CBRE
ENTERPRISE NOTES

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Proposed Changes to Lease Accounting: Let the Redeliberations Begin!

Highlights

- The FASB and IASB received more than 600 comment letters in response to the Revised Exposure Draft on lease accounting.
- Formal redeliberations have started; however, there is no clear consensus at this point regarding any of the major topics.
- It is highly unlikely that retaining current lease accounting or simply requiring additional disclosure in the notes to the financial statements are viable alternatives.
- It appears inevitable that lessees will be required to capitalize leases (except for short-term leases).
- The criteria and methodology for how leases are classified and expensed is still to be determined.
- At the earliest, the final standard could be issued by year-end 2014 with an effective date that would most likely be no sooner than 2018.
- In the interim, it is prudent for companies to assess the impact of the potential changes in: 1) Lease Management; 2) Processes; 3) Systems; and 4) Administration.

On May 16, 2013, the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB), collectively the “Boards,” issued the Revised Exposure Draft (RED) revealing their latest version of the proposed changes to lease accounting. Interested parties were invited to provide comments to the Boards by September 13. To the surprise of many, including some Board members, more than 600 comment letters were received.

In November 2013, the Boards were presented with an overview and summary of the comments/feedback on the RED and in late-January, the Boards held their first formal redeliberation session. The agenda for the session identified three areas for discussion:

1) Lessor Accounting
2) Small-Ticket Leases
3) Lessee Accounting

While the Boards made it clear up-front that no decisions would be made at this meeting, the take away from the four-hour session was that there is still a long way to go in this epic saga and they are far from consensus on any of the main issues. As a result, the earliest the final standard could be issued is by year-end 2014.

Highlights of the January meeting:

1) Although there is no clear agreement on how to move forward at this time, it seems highly unlikely that retaining current lease accounting or simply requiring additional disclosure in the notes to the financial statements are viable alternatives.
2) The Boards are taking seriously the concerns echoed in many comment letters regarding the complexity of the standard and the cost to implement.

For now, the bottom line seems to be that change is inevitable for lessees, with leases ultimately being capitalized on the balance sheet (except for short-term leases). The criteria and methodology for how they are classified and expensed is still up for debate.

Following are a few observations related to the Boards' discussions at the January meeting:

1) **Lessor Accounting** – Discussions centered on whether there should be symmetry between the methodologies for lessee and lessor accounting. There is acknowledgement that lessor accounting is not necessarily broken, so changes in this area may be limited.

2) **Small-Ticket Leases** – The two questions at the heart of the small-ticket lease discussion are what is considered a small-ticket lease and whether exempting "short-term" leases would achieve the intent of exempting "small–ticket" leases. The conversation focused on the application of a materiality test and if this test could be applied at a portfolio level. There was also discussion of whether "non-core assets" could be excluded; however, this was generally dismissed due to the inherent challenges in classifying a core vs. non-core asset. Again, there was no consensus—even on this fairly straight-forward item.

3) **Lessee Accounting** – Three approaches were discussed:

   a. **Approach 1** – Treat all leases as a financing (i.e., Type A leases), with the front-end loaded expense recognition pattern. This is what was proposed in the original 2010 Exposure Draft.

   b. **Approach 2** – Leases would be classified as either Type A or Type B. This is the approach proposed in the RED with some minor modifications. Under this approach, most property leases would be Type B, with a straight-line expense recognition pattern, while most equipment leases would be Type A, with the front-end loaded expense recognition pattern.

   c. **Approach 3** – A dual approach distinguished from Approach 2 in that Type A treatment would be afforded to leases considered capital/finance leases using current ASC 840 (FAS13)/IAS 17 standards, while Type B treatment would be afforded to leases considered operating leases under current accounting standards. In either case, the leases would be capitalized and no distinction would be made between property and non-property leases.

While the goal line is not yet in sight, we do believe there is a high likelihood of an agreement being reached that will require lessees to capitalize leases (except for short-term leases). Therefore, we continue to believe it is prudent for companies to initiate, if they have not already done so, the process of assessing how the proposed changes will impact them in the areas of:

I. Lease Management
II. Processes
III. Systems
IV. Administration

Accordingly, following the conclusion is an excerpt from the CBRE Global ViewPoint entitled "What Companies Should Be Doing Now," which addresses some of the more time-consuming and resource-sensitive issues most companies could face when the final standard is issued.

Conclusion

The Boards have not communicated formal dates; however, at the earliest, the final standard could be issued by the end of 2014 with an effective date that would likely be no sooner than 2018.

While this may seem a long way off, a look-back period will most likely be required for any comparable periods presented in a company's financial statements. For example, if the look-back period is two years with an effective date of January 1, 2018, any leases in-place at any time during 2016 and 2017, including those that expire during this period, will have to be factored into the restatement.

The CBRE Task Force continues to believe, no matter the outcome, when the dust settles, the landscape will look much the same. Leases will still be negotiated with the business' best interests in mind. While capitalization will be one factor in the decision process, we believe the financial merits of the deal will still be the primary driver.

CBRE's Global Task Force will continue to keep you apprised of developments on this important topic. Additional resources on this topic can also be found on CBRE's Lease Accounting website.

What Companies Should be Doing Now

(Excerpt from the CBRE Global Viewpoint)

If new rules are coming (and it appears they most likely are, at least in some form), the next question is what you and your organization should be doing to prepare. The following are our recommendations for what can be addressed well in advance of the effective date of the new standard. We are limiting our recommendations to items that require a long lead time or will likely have lasting value to your organization, regardless of the requirements the Boards establish in the final standard. We have divided our recommendations into four groups:

I. Lease Management
II. Processes
III. Systems
IV. Administration

I. Lease Management

The days of tracking real estate leases on spreadsheets are numbered for companies that follow U.S. GAAP. Many smaller companies do not currently see the need to centralize or standardize the recording process, given the fact that leases are only disclosed in the notes to the financial statements. With the new standard requiring real estate leases be capitalized on the balance sheet, companies will increasingly need to employ robust lease administration systems to ensure the accuracy and consistency of the financial statements.

Most large companies utilize one of many commercially available lease administration systems to both manage and account for their real estate leases. CBRE expects smaller companies that previously did not see the need to centralize and standardize lease accounting will now find it compelling to do so. These smaller companies can choose whether they want to implement these systems in-house with their own personnel or whether they prefer to outsource this task to firms like CBRE or other real estate service providers. Outsourcing of lease administration may be just the first step for these firms as they weigh the potential savings associated with outsourcing additional real estate functions like transaction management, project management, and facilities management.

II. Processes

Many companies do not track all of the data elements that will be required under the proposed new standard and, for those that do, often it is not recorded in a format that can be readily used to address the proposed requirements. For example, while most lease administration teams capture "stated" base rent and notes about variable lease payments (VLPs), such as future Consumer Price Index (CPI) increases, very few input the increases in a format that can be used to compute the present value of the total future rent payments. In fact, many corporations only enter current year rents and update them annually as changes occur. Going forward, all factors included in the calculation of the Right-of-Use (RoU) asset and lease liability need to be tracked in a numerical format.

An area of particular concern for many real estate leases will be commencement dates. Under the new lease accounting standard, the commencement date will be the key date used to trigger the calculations and related recording of assets and liabilities. While this seems fairly straightforward, most commencement dates recorded in lease administration systems are "estimates," since the official commencement date is often: 1) difficult to obtain; 2) requires going back to the landlord for support; and 3) often involves people who are no longer involved with the project once the lease is signed. It is therefore very important for lessees to review their currently recorded commencement dates to ensure accuracy and supportability for audit.

One of the most significant and perhaps unintentional consequences of the new rules will be the inclusion of the chief financial officer (CFO) and their finance team in select high-profile real estate decisions. Historically, corporate users identified space requirements to the real estate department, who, after ensuring the user had the budget available, would fulfill their requirements. Under the new lease accounting rules, it will be critical to establish an effective cross-functional decision-making process and team. The real estate team and the user will still be integral to the decision-making process but, under the new rules, since the CFO is typically viewed as the owner of the company's balance sheet, he or she and their team will likely need to be incorporated into the process for each significant deal. We believe it is imperative to develop and document the processes for these additional interfaces well in advance to avoid any barriers to future transactions once the new requirements come into play.

While Executory Costs (i.e., operating expenses) can be excluded from the calculation of the RoU asset, Initial Direct Costs (i.e., costs directly attributable to negotiating and arranging a lease that would not have been incurred without entering into the lease) will be required to be included in the determination of the RoU asset. Unfortunately, many companies do not have processes or systems in place to readily access this information. We believe it is prudent to begin developing processes around both the future capture of these items and the accumulation of past information.

III. Systems

Every company should evaluate their Information Technology (IT) systems that will play a role in the new lease accounting rules to determine:

1. If their current systems are capable of capturing the new required data;
2. If their current accounting system will integrate with their lease administration system to support the numerous entries that will be required; and
3. If the company's internal controls are strong enough to mitigate the risks of incomplete or inaccurate lease accounting calculations.

This last item is complicated since we don't know the degree to which auditors will focus on this area; however, since these new standards will likely have a significant impact on most balance sheets and be a key factor in the debt covenants of many companies, it is safe to assume the auditors will spend a significant amount of effort in this area.

Under current lease accounting treatment, the primary accounting-related items required from the lease administration function and their related systems are the adjustments necessary for the straight-lining of rents and the future minimum lease payments disclosed in the notes to the financial statements. However, under the new requirements, it will likely be imperative that this information be housed in a fairly sophisticated database. It is not impossible to manage these requirements using a spreadsheet as many companies do now; however, it will be very difficult to provide all of the documentation that auditors will most likely require to support the modifications to the balance sheet.

Going forward, there will be a need to support what could be the largest asset on the balance sheet of many corporations, the aggregation of RoU assets. Additionally, challenges in the process will be further magnified when companies are forced to address future lease-related activity that could lead to future reassessments and modifications of the RoU assets and liabilities, including new leases, terminated leases, changes in estimated values and assessments, changes in inflation rates, changes in the determination of a "significant economic incentive," and changes resulting from overall business planning. Most companies with real estate portfolios of any significant size will require a very sophisticated system to track these items.

IV. Administration

Many organizations do not have their lease documents centrally managed and accessible. Under the proposed requirements, it will be important that all documents are readily available and, in some cases, translated into the company's primary language. It will no longer be acceptable for accounting/ financial reporting teams to focus on "material" documents, while relying on field or country-level controllers to support all other items. Going forward, auditors will likely require a sample testing of leases. Therefore, it is important that processes are formalized in order to provide a level of assurance to the auditors, hopefully avoiding the more costly alternative of auditors physically reviewing a significant number of the leases to gain confidence in the companies' internal controls.

While many companies have already done so, if your company has not already developed a high-level estimate of the impact of the proposed requirements on your balance sheet and related financial ratios, we highly recommend doing so now. While it is generally accepted that a company's performance will be the same the day after implementation of the new standard as it was the day before, it is important for the company to know where it stands relative to its peer group. For example, if your company's main competitor's balance sheet is not impacted significantly by the changes to lease accounting because they own all of their real estate, while your company is heavily impacted since you lease most of your real estate, your ratios and financial measurements could be negatively impacted. This could result in market confusion regarding your company due to the newly visible differences in the balance sheets. Along these lines, if you haven't already done so, you should initiate discussions with any debt holders to eliminate any potential surprises that may arise as a result of the changes. Lenders will likely appreciate a proactive approach to modifying debt covenants in advance of the accounting changes, rather than having to issue covenant waivers later to avoid default.

For more information, please contact:

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