

The Mechanics of the Changes



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The need for a single global accounting standard is the impetus for the convergence of United States Generally Accepted Accounting Principles and International Financial Reporting Standards. The Financial Accounting Standards Board and the International Accounting Standards Board are also working together to issue joint guidelines on accounting for leases which will likely eliminate operating leases. The underlying premise behind the lease accounting changes is that leasing is really a form of financing, and should be portrayed as such on a lessee's balance sheet. The weight of this new presentation is expected to exceed \$1 trillion for publicly traded companies. The revised standard on accounting for leases is slated for issuance next year, with implementation in 2012 or 2013. Convergence appears to be on a slower track as the Securities and Exchange Commission hasn't really put this issue on its radar. A timeline for GAAP and IFRS convergence will not be determined until sometime in 2011.

This paper, the second of a series of articles on how the proposed lease accounting rules will impact the commercial real estate industry, will present a simple lease example and follow it through the balance sheet presentation and income statement effects. It will also compare the new treatment with the current guidance for the same scenario from a lessee's perspective.

ABC Co. leases 100,000 square feet of office space for 10 years. They will pay \$15 per square foot per year net rent in year one, and rent will increase 2 percent annually. In today's environment the lease qualifies as an operating lease. ABC's incremental rate of borrowing is 8 percent. To further simplify the model, assume one rental payment per year.

Today the only remnant of the lease that would appear on the balance sheet would be the cumulative difference between rent paid and GAAP rent – GAAP requires flattening the rental stream over the life of the lease. Rent expense of \$1,642,458 will be recognized annually and deducted from income in arriving at EBITDA.

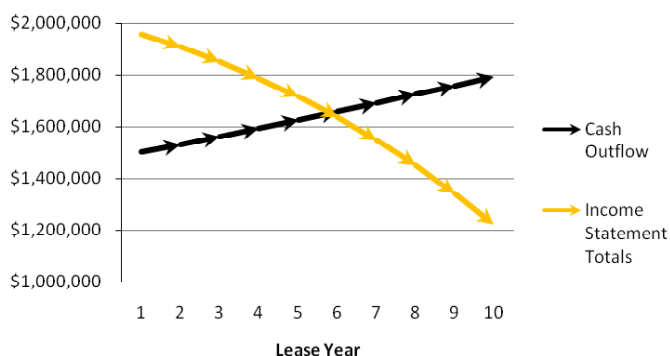
As currently proposed, the revised standard will radically change the presentation and accounting for the same lease. The first and most major change is that the lease will be recognized as a "Right to use" asset and a corresponding "Obligation to pay" liability. At lease inception these will both be valued at the present value of the minimum lease payments discounted at the lessee's incremental rate of borrowing. Applying this to the example above, ABC will record an asset and a liability in connection with the lease of \$10,884,243.

The asset will be amortized evenly over the life of the lease for an annual expense of \$1,088,424. The liability will be treated like a loan with principal and interest components. Like most loans, the interest burden will be greater at its onset than at its conclusion. In this example, ABC’s rent payment of \$1,500,000 in year one will be split into \$870,739 of interest and \$629,261 of principal reduction. In the final year of the lease more than 92 percent, or \$1,659,851, of the rent payment of \$1,792,639, will be used to reduce the liability and only \$132,788 will be recognized as interest. The two income statement expenses differ from today’s rent expense in that they are both added back to income to arrive at EBITDA.

The table below shows the relationship between income statement expense and rent payments under the proposed guidance.

Lease Year	1	10
Amortization Expense +	\$1,088,424	\$1,088,424
Interest Expense =	\$870,739	\$132,788
Total Expense	\$1,959,164	\$1,221,212
Rent Payments	\$1,500,000	\$1,792,639

The graph depicts the cash versus expense flows for the entire 10 year term.



If the lease example contained renewal options, the initial valuation would involve additional steps. ABC Co. would have to contemplate the renewals, based upon contractual, non-contractual and business factors to determine its most likely lease term. This is the term used for calculating the asset and liability

representing the lease. For example, if the lease had two five-year renewal options that would begin at the expiration of the original 10 year term, ABC will need to determine its most likely tenancy, 10, 15 or 20 years, and calculate the asset and liability accordingly.

An additional component of the proposed guidance will be placing all current leases on all lessees’ balance sheets. Current leases will be valued similarly to new leases; this new valuation includes both capital and operating leases. This process will also include the possibility of extending the lease into one or more renewal terms if that is deemed likely. Existing operating leases will NOT be grandfathered and left off the balance sheet.

These changes will elicit myriad questions from corporate occupiers and the commercial real estate industry. For example:

- Will lease accounting changes drive tenants to favor shorter-term leases in order to minimize the balance sheet effect? If so, how will this affect asset-based loans to landlords? Will lenders perceive greater risk and modify loans accordingly? How does this impact the willingness and pricing from landlords to fund relatively high costs of office improvements?
- What will be the effect of the additional debt on lessees’ balance sheets due to the lease accounting changes as it relates to corporate finance? In other words, the additional debt burden brought about as a result of these proposed changes may trip debt covenants in existing corporate finance instruments. How will lenders respond?
- Will tenants attempt to trade shorter lease terms or lower rental rates for self-funded tenant improvements? This will allow a tenant to capitalize TIs as fixed assets and depreciate them over their useful lives rather than the life of the lease. It will also minimize the weight of the lease on the balance sheet.

- What other industry changes might arise out of the new lease accounting rules? For instance, could a company requiring distribution space avoid additional balance sheet debt by using 3PL service contracts that include real estate in lieu of directly leasing distribution space?

There are many unanswered questions regarding the impending changes to lease accounting. Even in the simple example presented in this paper, it's clear to see the material balance sheet impact these changes will bring to companies with significant amounts of leased space. With many companies in precarious financial positions, adding additional debt could be detrimental to lending covenants and/or credit ratings. Understanding the mechanics of the changes and how they will affect companies will put you ahead of those who will simply react.

Anticipating these changes in upcoming transactions will lead to a smoother transition for existing leases once compliance begins.

Grubb & Ellis' Corporate Finance will continue to provide further updates on this evolving topic.

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