

LEASE ACCOUNTING: A DAY AT THE TRACK

Combining New Lease Accounting Standards and Base Year Lease Audit Make a Winning Ticket Better

By: Marc A. Maiona

July 11, 2011

Not unlike a handicapper's day at the track, with the new lease accounting rules there will be winners and losers. Similarly, identifying the winners and losers in advance requires careful analysis and a sharp focus on the smallest of details. In our analysis of the current state of the new lease accounting proposals, as they stand at the end of June 2011, it is clear tenants who successfully audit their base year tax and operating expenses will end up holding a winning ticket under the new standards – and it's the trifecta!

Under the current GAAP/IFRS lease accounting rules, tenants who have proactively monitored and audited their base year expenses to ensure those costs were as high as possible have realized two economic benefits; improved cash flow and higher GAAP/IFRS-based profitability. These cash flow and profit improvements were the result of higher base year costs being applied against the subsequent years' expenses. For leases classified as operating leases under the current rules (i.e., FAS 13 / ASC 840 for GAAP and IAS 17 under IFRS), the annual cash flow and GAAP/IFRS-based profitability benefits were equal to one another due to the straight lined rent treatment for operating leases (i.e., cash flow savings equaled the increase in profits). Additionally, the increase in base year expenses had no impact on the tenant's balance sheet for operating leases as those leases were never recorded on the balance sheet.

To illustrate the impact on a tenant's GAAP or IFRS-based financials from a base year audit under the current standards, consider the following hypothetical example: a tenant leases 100,000 square feet of office space under a base year structured lease for a term of five years commencing on January 1st, and its base year is the year immediately preceding the year the lease commences. Its original base year expenses are reported to be equal to \$10 per square foot, and its base rent over the five year term starts at \$30 per square foot and increases by \$2 per square foot per year, for an average or straight lined base rental rate of \$34. At the end of the first year of its term, the tenant's landlord reports its total tax and operating expenses for the year equaled \$11.75 per square foot, and for the sake of this example assume that rate will then be constant over the remaining term. Based on these parameters, the tenant's GAAP/IFRS-based reporting for this lease would reflect the following:

TABLE 1

LEASE ECONOMICS BEFORE BASE YEAR AUDIT					
	Year 1	Year 2	Year 3	Year 4	Year 5
Rentable Square Footage (RSF)	100,000	100,000	100,000	100,000	100,000
Base Rent / RSF	\$ 30.00	\$ 32.00	\$ 34.00	\$ 36.00	\$ 38.00
Original Base Year Expenses / RSF	10.00	10.00	10.00	10.00	10.00
Net Base Rent / RSF (1)	\$ 20.00	\$ 22.00	\$ 24.00	\$ 26.00	\$ 28.00
Comparison Year's Expenses / RSF	\$ 11.75	\$ 11.75	\$ 11.75	\$ 11.75	\$ 11.75
FAS 13 / IAS 17 LEASE ACCOUNTING BEFORE BASE YEAR AUDIT - P&L IMPACT					
FAS 13 Straight Lined Rent (2)	\$ 3,400,000	\$ 3,400,000	\$ 3,400,000	\$ 3,400,000	\$ 3,400,000
SG&A Expense (3)	175,000	175,000	175,000	175,000	175,000
Annual P&L per GAAP/IFRS	\$ 3,575,000	\$ 3,575,000	\$ 3,575,000	\$ 3,575,000	\$ 3,575,000

Aggregate P&L Impact: \$ 17,875,000

Present Value (at 8%) of P&L Impact: \$ 15,415,853

(1) Base Rent / RSF less Original Base Year Expenses / RSF

(2) Equal to average base rent / RSF / Year.

(3) Equal to difference between Comparison Year's Expenses / RSF and Original Base Year Expenses / RSF, times RSF

Now, assume this same tenant was mindful of the [audit window](#), if any, in its lease and exercised its base year audit rights (and who wouldn't if their first comparison year's expenses increased by 17.5%?). If, at the conclusion of this audit, the tenant and landlord agreed the base

year expenses should have been \$1.65 per square foot higher, equal to \$11.65 instead of \$10 per square foot, the lease economics and their corresponding impact on the tenant's P&L would be as follows (note, of course, the base rent, which is inclusive of the base year expenses, does not change if the base year expenses change):

TABLE 2

LEASE ECONOMICS AFTER BASE YEAR AUDIT					
	Year 1	Year 2	Year 3	Year 4	Year 5
Rentable Square Footage (RSF)	100,000	100,000	100,000	100,000	100,000
Base Rent / RSF	\$ 30.00	\$ 32.00	\$ 34.00	\$ 36.00	\$ 38.00
Revised Base Year Expenses / RSF	11.65	11.65	11.65	11.65	11.65
Net Base Rent / RSF (1)	\$ 18.35	\$ 20.35	\$ 22.35	\$ 24.35	\$ 26.35
Comparison Year's Expenses / RSF	\$ 11.75	\$ 11.75	\$ 11.75	\$ 11.75	\$ 11.75
FAS 13 / IAS 17 LEASE ACCOUNTING AFTER BASE YEAR AUDIT - P&L IMPACT					
FAS 13 Straight Lined Rent (2)	\$ 3,400,000	\$ 3,400,000	\$ 3,400,000	\$ 3,400,000	\$ 3,400,000
SG&A Expense (4)	10,000	10,000	10,000	10,000	10,000
Annual P&L per GAAP/IFRS	\$ 3,410,000	\$ 3,410,000	\$ 3,410,000	\$ 3,410,000	\$ 3,410,000
				Aggregate P&L Impact:	\$ 17,050,000
				Present Value (at 8%) of P&L Impact:	\$ 14,704,353
				Tenant's Increased GAAP/IFRS-based Profits on Present Value Basis:	\$ 711,501

(1) Base Rent / RSF less Original Base Year Expenses / RSF

(2) Equal to average base rent / RSF / Year.

(4) Equal to difference between Comparison Year's Expenses / RSF and Revised Base Year Expenses / RSF, times RSF

While the tenant's base rent remains unchanged, and thus the straight lined rent expense on its P&L does not change, the \$1.65 per square foot increase in its base year expenses translates into an even \$165,000 per year improvement in its cash flow, which is reflected in a corresponding decrease in its Selling, General & Administrative (SG&A) expenses. Over the five year term of the lease this translates into aggregate increased profits of \$825,000 (\$165,000 x 5), or \$711,501 on a present value basis (utilizing an 8% discount rate). Hence, the tenant's base year audit produces two winners: improved cash flow and greater GAAP/IFRS-based profitability. But while an exacta is always great, even a novice at the track can tell you a trifecta is better.

"And away they go ..."

Though a small book could be devoted to all of the nuances of the new lease accounting standards (some chapters can be found [here](#)), as of this writing the new standards are poised to effectively require tenants to capitalize all leases with a term longer than one year, record a corresponding asset and liability on their balance sheet and recognize amortization and interest expense on their P&L in lieu of straight lined rent expense. Moreover, the P&L impact will be front loaded due to the methodology by which the asset and liability balances are to be drawn down over the term.

In simplified terms, as it applies to base year lease structures, tenants will effectively capitalize the "net" base rent they pay to their landlords, while the base year expenses embedded in their gross lease rate will be segregated and included as part of their SG&A expenses in the period in which they are paid. (Note, this is a recent development and it's a marked change from the original proposals which would have required property tax and insurance-related costs to be capitalized along with the net base rent. [Click here](#) for a detailed discussion of this aspect of the accounting boards' original proposals.) Aside from the departure in terms of how a tenant's GAAP/IFRS-based P&L is impacted under the existing and new standards, the new accounting standards introduce a new horse into the race in the form of tenants being required to record assets and liabilities related to their leases on their balance sheets. In light of the fact the corresponding asset and liability amounts on the tenant's balance sheet are tied to the tenant's net base rent, the relationship between the base year expenses and the tenant's net rent under a base year structured lease becomes more important, as does a tenant's need to ensure its base year expenses are as high as possible.

Continuing with the hypothetical example above, before undertaking an audit of its base year expenses (i.e., when those costs were erroneously reported as being \$10 per square foot), the tenant's balance sheet and P&L would reflect the following pursuant to the new lease accounting standards, as they currently exist at the end of June 2011:

TABLE 3

NEW LEASE ACCOUNTING BEFORE BASE YEAR AUDIT					
Balance Sheet Impact					
Asset / Liability At Commencement \$10,216,697.62	Year 1	Year 2	Year 3	Year 4	Year 5
Year End Asset Balance	\$ 8,173,358	\$ 6,130,019	\$ 4,086,679	\$ 2,043,340	\$ -
Year End Liability Balance	\$ 8,216,698	\$ 6,674,033	\$ 4,807,956	\$ 2,592,593	\$ -
P&L Impact					
Amortization Expense	\$ 2,043,340	\$ 2,043,340	\$ 2,043,340	\$ 2,043,340	\$ 2,043,340
Interest Expense (8% IBR)	657,336	533,923	384,636	207,407	-
SG&A Expense	1,175,000	1,175,000	1,175,000	1,175,000	1,175,000
Annual P&L per GAAP/IFRS	\$ 3,875,675	\$ 3,752,262	\$ 3,602,976	\$ 3,425,747	\$ 3,218,340
Aggregate P&L Impact:					\$ 17,875,000
Present Value (at 8%) of P&L Impact:					\$ 15,524,007

Asset / Liability and Interest Expense calculated assuming "Incremental Borrowing Rate" ("IBR") of 8.0% per year

Following the audit, by virtue of increasing the base year expenses by \$1.65 per square foot, the tenant would achieve the same cash flow improvement as under the existing accounting rules, and would also achieve the same nominal increase in its profitability as under the existing standards. So the "exacta" of two winners remains intact. However, by entering the new, balance sheet-related horse into the race, tenants who successfully audit their base year expenses end up holding the winning trifecta ticket, as illustrated below:

TABLE 4

NEW LEASE ACCOUNTING AFTER BASE YEAR AUDIT					
Balance Sheet Impact					
Asset / Liability At Commencement \$9,505,196.69	Year 1	Year 2	Year 3	Year 4	Year 5
Year End Asset Balance	\$ 7,604,157	\$ 5,703,118	\$ 3,802,079	\$ 1,901,039	\$ -
Year End Liability Balance	\$ 7,670,197	\$ 6,248,812	\$ 4,513,717	\$ 2,439,815	\$ -
P&L Impact					
Amortization Expense	\$ 1,901,039	\$ 1,901,039	\$ 1,901,039	\$ 1,901,039	\$ 1,901,039
Interest Expense (8% IBR)	613,616	499,905	361,097	195,185	-
SG&A Expense	1,175,000	1,175,000	1,175,000	1,175,000	1,175,000
Annual P&L per GAAP/IFRS	\$ 3,689,655	\$ 3,575,944	\$ 3,437,137	\$ 3,271,225	\$ 3,076,039
Aggregate P&L Impact:					\$ 17,050,000
Present Value (at 8%) of P&L Impact:					\$ 14,805,290

Tenant's Increased GAAP/IFRS-based Profits on Present Value Basis: \$718,718

Asset / Liability and Interest Expense calculated assuming "Incremental Borrowing Rate" ("IBR") of 8.0% per year

As the table above shows, by virtue of the base year audit increasing the tenant's base year expenses by \$1.65 per square foot, the initial (and subsequent years'), impact on its balance sheet is reduced by \$711,501 (\$10,216,698 - \$9,505,197), thereby lessening the much-dreaded hit to the balance sheet from the new lease accounting standards. This third benefit, therefore, represents the difference between the exacta and the trifecta, and will be of particular interest to those tenants who are sensitive to the impact the transition to the new lease accounting standards will have on their balance sheets and financial ratios.

Finally, as though the ability to instantly change a winning exacta into a trifecta ticket without any additional effort or cost was not good enough, the tenant who successfully undertakes a lease compliance audit of its base year expenses will also recognize the associated P&L improvement sooner than it would have under the existing accounting standards. How? Due to the fact the GAPP/IFRS-based P&L impact under the new lease accounting standards will be front loaded, a reduction of the associated asset and liability balances (i.e., by virtue of increasing the base year costs and thus decreasing the "net" base rent charges), means the increased profits are also front loaded. By way of example, in the scenarios above, under the existing accounting rules the tenant would realize its \$825,000 of increased savings evenly over the term of the lease, at a rate of \$165,000 per year (i.e., compare the "Annual P&L per GAAP/IFRS" line under Table 1 to the same line under Table 2). However, under the new lease accounting proposals (as they have been revised through June of 2011), the tenant would realize increased profits of \$186,020 in Year 1 of this hypothetical lease term, and \$176,318 of improved profits in Year 2, etc. (i.e., compare the "Annual P&L per GAAP/IFRS" line under Table 3 to the same line under Table 4). While these increased profits decline through the five year lease term, the present value of the annual profit enhancements exceeds the present value of the annual profit increases realized under the existing accounting standards, as shown by comparing the \$718,718 of present valued increase in profits under the new standards (Table 4) to the \$711,501 of present valued increase in profits under the existing standards. It is as though the tenant didn't just bet the trifecta, but instead it bet it with the long shots – what a great pay off!

The lesson? For tenants looking to preserve cash flow, increase – and accelerate – profits and protect their balance sheet, your horses are about to come in ... if you protect and exercise your base year audit rights.

~~~~

**Postscript from the Winner's Circle:** If you think increasing base year expenses by \$1.65 per square foot is as great of a fantasy as winning the "Pick 6", [here](#) is but one real example how CyberLease increased a client's base year expenses by more than \$1.65 per square foot. **Significant errors are common ... hold your tickets!**