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The FAS 13 / IAS 17 Lease Accounting Group of CoreNet Global in Cooperation with Newmark Knight Frank

Present

Corporate Real Estate Implications of Planned Lease Accounting: A Working Session – Part III

STRATEGY & PORTFOLIO PLANNING COMMUNITY

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Concept

- ***FASB and IASB see little difference between leasing versus purchasing & leasing assets, including real estate***
  - Editorial comment: Equipment leasing and finance is the driver, not real estate

- ***Current differences in treatment of operating and capital (finance) leases lead to a lack of comparability and transparency in financial statements***

- ***Thus, "The Lease Accounting Project", to standardize treatment of ALL leases as (i) capital leases that (ii) are shown on the balance sheet***

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Process

- *Discussed by the Boards for years*
- *Released discussion paper in March 2009*
- *Released "Exposure Draft" in August 2010*
- *Invitation for public comments through December 15, 2010*
- *Plan to finalize and publish standards in June 2011*
- *Worldwide implementation intended for 2012 or 2013*

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Summary

1. Leases capitalized and on balance sheets – "Right-of-use asset" and "Lease liability", derived discounting obligation using marginal borrowing rate

2. No grandfathering, and likely 2 year re-statements

3. "Likely" obligations versus current "minimum" obligations – Includes weighted renewal options and contingent rents, requiring many subjective assumptions (e.g., likelihood of renewal, projected market rents, projected business performance, currency exchange rates, etc.)

4. Gross rents converted to Net rents - Separate into NET rent versus operating expenses and RE taxes

5. Net rent expense broken into amortization and interest expenses – for P&L, straight-line depreciation of the "right-of-use" asset, plus interest applied to the unamortized lease liability; creates "front-ending" of lease costs and a declining rent curve

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Summary (cont.)

6. Treatment of tenant improvements contributions remains the same – Tenant owns and depreciates leasehold improvements, and deducts any contribution as a straight-line credit against rent over lease term

7. Subleases become more complex but not as painful – (i) subleases fall under lessor accounting; (ii) there is no write-down of the lease "right of use" asset, rather the lease and sublease are both reported

8. Assumptions for ALL leases will need to be re-visited on a regular basis – As opposed to current practice in which all assumptions are set at inception, they will be reviewed as often as each reporting period* during the life of each lease (as currently drafted). Additionally, the "right-of-use" asset would be subject to impairment.

9. Still keeping the footnotes section on leasing activity, and actually expanding it

* e.g., Perhaps quarterly for public companies

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Strategic Implications

Corporate financial reporting

- Leverage ratios
- Return on assets / investment ratios
- EBITDA versus EPS
  - Impact at implementation
- Current debt covenants
- Credit ratings and ratings agencies
- Own versus lease
- Length of leases
- Use of renewal and purchase options
  - None, or
  - Protections and bargain opportunities
- Funding of tenant improvements

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Operational Implications (and Opportunities)

Administrative burden

- Corporate real estate
  - Lease administration
- Finance / accounting
- Tax
- Information technology

Business units

- Space use projections
- If percentage rents, revenue projection
- Financial metrics

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Summary of Interview Comments

PROPOSED CHANGE IS INEVITABLE

Adoption of the proposed balance sheet recognition of all leases as right-of-use asset and obligation-to-pay-rent liability is inevitable.

- Long overdue, the lack of transparency is finally addressed;
- Volatility to financial statements could be one of its unintended consequences;
- Many believe that the cost and resources required to comply do not add a bit of value to the company, and it is unclear whom the proposed changes benefit.

"It's accounting's version of Y2K, but without an end"
– Jeri Ballard (Shell Oil Company)

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Summary of Interview Comments

RENEWAL OPTION

The predominant view is that this is the most controversial piece of the proposed change.

- Some analysts believe that this should be included in the asset/liability measurement but are concerned with the subjectivity applied in estimating renewal rent, contingency rent and the probability of renewal, and the administrative burden of periodic reassessment;
- Others believe that it should not be included, since it creates more problems than those which the new standards intend to solve;
- The subjectivity applied for renewal option can be an auditing nightmare, and as such, further guidance of ‘auditable events’ is required;
- The new standards need clarity on what constitutes implicit options;

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Summary of Interview Comments

RENEWAL OPTION (continued)

- The issue can be likened to a math problem – one can not solve for an answer with so many variables, and even if it could be done, the resulting answer would be useless;
- Some companies have already accounted for renewal options under current lease accounting standards;

"It may be an over reaction – market place dynamics, lessees' and lessors' economic and financial objectives will, for the most part, govern the length of the lease" – Robert Cook (Independent Real Estate Consultant)

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Summary of Interview Comments

SUBSEQUENT MEASUREMENT

Right-of-Use assets are to be depreciated on a straight-line basis while Obligation-to-Pay rent liabilities are to be amortized on a debt amortization basis. Consequently, the impact to the P&L is front-loaded since the debt amortization method starts with higher interest expense in the early years.

- This is consistent with current accounting principles for capital leases;
- Assets and liabilities should be symmetrically treated on a straight-line basis in as much as the use of space is even throughout the lease term;
- Use of a consistent straight-line basis avoids unnecessary volatility to the financial statements;
- Back-loaded future increases in operating expenses provide a leveling effect on front-loaded depreciation and interest expenses;
- Straight-lining is simple – simplicity is something everybody can support.

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Summary of Interview Comments

DISCOUNT RATE

The right-of-use asset and liability shall be measured at the present value of lease payments, discounted using the lessee's incremental borrowing rate or lessor's implicit rate if such is readily determinable.

- Incremental borrowing rate is a good proxy for many;
- Others prefer a standard discount rate applied to all leases;
- Credit worthy companies have a lower incremental borrowing rate, which consequently results in greater balance sheet impact, as it would appear that better-performing companies would be penalized;
- A lower discount rate results in higher balance sheet recognition, but would conversely result in a relatively lesser front-end P&L impact.

"Discount rate is a paradox in itself" – Sven Pole (CB Richard Ellis)

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Summary of Interview Comments

DO YOU STILL EXPECT CHANGES TO MARKET PLACE BEHAVIOR IF THE PROPOSED CHANGES TO LEASE ACCOUNTING STANDARDS HAVE IN A WAY ALREADY BEEN ACCOUNTED FOR BY CREDIT RATING AGENCIES?

- Business imperatives will prevail – especially for large companies where changes to the structure of the lease has no meaningful impact to them;
- Investors in retail stocks are unlikely to find any surprises, but the extent to which non-retailers have relied on operating lease treatment may bring some surprises to investors;
- Lease transactions will now be looked at with far more scrutiny and as such may require changes to how leases will be structured;
- Companies may plan on duration matching of lease term to achieve a good balance between business operations, economics and financial consideration.

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Summary of Interview Comments

GENERAL COMMENTS

- Healthy companies are not as concerned with the changes but will exercise prudence in the way they would structure the leases. Weak and highly leveraged companies will be sensitive to the changes, and that is where a shift in market place behavior would be evident;
- Some companies – particularly insurance companies – are concerned about how the changes will impact regulatory accounting;
- The 2 year restatement obligation would require 3 years of information to be able to complete comparison statements. Therefore, it could be as late as 2015 before companies could issue financial statements with the required changes;
- Contingent rent, particularly that which is tied to revenue, should be accounted for when revenue is incurred;
- Some see compliance challenges in the earliest years of adoption, but if the mechanisms, criteria and internal rules are in place, it should be a manageable problem;

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Summary of Interview Comments

GENERAL COMMENTS (continued)

- Software developers may be working on the basic framework but can not complete anything until the new lease accounting standards are finalized. Potential delays in software deployment are anticipated; therefore, expect a lot manual calculation in the initial phases of the new lease accounting standards;
- "Maybes" should not be in the balance sheet, they should be in the footnotes;
- Leasehold improvement should be amortized over the lesser of the asset life or non-cancellable term, as opposed to the expected lease term after applying the renewal probability;
- Adding the values of non-contractual renewals and other options goes against the basic concept of recognizing only long-term obligations that can not be terminated without penalty;

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Summary of Interview Comments

GENERAL COMMENTS (continued)

- The accounting principle of matching current revenues with current expenses is now evolving into taking future expenses and matching them with current revenues;
- Purchase alternative will now come into greater focus, especially for cash rich companies or for those who are sole or major tenants in their respective buildings;

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Summary of Interview Comments

OTHER KEY ISSUES THAT HAVE NOT BEEN ADDRESSED IN THE EXPOSURE DRAFT:

- Lease incentives - It appears that cash incentives, such as tenant improvement allowances, should be included in the right of use asset and liability calculations;
- Sublease Loss Reserve Accounting - FAS 146 (the sublease loss obligation) is not directly addressed;
- Day One Deferred Gain on Sale Balances (Sale-Leaseback) – Disposition of Deferred Gain on Sale balances at the date of initial adoption of the standard is not addressed;
- Day One Lease Commission Balances - The disposition of amortizing balances on lease commission are not specifically addressed;
- Build to Suit Accounting (EITF 97-10) – Guidance on the application of EITF 97-10 would be required if leases will be on the balance sheet;

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Summary of Interview Comments

OTHER KEY ISSUES THAT HAVE NOT BEEN ADDRESSED IN THE EXPOSURE DRAFT (Continued)

- Assigned Leases –Guidance is needed on whether assigned leases should be included in calculations or disclosures;
- Additional Disclosures - Information disclosed on terms could be negative to negotiations with landlords (eliminating competitive advantage). Could there also be legal ramifications?

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Debt-to-Equity Ratio Impact Analysis

Impact on Balance Sheet *(XYZ Corporation)* *(in millions)*

Proposed New FASB

	Before	New Lease Standards Balance Sheet Impact		After	Difference Amount	%Δ
Assets	3,400	*Right-of-use asset*	228	3,628	228	7%
Liabilities	1,400	*Obligation to pay rent' liability*	228	1,628	228	16%
Equity	2,000			2,000	-	0%
Debt / Equity Ratio	0.70			0.81	0.11	16%

Current Credit Rating Agency Adjustment

(in millions)

	Before	New Lease Standards Balance Sheet Impact		After	Difference Amount	%Δ
Assets	3,400	*Right-of-use asset*	296	3,696	296	9%
Liabilities	1,400	*Obligation to pay rent' liability*	296	1,696	296	21%
Equity	2,000			2,000	-	0%
Debt / Equity Ratio	0.70			0.85	0.15	21%

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New FASB vs. Rating agency Estimate

	Rating	FY 2009 Rent Expense	NEW FASB: Estimate of Liability Recognition	NEW FASB: Amount as Multiple of Rent Expense	RATING AGENCY ESTIMATE: Estimated Adjustment	RATING AGENCY ESTIMATE: Amount as Multiple of Rent Expense
		a.	*b.*	*b/a*	*c = a x d*	*d.*
RETAIL						
Pharmacy/Convenience Store	Caa2	962	6,966	7.2x	7,696	8.0x
Dept. Store/Anchor Type	Ba2	916	4,222	4.6x	7,328	8.0x
Shoe Store	Ba3	666	2,029	3.0x	5,328	8.0x
Toy Store	B1	519	3,032	5.8x	4,152	8.0x
Office Supply Store	B2	502	2,279	4.5x	4,016	8.0x
Big Box	Ba3	461	2,534	5.5x	3,688	8.0x
Total/Weighted Average		4,026	21,062	5.2x	32,208	8.0x
AIRLINES						
Airline Company # 1	B2	1512	6,966	4.6x	12,096	8.0x
Airline Company # 2	Caa1	1300	4,222	3.2x	10,400	8.0x
Airline Company # 3	B2	1300	2,029	1.6x	10,400	8.0x
Airline Company # 4	Caa1	1290	3,032	2.4x	10,320	8.0x
Airline Company # 5	B3	885	2,279	2.6x	7,080	8.0x
Airline Company # 6	B1	303	2,534	8.4x	2,424	8.0x
Total/Weighted Average		6,590	21,062	3.2x	52,720	8.0x
SHIPHOLDING COMPANY	Ba2	447	1,549	3.5x	3,576	8.0x
TELECOMMUNICATION W/ RETAIL STORES	Ba2	1800	9,672	5.4x	9,000	5.0x
AUTO MANUFACTURER	B1	800	653	0.8x	4,800	6.0x

	Current	New FASB	%Δ	Rating Agency	%Δ
Dept. Store/Anchor Type - Debt-to-Equity Ratio	1.6	2.1	27%	2.4	48%

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Topics for Recommended Comments

- **Straight-lining of rents using "interest adjusted" approach (like loan amortization), not straight-lining of depreciation**
- **Make clear that operating expenses are NOT "service contracts"**
- **Do not include renewal options in lease term, or, at most 5 years**
- **Do not include contingent rents or cancellation option penalties in lease obligations**
- **No re-measurement unless there is a contractual change**
- **No impairment of "right of use" asset**
- **Change footnote disclosures to match credit ratings agency approach**
- **Change discount rate to an independent standard**
- **Stress that the proposed changes' costs outweigh the benefits…<u>minimize complexity</u>**

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The Future of FAS 13 – Q1 Lessees

Do you agree that:

1. **A lessee should recognize a right-of-use asset and a liability to make lease payments?** *Why or why not? If not, what alternative model would you propose and why?*
2. **A lessee should recognize amortization of the right-of-use asset and interest on the liability to make lease payments**? *Why or why not? If not, what alternative model would you propose and why?*

Comment:

- Yes, lessees should recognize lease liabilities and assets on the balance sheet to provide a more complete and accurate representation of their financial obligations.

- The proposed methodology, however, creates significant “front-ending” of expense, which is exacerbated in longer leases (including option terms). This is distorting, and does not reflect actual financial performance.

- A more accurate representation would be to depreciate the right-of-use asset using an “effective interest” approach similar to that used in loan amortization, whereby the annual total of depreciation and interest remains flat over the term. At the beginning of term, therefore, interest would be proportionately high and depreciation low, which would gradually reverse over the term, ending in a zero balance.

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The Future of FAS 13 – Q6: Contracts that contain service components and lease components

1. **Do you agree with either approach to accounting for leases that contain service and lease components?** *Why or why not? If not, how would you account for contracts that contain both service and lease components and why?*

Comment:

- In so-called "gross" and "modified gross" leases, all or some part of the lessee's operating expenses are included in the initial base rent. Since the amount of such expense is not readily determinable by the lessee without disclosure by the lessor, and since the payment of such expense is part of the lessee's contractual obligation, such base year operating expenses should be included in the calculation of the associated asset and liability.

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

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The Future of FAS 13 - Q8: Lease Term

1. **Do you agree that a lessee or a lessor should determine the lease term as the longest possible term that is more likely than not to occur taking into account the effect of any options to extend or terminate the lease?** *Why or why not? If not, how do you propose that a lessee or a lessor should determine the lease term and why?*

Comment:

- Renewal or extension options in real estate leasing are true options, i.e. the lessee has no contractual obligation to pay unless and until the lessee exercises the option. Typically, the lessee is required to take action within a specified time period in order to exercise its option; if no action is taken, whether intentionally or inadvertently, the option expires and the lessee has no further rights or obligations following expiry of the then-current lease term. These facts taken together militate against inclusion of option terms in the initial calculation of asset and liability amounts: the lessee has no rights or obligations with respect to the option until they are created by an affirmative act at the time of exercise.
    - **In this respect a renewal term is no different than a new lease; therefore a new asset and a new liability should be recorded at the time of exercise.**
- The conditions that influence a lessee's decision whether or not to exercise an option are unknown and unpredictable at the inception of a typical real estate lease, given the time span between inception and exercise, which can often be five years or more. These conditions include changes in the lessee's industry and competitive environment, real estate and financial markets, the lessee's business, marketing, and growth strategies, changes in technology, and so forth.
    - **Given the rate of acceleration of change over the past couple of decades and into the future, any attempt to assess the likelihood of renewal or extension is purely speculative.**

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The Future of FAS 13 - Q8: Lease Term Comments Cont.

- Renewal or extension options in real estate leasing are typically used as a protection from landlord abuses. They are generally not in fact exercised, but serve as a basis for negotiation.
- Rarely, a real estate lease will contain automatic renewal or extension options that do not require any action by the lessee for their exercise. Equally rare in modern practice is the inclusion of such option at bargain rental rates.
  - **Accordingly, and in view of the above, renewal or extension options in real estate leases should not be included in the lease term, unless they are automatic or contain strong financial incentives in favor of exercise.**
- 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.
- A termination option is effectively the converse: the absence of an affirmative act by the lessee results in the continuation of the lease obligation to the end of its term. The same concerns apply regarding the unpredictability of future conditions affecting the decision to exercise, however these are somewhat mitigated by the shorter time (typically less than five years) between inception and exercise. Also note that lessors typically "charge" for early termination rights by requiring higher rents: the willingness of a lessee to pay a higher rate may be taken as an indicator of the lessee's view toward the likelihood of exercise.
  - **An assessment of such likelihood, and the inclusion or exclusion of subsequent term in the calculation of liability, is therefore probably more appropriate in the case of early termination options than renewals or extensions**.

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The Future of FAS 13 - Q9: Lease payments

Do you agree that:

1. **Contingent rentals and expected payments under term option penalties and residual value guarantees that are specified in the lease should be included in the measurement of assets and liabilities arising from a lease using an expected outcome technique?** Why or why not? If not, how do you propose that a lessee or a lessor should account for contingent rentals and expected payments under term option penalties and residual value guarantees and why?
2. **Lessors should only include contingent rentals and expected payments under term option penalties and residual value guarantees in the measurement of the right to receive lease payments if they can be reliably measured?** *Why or why not?*

Comment:

- 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.
- The assumptions needed to quantify such items, for which the amounts are not contractually stated, are highly subjective, requiring speculation about any number of future states, including foreign exchange rates, sales performance (in the case of a retail lease with percentage rents), real estate market conditions, CPI, and so forth. Little is to be gained in terms of accuracy or transparency by their inclusion.
- 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.

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The Future of FAS 13 – Q10: Reassessment

1. **Do you agree that lessees and lessors should remeasure assets and liabilities arising under a lease when changes in facts or circumstances indicate that there is a significant change in the liability to make lease payments or in the right to receive lease payments arising from changes in the lease term or contingent payments (including expected payments under term option penalties and residual value guarantees) since the previous reporting period?** Why or why not? If not, what other basis would you propose for reassessment and why?

Comment:

- As noted above, a number of the provisions to which we take exception entail high degrees of speculation and subjectivity that will result in inevitable and frequent revision.

- The process of reevaluating assumptions across a large portfolio of real estate leases will be labor intensive, difficult to automate, and inherently inaccurate, as the revisions will be subject to the very same degree of speculation as the original assumptions. Either that, or the existing assumptions will be "rubber stamped" as to their continued validity.

- We believe the proposed standard, specifically with respect to these items, will impose substantial costs and administrative burden on lessees, while providing very little incremental benefit to the readers of financial statements.

- Therefore we believe that there should be no re-measurement unless there is a contractual change.

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The Future of FAS 13 - Q15: Disclosure

1. **Do you agree that lessees and lessors should disclose quantitative and qualitative information that:**
   a) Identifies and explains the amounts recognized in the financial statements arising from leases; and
   b) Describes how leases may affect the amount, timing and uncertainty of the entity's future cash flows?

   (paragraphs 70−86 and BC168−BC183)? Why or why not? If not, how would you amend the objectives and why?

Comment:

- Yes, 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.

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The Future of FAS 13 - Q17: Benefits and costs

1. **Paragraphs BC200–BC205 set out the boards' assessment of the costs and benefits of the proposed requirements. Do you agree with the boards' assessment that the benefits of the proposals would outweigh the costs?** Why or why not?

Comment:

- In general, we agree with paragraphs BC200-BC205, in that the proposed standard provides enhanced clarity and accuracy of reporting. With specific regard to options and contingent items *in real estate leases*, we agree strongly with paragraph BC203 to the extent that the proposed changes would result in a tremendous increase in administrative burden and cost for lessees, an effect that would extend well beyond the preparers cited in the paragraph (i.e. retail lessees).

- We disagree with the conclusion in paragraph BC204 to the effect that greater accuracy would be achieved: to the contrary, the multi-year time scale involved in real estate leasing renders speculation about contingencies and renewals essentially valueless.

- The desired benefits of transparency and comparability can be achieved with much less effort and costs, as reflected in the comments herein.

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The Future of FAS 13 - Q18: Do you have any other comments on the proposals?

Comment:

- 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. For example, a highly creditworthy lessee with a low cost of borrowing will book a much larger liability than a lessee with poor credit and high borrowing cost, for exactly the same transaction. It is also worth noting that the borrowing cost of a creditworthy lessee may be significantly below the discount rates used to determine values in the real estate business, leading to a paradox in which the lessee may be required to book an asset that is significantly larger than the market value of the underlying real property. Better to use an independent index, such as "200% of the 10-year Treasury rate", or a rate published by FASB/IASB, or rates commonly prevailing in the real estate sector.

- Additionally, whatever rate is used should not be reassessed during the term of a given lease.

FASB / IASB:

- http://www.fasb.org/cs/ContentServer?c=FASBContent_C&pagename=FASB%2FFASBContent_C%2FProjectUpdatePage&cid=900000011123

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Thank You

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