should not be impacted, but other business practices will be affected. So while the new lease accounting standards represent a monster hiding under CRE's bed, this paper explains why the monster is not as scary as most originally envisioned.

Keywords: *lease accounting, lease versus buy, renewal options, contingent rents, significant economic incentive, disguised minimum rent*

THE MONSTER UNDER THE BED

For nearly a year the corporate real estate (CRE) industry has been afraid to turn off



the lights and go to bed because of the new lease accounting monster. But like so many things people imagine to be so scary and foreboding, shining a little light on the matter and understanding it better leads to the revelation that it is not what it was perceived to be originally. Are the new accounting rules really a monster that threatens to change CRE strategy and practices? To answer this question one first has to understand the impact of the Financial Accounting Standards Board's and the International Accounting Standards Board's (FASB and IASB, collectively 'the Boards') proposed lease accounting standards, as set forth in their respective Exposure Draft documents issued in August 2010. It was these proposals that caused so many to believe that the Boards had put a monster under the bed. The scariest elements of the original proposals have thankfully proved much tamer thanks to some important revisions the Boards have recently made to their proposals. This paper reflects revisions to the Boards' original proposals through to 19th May, 2011.

Nonetheless, the CRE industry will find there is still *something* unpleasant under the bed when the new lease accounting standards are finalised later in 2011, and it unquestionably will affect existing business practices. However, these new, tamer proposals ultimately should not affect strategic decisions surrounding the question of whether to lease or own real estate, although undoubtedly they will affect other business processes. In order to appreciate why CRE can now be more optimistic it is important to understand both the original proposals and the changes to those proposals recently adopted by the Boards.

DESCRIBING THE MONSTER –THE BOARDS' EXPOSURE DRAFTS

Upon issuing their respective Exposure Drafts in August 2010, the Boards asked for interested parties to submit comment letters identifying the perceived pros and cons

of the newly proposed standards. The Boards received nearly 800 letters, virtually all of which took strong exception to at least one component of the proposals, and most took strong exception to multiple components. The aspects of the Boards' proposals which, from the perspective of the CRE industry, generated the most, and most vociferous, comments included the following, and in most cases those comments caused the Boards to re-evaluate their original positions.

Front-loaded impact on profit and loss –It is big!

The Boards' proposals sounded the death knell of the operating lease as it exists under existing accounting standards, which was of great significance to the CRE world as the overwhelming majority of all real estate leases are currently classified as operating leases under the existing standards. The newly proposed standards effectively stipulated *all* real estate leases would be capitalised and appear on the entity's balance sheet. (Leases having a maximum possible term, including renewal options, of less than 12 months would be capitalised under the original proposals, but receive simplified treatment on the profit and loss account. In the Boards' joint meetings during May 2011 this topic was discussed with suggestions that it be altered in some manner, although no decisions on the issue were reached during those meetings.) Furthermore, the rent expense payable under each lease would no longer be straight-lined as it is today for operating leases, but rather would be recorded as a front-loaded combination of amortisation and interest expense on the tenant's income statement. Additionally, this amortisation and interest expense would replace 'rent' expense for operating leases, thereby affecting earnings before interest, tax, depreciation and amortisation (EBITDA) calculations and also having an effect on the ability of US government contractors to be

reimbursed for 'rent' expense under some of their contractual arrangements with the government.

This 'capitalise all leases' concept represented a radical departure from the existing standards. Aside from having every lease appear on a tenant's balance sheet, the elimination of straight-lined rent under the FASB's Statement of Financial Accounting Standards No. 13, Accounting for Leases (FAS 13), Accounting Standards Codification 840 (ASC 840) and the IASB's International Accounting Standard No. 17 (IAS 17) (hereinafter 'existing standards') meant transitioning to the new standards would have an immediately negative effect on tenants' GAAP or IFRS-based profitability. As compared with existing accounting standards for operating leases, once the lease term was essentially half over this initially detrimental effect on the profit and loss account (P&L), it would ultimately become accretive to GAAP/IFRS-based earnings as compared with the straight-lined treatment under existing operating lease accounting. Although the reduction in near-term profitability triggered a deluge of comment letters, the increase in profitability in later years as compared with existing operating lease treatment was surprisingly lost on most commentators. Figure 1 illustrates the contrast between existing operating lease accounting and the proposed standards. Figures 1-8 utilise the following hypothetical lease terms: (a) 100,000 rentable square feet (RSF); (b) triple-net

(NNN) lease structure; (c) ten-year non-cancellable lease term; (d) one five-year fair market value renewal option, which is assumed for calculations to equate to US\$55/RSF/year; (e) base rent schedule for initial term: years 1-3, US\$40/RSF/year, years 4-6, US\$45/RSF/year, years 7-10, US\$50/RSF/year; (f) no tenant improvement allowance or incentives; (g) no 'initial direct costs' and (h) an incremental borrowing rate of 7.0 per cent. For Figures 3-8, monthly percentage rent payments have been utilised equal to 4.0 per cent of annual sales above a break point of the base rent, assuming probability weighted annual sales at lease commencement of US\$10 million with assumed annual increases in sales of 4.5 per cent at each anniversary of the lease commencement date. For Figures 5-8, property tax, insurance & operating expense/RSF at lease commencement have been utilised equal to US\$3.00, US\$2.00 and US\$10.00, respectively, with assumed annual inflationary increases of 3.0 per cent for each.

Term –It has big, sharp teeth!

Based on the existing standards, term-related options are included in the accounting calculations only if it is 'reasonably assured' (*at the inception of the lease*) that the options would be exercised.¹ The Exposure Drafts, however, proposed that leases containing renewal and/or termination options would see those options included in the determination of the 'term' of the lease, and have their associated

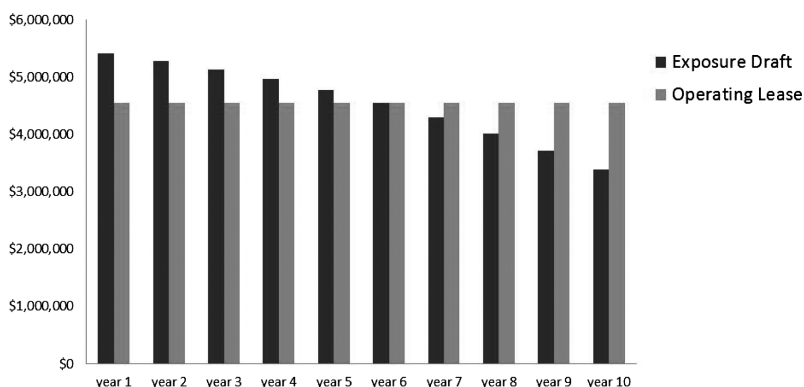


Figure 1 Impact on P&L for existing operating lease versus exposure draft treatment (no renewal) illustrating P&L impact for the hypothetical tenant's NNN base rent only

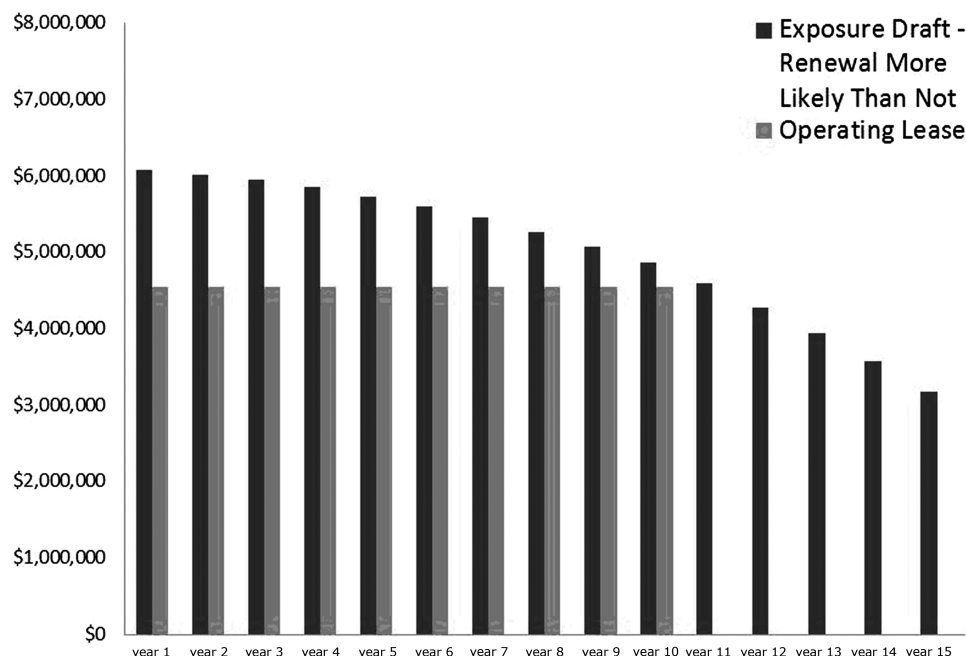
rental streams capitalised and reported in the lessee's financial statements if the options were 'more likely than not' to be exercised, with that determination (and the corresponding accounting) subject to continual re-evaluation throughout the term of the lease. This 'more likely than not' concept was a significant departure from existing standards. Hence, the Exposure Drafts proposed changing what most people historically have viewed as at least a 90 per cent threshold for having to include renewal or termination options — meaning very few options are currently included in the calculus — to a much lower threshold of 50 per cent, where the options would be considered exercised for the purposes of the accounting.

Ignoring even the highly subjective nature of establishing whether a tenant would be 'more likely than not' to exercise its renewal or termination options, this one aspect of the Boards' proposals drove many to speculate that more tenants would end up buying instead of leasing real estate as a

ten-year lease with two ten-year renewal options that were 'more likely than not' to be exercised would be treated as a 30-year lease for the purposes of the lessee's accounting. The added fact that the Boards' proposals would also have required tenants to continually re-evaluate prior conclusions as to whether or not they were likely to exercise those options, and to revise their accounting accordingly — despite the fact that there had not been any actual change to the underlying contract — helped to make the monster under the bed even scarier.

In contrast to Figure 1, which shows the net base rent P&L impact for a tenant who, under the existing accounting standards, was *not* 'reasonably assured' to exercise its renewal option, Figure 2 illustrates a scenario where the same tenant *was* 'more likely than not' to exercise that very same renewal option. The result illustrates why this aspect of the Boards' proposals caused the strong reaction expressed in so many of the comment letters received by the Boards.

Figure 2 Impact on P&L for existing operating lease versus exposure draft (renewal option included)



Contingent rentals –It looks mean’

In the CRE arena, the terminology of ‘contingent rentals’ largely translates into the following:

- consumer price index (CPI) or other similar rent adjustors based upon an indexed rate; and
- percentage rent commonly found in retail leases.

The Exposure Drafts’ proposals with respect to contingent rents also represented a marked departure from existing standards. Pursuant to existing standards, all contingent rents are expensed as incurred. The Boards’ proposals turned this on its head and required all contingent rents to be capitalised.

With respect to rent charges contingent upon a future index or rate, such as CPI adjustments, the Boards proposed that the rent payments subject to capitalisation would incorporate estimates of those future rates. More significantly as far as retailers were concerned, the Boards’ original proposals would have required lessees to forecast all of their percentage rent payments over the entirety of the lease term, including any of those renewals that were ‘more likely than not’ to be exercised, and then capitalise those amounts. All of these projections were to be made using a

probability weighted methodology of what the future outcomes would be (ie a 30 per cent chance of percentage rent in the first lease year being US\$100,000, a 40 per cent chance of it being US\$150,000 etc). Understandably, the comment letters received by the Boards did not contain any support for the capitalisation of amounts derived by the crystal ball approach to determining contingent rent payments, not least because these payments were, at their core, contingent and not fixed.

Putting this into clearer context, a retailer paying base rent indexed to CPI and percentage rent would have to predict inflation, determine its most probable sales and calculate all of the resulting rent charges not just over the initial term, but perhaps over 20 or 30 years if it had multiple renewal options in its lease. Aside from the obvious objections most tenants raised, this would have been a very cumbersome requirement for tenants to implement. Moreover, in the minds of most observers this aspect of the new accounting standards served to unnecessarily and, given the multiple predictions involved, inaccurately inflate the balance sheets for retailers paying percentage rent charges, and would also have an outsized impact on their P&L for several years following the implementation of the new standards as compared with existing standards. Figures 3 and 4 illustrate this incremental P&L impact

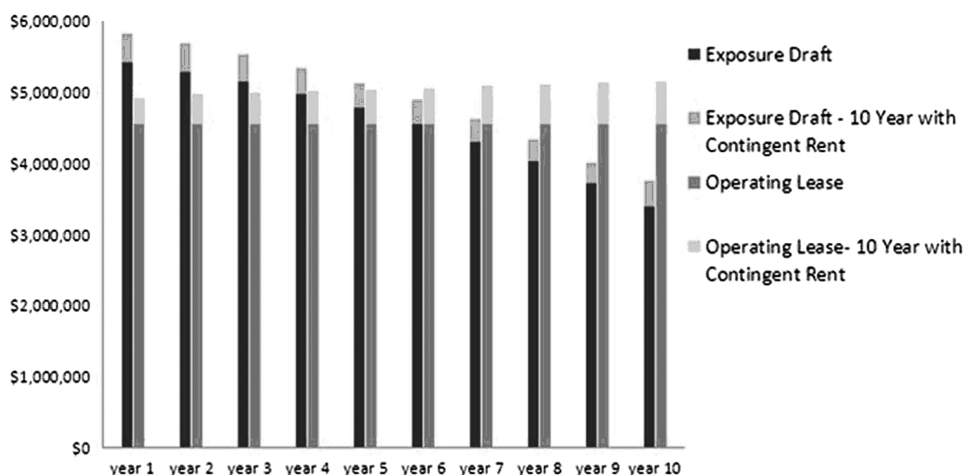
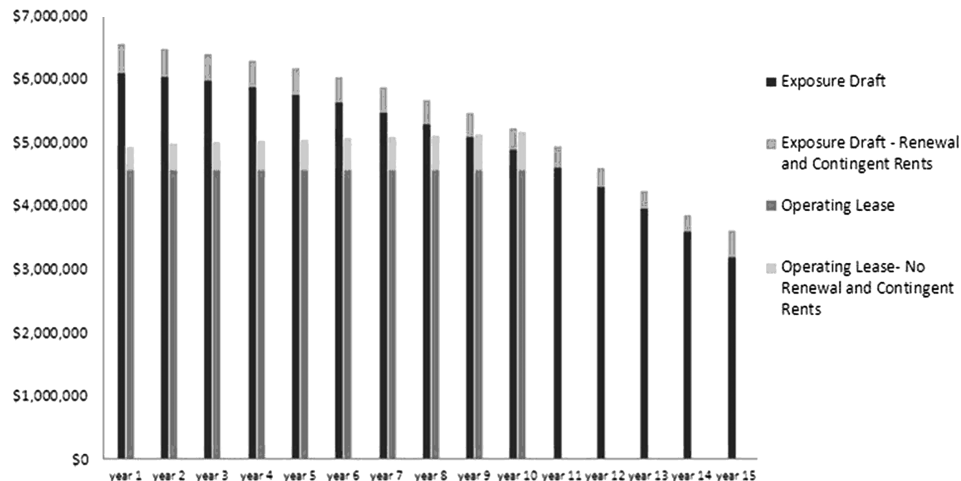


Figure 3 Impact on P&L for existing operating lease versus exposure draft with contingent rent (no renewal)

Figure 4 Impact on P&L for existing operating lease versus exposure draft with renewal and contingent rent included



from contingent rent for a tenant who determines it is unlikely to renew its lease and for one who is ‘more likely than not’ to exercise its renewal option, respectively. Note that Figures 3 and 4 illustrate the P&L accounting for the hypothetical tenant’s NNN base rent and contingent rents only.

Property tax and insurance costs to be capitalised –It just growled’

Under existing accounting standards, so-called ‘executory costs’ are eliminated from the accounting treatment of minimum rent payments, whether for capital or operating leases, and this exclusion explicitly applies to property tax and insurance charges payable to the tenant’s landlord. FAS 13/ASC 840 states: ‘the lessee’s obligation to pay (apart from the rental payments) executory costs such as insurance, maintenance, and taxes in connection with the leased property shall be excluded’ from minimum lease payments.² The importance of the Boards’ proposals in the context of operating expenses, taxes, utilities and/or common area maintenance charges had to do with the distinction between the payment of rent and the payment for services provided to a tenant under the terms of its lease. In their Exposure Draft documents, the Boards recognised many leases include service components, which are a type of ‘performance

obligation’, and the service components can be distinct services with quantifiable costs. Ultimately, under the Boards’ proposals this boiled down to the fact that payments of rent were to be capitalised while payments for distinct services tied to performance obligations were to be expensed as incurred. Critically, however, the devil in the detail with respect to what constituted a ‘distinct service’ was not found in the Exposure Drafts on lease accounting *per se*, but rather, by reference, in another of the Boards’ so-called convergence projects related to revenue recognition,³ which served the purpose of defining a ‘distinct performance obligation’.⁴

In accordance with the Exposure Draft on lease accounting and the one on revenue recognition, as well as pursuant to the associated staff papers released by the accounting boards, ‘indicators that a good or service is distinct include:

- The good or service is identified separately in the contract;
- The good or service has a distinct profit margin;
- The good or service has a distinct function’.⁵

Most leases separately identify the services a landlord (or, in the case of certain triple net

leases, the tenant) is to provide to the tenant and/or building, and those services have distinct functions and profit margins. Therefore, the Boards' original proposals allowed tenants to exclude those amounts which represented a payment or reimbursement to the landlord for distinct services provided pursuant to the lease. At first blush this seemed pretty innocuous as it would have conceptually applied to all of the payments a tenant was required to make for operating expense, property tax, insurance, utility and common area maintenance charges. It similarly would have seemed to apply also to the portion of a tenant's base rent, if any, which represented its base expense amount under a modified gross lease or that portion of its rent attributable to those costs under a true full service gross lease structure. However, the Boards did not make things quite so simple. Importantly, the Exposure Drafts and associated staff papers did not view all operating expenses, taxes, utilities, etc as being distinct service components. Specifically, they stated taxes and insurance are: 'not distinct from the lease', because 'they are a consequence of [a landlord's] ownership of the building'.⁶ Therefore, based on the Boards' proposals, tenants would have to capitalise the payments

related to taxes and insurance, and thus the financial statement impact from the new lease accounting rules would *not* be based on a tenant's *net* base rent.⁷ This was yet another element of the proposed standards that further exacerbated the impact of the new standards as compared with existing operating lease treatment, as it would have required tenants to record assets and liabilities on their balance sheets for costs which would be expensed if they owned rather than leased the building. Figures 5 and 6 illustrate the further incremental impact this issue has for the non-renewal and renewal scenarios described in Figures 3 and 4. Note that Figures 5 and 6 illustrate the P&L accounting for the hypothetical lease's NNN base rent, contingent rents and tax and insurance costs only.

SHRINKING THE MONSTER –A MORE MODEST PROPOSAL

After receiving nearly 800 comment letters expressing different factions' concerns and disagreements with the Boards' proposals, and after considering that feedback, the Boards have materially revised their proposed lease accounting rules to be much more

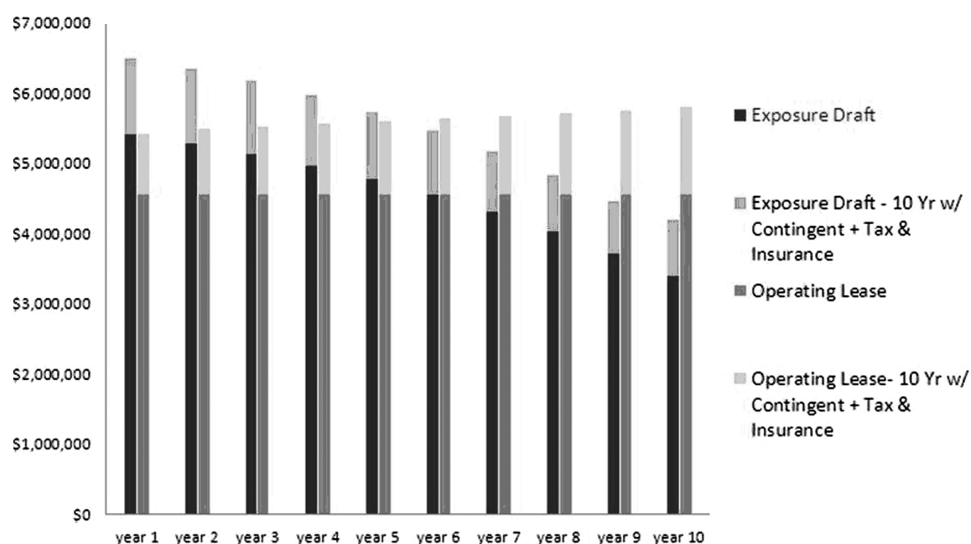
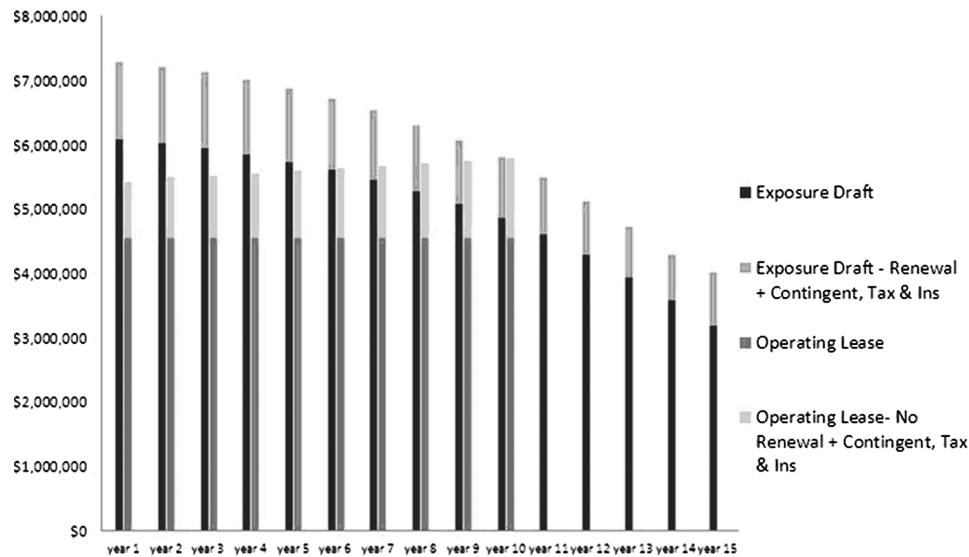


Figure 5 Impact on P&L for existing operating lease versus exposure draft with contingent rent, tax and insurance (no renewal)

Figure 6 Impact on P&L for existing operating lease versus exposure draft with renewal and contingent rent, tax and insurance



palatable, resulting in a smaller overall financial statement impact for most leases. These changes have served to make the monster much less ferocious and should allow CRE professionals to breathe at least a small sigh of relief.

Front-loaded impact on P&L remains –It is pretty big!

The Exposure Drafts called for the elimination of operating leases, and for the P&L impact for all leases to be based upon an effective interest method of amortising the asset, on a straight-line basis, over the term of the lease, and charging interest on the outstanding liability to make rent payments. This served to front-load the P&L impact of any lease such that the amounts recorded on the lessee’s P&L in the first year of the lease term would be higher than in the next, and would subsequently decline in each year. Ultimately, this was viewed with a great deal of negativity by those submitting comment letters, in large part due to the negative impact it would have on near-term earnings upon transition to the new standards, and secondly due to the fact that the front-loaded method of presentation would differ from the cash-flow payments under virtually all leases, and certainly under

real estate leases which typically have higher rent charges at the end of their term than they do at the beginning.

Earlier in 2011 the Boards attempted to accommodate these concerns by tentatively agreeing, during their April meetings, to revert to a system of ‘classifying’ leases, whereby so-called ‘finance leases’ would be capitalised and recognised on the P&L using the front-loaded approach, but where so-called ‘other than finance leases’, while still capitalised, would be recognised on a straight-line basis over the term of the lease. Under this scenario, most real estate leases would have been classified as ‘other than finance leases’ and thus would have received the straight-line treatment. However, after reaching that tentative agreement in April, during their May meetings in London, the Boards, following fairly lengthy debate, formally reversed that decision and have now recommitted themselves to the original proposal, resulting in a front-loaded impact on the P&L for all leases.

This reversal of position was largely the result of the Boards being unable to find a way to reconcile the accounting disparity between (a) the effective interest method of amortising the asset and charging interest on

the declining balance of the related liability, and (b) the straight-lined rent amounts. The Boards ultimately determined that they could not fit that proverbial square peg into the requisite round hole. Many in the CRE community who had been following the Boards' deliberations were very encouraged by the possibility of being able to avoid the front-loaded impact of the new standards. Unfortunately, those hopes were premature. As a result, CRE professionals and their counterparts in finance will need to prepare for the changing profile of their leases' impact on their income statements. Ultimately, if viewed purely through a short-term lens, this front-loaded effect could cause some tenants to think differently about future lease commitments. However, if viewed more realistically over the longer-term duration of a lease, it should not have any legitimate effect on strategic decision making. While the Boards are now recommitted to this aspect of their original proposals, thankfully they have made other important changes that lessen the overall impact for lessees.

Term options –Its teeth are not really that big'

At the time of writing this paper in late May 2011, the Boards have agreed to significantly retract their original proposals related to the treatment of term-related options in a lease. Rather than using a threshold of 'more likely than not', the boards have decided to revert to a position of requiring term-related options to be included only if there is a 'significant economic incentive' for the lessee to exercise those options. Importantly, this change in position effectively raises the 50 per cent threshold of 'more likely than not' to something closely approaching, if not equivalent to, the 'reasonably certain' threshold under current standards. As a result, it is likely that significantly fewer options will be included in the new accounting calculations than would have been included had the originally proposed treatment prevailed.

While the Boards still need to provide clarity and guidance around the concept of 'significant economic incentives', it is expected to be similar to the guidance in existing standards that generally relies on a combination of 'bargain' terms and/or penalties associated with non-renewal or failure to terminate. During the Boards' joint meetings held in London over 17–19th May, 2011, they debated the issue of what should be considered in determining whether a 'significant economic incentive' exists. While no official vote was held on the issue, the Boards discussed having lessees consider what they referred to as 'contract factors' and 'asset factors', along with 'market factors' and 'entity factors', although with a greater emphasis on the first two. Importantly, based upon the Boards' meeting on 19th May, the 'market factors' element of determining the existence of 'significant economic incentives' is not expected to be treated as a moving target such that, by way of example, leases with established rental rates for renewal terms could move 'in' or 'out of the money' during the initial term of the lease with a corresponding change in accounting treatment being required along the way. Instead, the Boards seem to support an approach where the presence of a rental rate related incentive would either have to be determined to be significant enough to require the option to be included at the commencement of the lease, or might only have to be reassessed/determined at the time the option is scheduled to expire, and some members of the Boards favoured ignoring 'market factors' entirely. Between lease commencement and the option expiration date, the Boards do not seem inclined to require or permit the options to be reassessed with any required frequency. As renewal options incorporated in most commercial real estate leases are based on some version of 'fair market value' rates, under these revised proposals it is unlikely that a tenant could establish it had a 'significant economic incentive' to renew its lease absent other material contract or asset

based factors. It is expected that tenants will have the ability to establish materiality guidelines (and will be required to do so for audit purposes) around the meaning of 'significant' as it relates to their CRE practices and various options. In that sense it is conceivable that a renewal option at 95 per cent of fair market value would not, in and of itself, be considered 'significant' for some tenants.

In their deliberations on 19th May, the Boards were more focused on so-called 'contract factors' such as, by way of example, whether a lease included provisions which would cause the tenant to have to pay a penalty if it did not renew its lease, or would require the tenant to incur significant costs to restore the leased premises if it did not renew. The Boards were similarly focused on 'asset factors', including issues such as whether a location possessed strategic characteristics for the business (eg was located next to another owned facility) or featured specialised improvements that had remaining useful lives (eg a five-year lease for a laboratory with improvements for wet labs, cold storage etc).⁸ Based upon the Boards' deliberations (which are still ongoing at the time of writing), either or both of these factors could readily result in a tenant being determined to have a 'significant economic incentive' to renew its lease even if that renewal option was based upon the fair market value at the time the option would be exercised.

Ultimately, the practical reality of this revision away from 'more likely than not' means far fewer commercial real estate leases with renewal and/or termination options will see those options included in the associated accounting calculations. Notwithstanding this reality, however, tenants will still be required to demonstrate to their auditors that the options either possess or lack 'significant economic incentives'. So, while the scariest impacts of renewal and termination options have been greatly reduced, CRE's business processes will still need to address the creature under the bed.

Contingent rentals —It just wagged its tail!

The Boards' proposals on the subject of contingent rentals caused one large retailer to predict it would cost nearly US\$50m for it to adopt the new accounting standards due, in part, to the number of leases it had with percentage rent provisions. Moreover, the 'probability weighted' outcome requirement was unlikely to produce accurate results despite a tenant's best intentions. Consequently, in the course of their recent deliberations the Boards have agreed to significantly revise this aspect of their original proposals. Instead of having to predict future index rates (such as CPI), tenants will utilise a much simpler 'spot' rate. In the case of CPI adjusters, for example, this would translate into using the current CPI rate at lease commencement without regard to what the probability weighted outcome would have been over the term of the lease. Any differentials between the outcome of using the 'spot' rate and the actual rate that occurs over the term of the lease would simply be recorded as a period expense.

The question of how to report percentage rent charges also has been significantly scaled back and simplified, with the associated impact on many tenant's financials being greatly reduced as compared with the Boards' original proposals. Based upon these revised proposals, percentage rent payments will only be included in the capitalised rent charges if they constitute 'disguised minimum rent' payments, and no longer need to be calculated using the cumbersome probability weighted method. For many this begs the question of what constitutes a 'disguised minimum rent' payment. Pragmatically, it seems it will mean tenants who might hope to minimise the impact on their financials by signing leases with lower — if not non-existent — base rent payments in exchange for higher percentage rent payments will not see their hopes become reality. However, for many retailers whose leases include percentage

rent clauses where those percentage rent payments represent more of a potential ‘kicker’ for the landlord than they represent the substance of the underlying lease transaction, those percentage rent charges should be able to be expensed as incurred and thus remain outside of the lease accounting treatment and off their balance sheets. As with the issue of establishing ‘significant economic incentives’, tenants with percentage rent clauses in their leases similarly will need to establish an auditable standard or process for calculating and determining whether those payments are actually masquerading as minimum rent payments. Needless to say, the ‘thing’ under the bed is getting friendlier.

Taxes and insurance –‘Oh, the growling was its stomach rumbling!’

When it was originally observed that the Boards’ proposals required lessees to capitalise the portion of their overall rent charges that represented a reimbursement to the landlord of insurance and property tax expenses, it seemed odd that an entity choosing to own its real estate would be able to expense its insurance and property taxes, but if it chose to lease the building it would have to capitalise those costs. The Boards have now moved away from their original proposal on this subject. More specifically, the Boards have now tentatively agreed that distinguishing between the lease and its embedded service components will no longer be based on the concept of ‘distinct service components’ as set out in the revenue recognition project, but instead be segregated based upon actual or observable cost data. This is essentially the same as the existing lease accounting rules where ‘executory’ and service costs are not subject to capitalisation. Hence, a tenant entering into a new lease with a ‘base year’ structure for determining its tax and operating expense obligations will exclude those costs from its capitalised rent, and can estimate those costs if they have not yet been fully or finally determined by their

landlord (ie the scenario that would occur if a tenant signed a lease in 2011 giving it a 2012 base year offset). This revision in the Boards’ proposals serves to bring the accounting for leases to a more reasoned position as compared with the treatment costs incurred in owning real estate (ie taxes and insurance costs are period expenses, not capitalised costs) and aligns it more closely with the existing concepts of what is included and excluded from lease accounting calculations.

WHAT IS REALLY UNDER THE BED?

The Boards have made important changes to their original proposals, and those changes mean that the monster hiding under the bed is nowhere near as ferocious as everyone first imagined when the Boards issued their respective Exposure Drafts last August. But is what remains a monster, a mouse or something in-between?

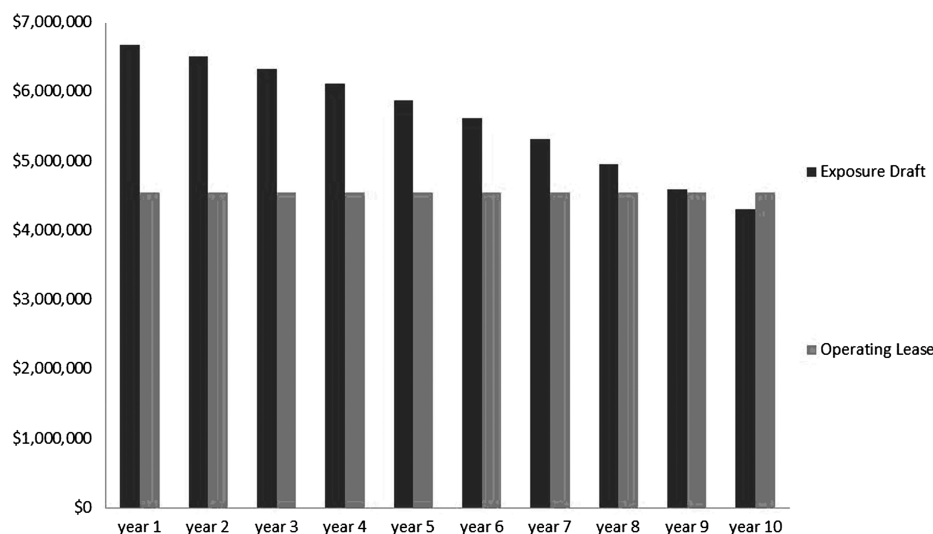
Up until now many tenants assumed it was a monster because they were presented with inaccurate descriptions and depictions of the financial calculations and/or were not aware of the important changes the Boards had recently made. The correct analysis, however, reveals the impact in terms of a tenant’s P&L statement is smaller than originally perceived for two reasons. First, it is smaller as a result of the Boards’ revised proposals. Second, it is made smaller by eliminating a fairly common misconception. This misconception resulted from some erroneously comparing the straight-lined base rent under existing standards not just against the Exposure Drafts’ method of reporting base rent, but against the totality of the Exposure Drafts’ proposals (ie incorporating *all* rent elements subject to capitalisation, including base rent, contingent rent, taxes and insurance). In other words, for many the ‘thing’ under the bed was made to look worse by comparing apples and oranges.

The true P&L impact from any given lease under existing standards includes not just the straight-lined base rent, but also contingent rents, taxes, insurance and operating expenses, all of which are expensed as paid. By including these amounts in the total P&L profile for both the existing and the proposed standards, an objective basis for comparing the existing standards against the new standards emerges. The disparity in how the standards have sometimes been compared, as opposed to how they should have been compared and explained, is illustrated by Figures 7 and 8. Figure 7 shows the existing standards' straight-lined base rent compared against full Exposure Draft capitalised rent streams (ie with contingent rents and taxes and insurance costs capitalised). Figure 8 shows the correct *full* P&L accounting for a lease under existing standards against the *full* P&L accounting for the same lease under the Boards' currently revised proposals, the latter of which assumes the tenant does not have a 'significant economic incentive' to renew its lease and is not paying 'disguised minimum rent' via its percentage rent charges. In practice these assumptions would need to be supported by objectively defined criteria for audit purposes. If anyone's analysis was similar

to Figure 7 they may very well have believed a real monster was under their bed. Figure 8, however, helps dispel that myth by showing the real difference between the existing and proposed standards is not as drastic as many feared, as reflected by the flatter slope of the full P&L lines between proposed and existing standards. More importantly, this 'kitchen sink' presentation allows both CRE professionals and their finance counterparts to recognise the aggregate, nominal expense has not changed at all — it is the same for existing standards and the proposed standards as revised — thanks in large part to the revised requirement that only those renewal options with a 'significant economic incentive' would need to be included.

Tenants' balance sheets will be similarly affected by the new accounting standards, but also to a lesser extent than originally contemplated. For example, when the original proposals were first released in August 2010, the shift of leases onto a firm's balance sheet sounded alarms, but when the size of the asset and corresponding liability was to have been significantly impacted by renewal options that were 'more likely than not' to be exercised, and further inflated by contingent rents and tax and insurance costs, some

Figure 7 Impact on P&L: Erroneous comparison



observers predicted an increase in tenants opting to buy rather than lease real estate. However, by virtue of the Boards' recent revisions those elements should not affect the asset and liability calculations nearly as significantly as originally contemplated. As a result, and in keeping with prudent wisdom that accounting treatment should not dictate the course of a business decision, it would now be surprising to see tenants revising their lease versus buy decisions as a result of these newly revised proposals.

ADAPTING BUSINESS PROCESSES TO NEW ACCOUNTING STANDARDS

What will change and what should CRE professionals be doing differently now to align their business processes to the new lease accounting standards?

Strategic lease versus buy decisions should not be altered

CRE's historical 'best practices' of establishing whether to lease or own a particular building should not be affected by the new accounting

standards, particularly in light of the significant modifications the Boards have made in the past few months. Factors such as long-term need, suitability, strategic plans, specialised improvements, relative value compared with lease costs, risk of ownership etc, should all still direct the outcome of the analysis, without any change as a result of changes in accounting. It should be noted that, while the full P&L impact has over the term of the lease, shown in Figure 8, is equal in nominal dollars for both the existing and the proposed revised accounting standards, the front-loaded P&L profile, while smaller than originally envisioned, will not impact the net present value (NPV) cost analyses involved in many firms' lease versus buy decisions as those calculations are based on cash flows, not GAAP/IFRS accounting treatments. Thus the front loading should not cause any change in strategy when other factors in the decision do not indicate owning the building as the best strategic decision for the firm. In light of the Boards' recent changes concerning the treatment of term-related options and contingent rents, CRE professionals will be better served

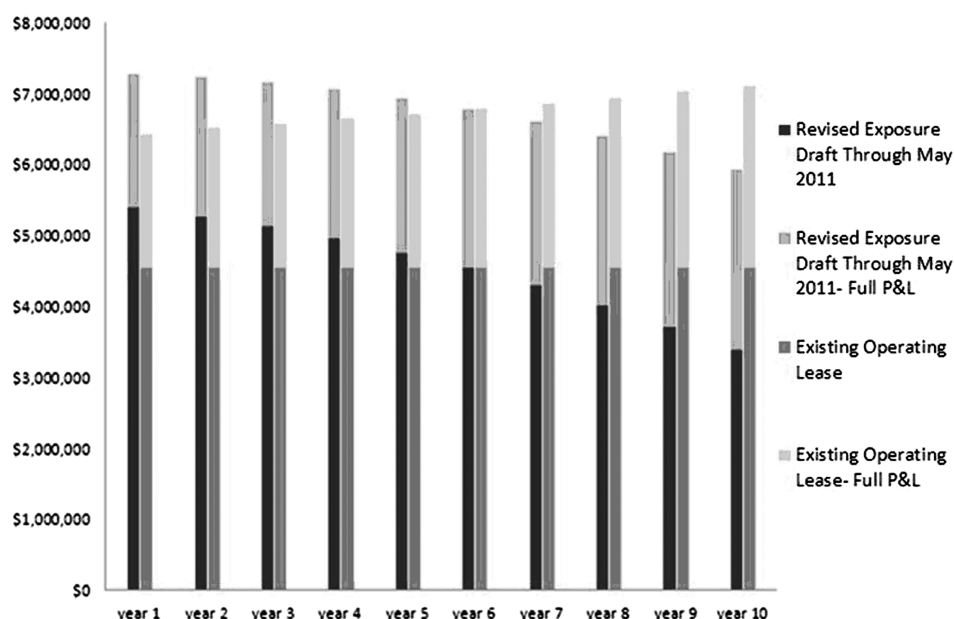


Figure 8 Impact on P&L for existing operating lease versus revised exposure draft with revisions through May 2011 (no renewal)

paying closer attention to contractual and asset based factors surrounding renewal options and contingent rent provisions.

Understand the finer consequences of lease provisions

By recognising that term-related options will not be included in the lease accounting calculations in the absence of a 'significant economic incentive', tenants can manage their lease negotiations and provisions accordingly. To do so effectively, however, they will need to have also established clear, objective and auditable guidelines as to what constitutes a 'significant economic incentive' for their particular business. By way of example, in the course of negotiating a new ten-year lease with a renewal option, tenants will be well advised to pay closer attention to contractual provisions such as restoration obligations and consider whether to have established renewal rates or ones based on some iteration of fair market value etc. Similarly, asset based factors such as specialised tenant improvements having an expected useful life in excess of the initial term of the lease may be a significant enough factor to trigger, either alone or in tandem with other factors, the renewal option to be included. The same approach will be required in connection with contingent rent charges, particularly percentage rent. However, again, the accounting does not change the aggregate, nominal consideration, so whether or not the contingent rent is capitalised should not alter any lease versus buy decisions.

Understand the impact on specific lease structures

In an analysis of the new lease accounting standards at the end of 2010, CyberLease anticipated that the method of restructuring existing leases known among CRE professionals as a 'blend and extend' would be adversely affected by the new standards.⁹ Utilising the benefits of existing standards, the 'blend and extend' strategy is pursued on

the basis it provides three key benefits to a tenant, namely it:

- conserves cash flow;
- takes advantage of a down market to lock in lower rates for the future; and
- improves current and near-term profitability as compared with the existing rent structure.

Under the current accounting rules, all three benefits can be achieved; however, virtually every realistically conceivable 'blend and extend' deal will reduce current and near-term profitability (because it will reset the front-loaded expense profile) if the Boards' proposal of treating these types of lease amendments as simple reassessments rather than as a termination of the existing lease and creation of a new lease is incorporated in the final standards.¹⁰ Hence, for tenants hoping to use the 'blend and extend' as a tool to improve short-term earnings, time is relatively short. This is but one important example of why it is imperative for CRE professionals to begin analysing lease proposals and structures in an entirely new way.

Realise a new analysis is required

Since the advent of the HP-12C calculator and Microsoft Excel (and Lotus 1-2-3 before that), astute CRE professionals have largely analysed competing lease proposals with an eye on the annual NPV per square foot cost of competing deals. Many also included a cash flow analysis and some even included pre and post-tax considerations. These measurements are still important, but they will be equal to, if not trumped by, considerations related to the balance sheet profile of competing leases. By way of example, no longer will it be accurate to consider two NNN leases of identical size and identical term to be equal if the combined base rent and tax and operating costs for both equal US\$35 per square foot per year, but the first lease

carries base rent of US\$25 and NNN charges of US\$10, while the second carries base rent of US\$23 and NNN charges of US\$12 per RSF. Simplistically, the former will have a 10 per cent greater impact on the tenant's balance sheet and a more front-loaded P&L profile than the latter. CRE professionals and their advisers are not accustomed to analysing leases with these additional considerations on the table, but will need to be able to do so quickly.

Prepare for implementation challenges

The Boards may have tamed or muzzled the 'thing' under the bed by way of modifications to their original proposals, but anyone who believes implementation will be easy might have better luck relying on the Tooth Fairy to rescue them. Any tenant required to provide audited financials prepared in accordance with GAAP or IFRS will be affected by these new standards. Even tenants with robust lease administration software databases will find they lack the data, processes and controls necessary to easily implement these new standards, nor is lease administration likely to equal lease accounting from the C-Suite's perspective. For many, implementation of these new standards will have a 'forest for the trees' effect, as there are many new issues to consider.

For example, under current operating lease standards, tenants are supposed to exclude executory and service costs from their straight-lined rent calculations. This should result in tenants with gross or modified gross leases deducting the executory and service costs that are included in their gross base rent such that they straight-line the net base rent. However, from a practical standpoint, many tenants have not bothered to do so because of the reality of the existing standards. In other words, a tenant with a base year structured lease, with base year costs of US\$12 per square foot, and with base rent (ie including its US\$12 base year costs) of US\$22 per square foot probably

recorded US\$22 per square foot of expense on its P&L every year under the existing standards. However, using US\$22 per square foot as the capitalised rent amounts under the newly proposed standards, as recently revised, would be wholly inaccurate both in terms of the balance sheet and P&L presentation. Consequently, for every existing lease, tenants will need to capture accurate data and correctly segregate these into specific categories in order to yield accurate financial results.

GET INTRODUCED –THE SOONER YOU MEET THE MONSTER, THE NICER IT WILL BE

In consideration of the complexity of the new proposals, even as they have been recently revised, the singular most important consideration in terms of when CRE professionals truly need to begin dealing with the new accounting standards is entirely dependent upon who they work for or represent. Some will need to have started work on their transition initiative six months ago, others with a very modest number of leases should be able to wait a year or so, assuming the Boards' projected effective date of January 2015 holds true. Obviously this begs the question of 'what camp do I fall into?' The answer is dependent upon one's firm and its governing accounting requirements. For example, The Securities and Exchange Commission requires most public companies to provide five years of comparative, selected financial data in their audited financial statements, so those firms had better be more than waist deep in their transition process now.¹¹ Why? Because if the new standards take effect in 2015, the tenant would need to provide comparative financials (ie reporting as though the new standards were in effect) for calendar years 2011–15. In other words, it is not sooner than readers think, it is *now* if they work for or represent a publicly traded company required to provide five years of comparative data. Granted, between now and 2015 the company should not need to

report on both standards, but if that firm waits until 2014 it will need to go back in time to recreate the comparative data. Realistically, it is unlikely that the firm will have all of the data, nor is it likely to be able to accurately capture all of the leases which were in effect between 2011 and 2015 but expired before 2015. The consequences of not looking under the bed now will mean inaccuracies in financial reporting, which is not a trivial matter to anyone, least of all executives signing off on their firm's financial statements.

The good news is readers should not be afraid to shine a bright light under their bed. What many thought was a monster turns out to be just a big, old, hungry dog and it will only bite those who delay dealing with it. The bad news for those who wait, is that it may just be '*Cujo*' they find lurking under the bed.

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- (1) See, for example, FAS 13/ASC 840, Sections 5(f) and, by reference, Section 5(e), for definition of the lease term.
- (2) Section 5(j)(i) of FAS 13/ASC 840.
- (3) FASB (2010) 'Exposure Draft, Leases (Topic 840)', 17th August, Section B7, p. 43.
- (4) FASB (2010) 'Exposure Draft, Revenue Recognition (Topic 605)', 24th June, pp. 3 and 14–15.
- (5) IASB/FASB (2010) 'Accounting for Arrangements with Service and Lease Components', IASB/FASB Joint Meeting Staff Papers, 15th March, p. 8.
- (6) *Ibid.*, p. 18. It should be noted that the Staff Papers reflect the positions of FASB's and IASB's respective staff, while the Exposure Drafts reflect the Boards' official decision. On this particular topic, however, the Staff Papers and the Exposure Drafts are consistent.
- (7) For a more detailed analysis of this aspect of the Board's proposals, see: CyberLease (2010) 'New Lease Accounting Standards: ALERT! Taxes & Insurance To Be Capitalized', Cyberlease LLC, Irvine, CA, available at: <http://www.cyberleasellc.com/Resources/Lease-Audit-Articles/New-Lease-Accounting-Standards-Alert-Taxes-Insurance-To-Be-Capitalized.aspx> (accessed 12th July, 2011).
- (8) For further descriptions of these four factors see: IASB/FASB (2011) 'Reassessment of Options in a Lease', IASB/FASB Joint Meeting Staff Papers, Agenda Paper 2G/FASB Memo 174, 16th May, p. 6.
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- (11) See: Code of Federal Regulations, Title 17: Commodity and Securities Exchanges, Chapter II – Securities and Exchange Commission, PART 229 – Standard Instructions For Filing Forms Under Securities Act of 1933, Securities Exchange Act of 1934 and Energy Policy And Conservation Act of 1975 – Regulation S-K, Subpart 229.300 – Financial Information, Section 229.301 – (Item 301) Selected Financial Data.