



## REVISED EXPOSURE DRAFT ON LEASE ACCOUNTING ISSUED: BACK ON THE FRONT BURNER

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On May 16, the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB), collectively the “Boards,” issued the long-awaited Revised Exposure Draft for the “Leases” project. Just shy of three years after issuing the Original Exposure Draft in August 2010, the Revised Exposure Draft represents the culmination of the Boards’ deliberations after receiving nearly 800 comment letters and holding numerous joint working group meetings, public roundtables, workshops, webcasts, and other outreach activities. (Note: While the FASB and IASB have each released their own version, they are nearly identical in their proposed requirements).

The objective of the Boards’ Leases project is to “develop a new approach to lease accounting that would require assets and liabilities arising from leases” be recorded on a company’s balance sheet to provide greater transparency to users of financial statements. This is a significant departure from the “off balance sheet” treatment for the majority of leases under current accounting rules. Based on an economic impact study commissioned by the U.S.

Chamber of Commerce, The Real Estate Roundtable, BOMA and others, it has been estimated if the new lease accounting standard is implemented, the balance sheets of U.S. publicly traded companies could increase by \$1.5 trillion with real estate leases accounting for \$1.1 trillion.

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In the Original Exposure Draft issued in 2010, the Boards proposed a Right-of-Use (RoU) model be applied to all leases in order to accomplish their objective. The RoU model requires a lessee to record an asset on its balance sheet representing its right to use the underlying asset for a specified period of time, while at the same time recording a corresponding liability representing a lessee’s obligation to make future rent payments. This approach continues with the Revised Exposure Draft.

However, as reported by the CBRE Global Task Force on Lease Accounting (“Task Force”), the Boards have gradually, and somewhat begrudgingly, changed their original positions relative to several areas of particular interest to the commercial real estate industry. Whether the approach now espoused in the Revised Exposure Draft achieves the Boards’ objective of providing greater transparency to the users of financial statements is certainly up for debate, especially when considering the inherent complexity and

administrative burden associated in complying with the proposed requirements.

The Task Force has developed this white paper and companion [Frequently Asked Questions](#) document to assist both lessees and lessors in understanding the latest proposal by the Boards. Our goal is to provide guidance on what steps companies need to take to prepare themselves for the upcoming changes, and to propose strategic considerations in light of the Revised Exposure Draft.

## I. REVIEW AND IN-DEPTH DISCUSSION OF KEY TOPICS

### LESSEE PERSPECTIVE

#### Capitalization of Leases

Under existing lease accounting guidelines, leases are classified as either operating or capital/finance leases, with the majority of real estate leases classified as operating leases. Operating leases are “off balance sheet,” which means they are not recorded on a company’s balance sheet. They are simply disclosed in aggregate in the notes to the financial statements.

Consistent with the Original Exposure Draft, the Revised Exposure Draft continues to require **ALL** leases be capitalized or “on balance sheet.” This mandate includes **ALL** types of leases, including property (defined as “land and/or a building or part of a building”), equipment, airplanes, automobiles, copy machines, and a multitude of others. This will apply to ALL leases in existence on the effective date of the new standard. No leases will be grandfathered. The only exceptions to this requirement are for short-term leases, which are defined as those leases with a maximum possible lease term of 12 months, including options to renew, as well as certain other non-real estate related exceptions.

The amounts recorded on the balance sheet as the RoU asset and lease liability are determined by calculating the present value of the lease payments to be made over the lease term. A critical component of the present value calculation is the discount rate applied to the future

lease payments. In cases where the interest rate being charged by the lessor is unknown, which will be the case in most real estate leases, a lessee is to use their “incremental borrowing rate” at the lease commencement date as the discount rate.

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#### Incremental Borrowing Rate:

“The rate of interest that a lessee would have to pay to borrow over a similar term, and with a similar security, the funds necessary to obtain an asset of a similar value to the right-of-use asset in a similar economic environment.”

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This rate will naturally vary between companies based upon financial capacity, credit-worthiness, existing debt levels and other factors. The greater the discount rate, the lower the present value and the smaller the asset and liability recorded on a company’s balance sheet. Ironically, everything else being equal, the balance sheet of a company with weak credit will be impacted less than that of a company with strong credit, as the use of a higher discount rate will result in a smaller RoU asset and liability on its balance sheet. While in another ironic twist, leases determined to be Type B leases pursuant to the Revised Exposure Draft (leases of “Property” accounted for in a straight-line manner similar to today’s operating leases) will have the same net impact on a company’s income statement no matter what discount rate is applied. The end result will be that a company with stronger credit will experience a greater increase in the assets and liabilities on its balance sheet than a company with weaker credit, while the impact to its bottom line will be the same. (Note: The new lease types and the nuances of each are discussed in depth in a later section).

For nonpublic entities, the FASB has made one exception to the use of the incremental borrowing rate. The exception, which is for “practical expediency” purposes and applies only to companies that follow U.S. Generally Accepted Accounting Principles (GAAP), allows nonpublic entities to make an accounting policy

election to use a “risk-free discount rate” for a period comparable to the lease term. This implies the use of the rate for a U.S. Treasury Note with a maturity equal to that of the lease term. Ironically once again, the end result of this “simpler” approach will be a greater RoU asset and liability being recorded on the balance sheet as a lower discount rate will be used in most cases than a company’s credit-standing would suggest.

There is one small bright spot regarding the discount rate. The Revised Exposure Draft notes the discount rate only has to be reassessed when there is a change in the lease term or a change impacting a lessee’s “significant economic incentive” to exercise an option to purchase the underlying asset (Note: Further discussion on “significant economic incentive” to follow).

As referenced previously, short-term leases can be excluded from the requirements of the Revised Exposure Draft.

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### Short-term lease

*“A lease that, at the commencement date, has a maximum possible term under the contract, including any options to extend, of 12 months or less.”*

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As an accounting policy, a lessee is provided the option whether or not to elect to capitalize short-term leases. If they choose not to capitalize short-term leases, an expense will be recognized on a straight-line basis over the lease term consistent with current operating lease treatment. If it is decided to capitalize short-term leases, the lessee must adhere to the guidance as put forth for leases in the Revised Exposure Draft. Any lease containing a purchase option cannot be a short-term lease.

Some real estate leases may be on a month-to-month (MTM) basis. In these instances, the noncancellable period of the lease must be determined, which is the period of time for which a lease is considered enforceable. The Revised Exposure Draft notes a lease “is no longer enforceable when both the lessee and the lessor each have the right to terminate the lease without permission

from the other party with no more than an insignificant penalty”. This seems to indicate a typical MTM real estate lease, which can generally only be renewed with the agreement of both parties, would qualify as a short-term lease. If, however, a MTM lease can be renewed at the sole discretion of the lessee, the lease should be capitalized since the lease term could be extended for more than 12 months.

### Lease Term and Renewal/Termination Options

It is encouraging to know the Boards paid attention to the widespread criticism of the definition of a lease term in the Original Exposure Draft. As initially proposed, the Boards defined the lease term to include any “more likely than not to occur options to extend or terminate.”

This subjective language posed significant issues, ranging from what is the definition of “more likely than not” (i.e., a 50% or greater chance of being exercised) to how a lessee, with any degree of certainty, could assess whether they were going to exercise renewal options upon commencement of the original lease term. In our opinion, and that of many others, this definition was unrealistic, did not truly reflect the appropriate contractual obligation and would have resulted in significant ambiguity in the final determination of the amount capitalized.

Fortunately, the Boards realized their original language was too onerous, as they have now revised the definition of the lease term to the following:

*“The noncancellable period for which a lessee has the right to use an underlying asset, together with both of the following:*

- a. Periods covered by an option to extend the lease if the lessee has a significant economic incentive to exercise that option.*
- b. Periods covered by an option to terminate the lease if the lessee has a significant economic incentive not to exercise that option.”*

While this definition is still challenging at first glance, the bottom line is the “more likely than not” criteria has now been replaced by a new term in accounting vernacular,

“significant economic incentive.” This phraseology, although similarly subjective, presents a much higher threshold for requiring the inclusion of option periods as part of the lease term. The Board’s have noted that applying the concept of “significant economic incentive” will provide a threshold similar to the current lease accounting concept of “reasonably assured/certain.”

The Boards have attempted to provide guidance relative to making the determination as to whether a significant economic incentive exists by stating:

*“At the commencement date, an entity assesses whether the lessee has a significant economic incentive to exercise, or not to exercise, an option by considering all factors relevant to that assessment—contract-based, asset-based, market-based, and entity-based factors. An entity’s assessment will often require the consideration of a combination of those factors because they are interrelated.”*

The Boards provided the following examples of relevant factors to be considered:

1. The dollar amount of the lease payments in the option period.
2. The terms and conditions of any options that are exercisable after the initial option periods (i.e., the existence of an option to purchase at a below market rate).
3. Significant leasehold improvements expected to have significant economic value to the lessee.
4. Costs relating to the termination of the lease and the signing of a new lease, including negotiation costs, relocation costs, etc.
5. The importance of the underlying asset to the lessee’s operations.

The Boards have at least provided a slight break to the commercial real estate industry as they have stated “a change in market-based factors (such as market rates to lease a comparable asset) should not, in isolation, trigger reassessment.” So, a lessee’s option to renew at a below market rate will not by itself require the option period to be included as part of the lease term.

As with the “more likely than not” threshold of the Original Exposure Draft, the newly proposed “significant economic incentive” threshold will pose its own challenges and administrative burdens. This is especially the case for those companies with a large number of leases as they will continually need to reassess whether they have, or do not have, a significant economic incentive to exercise, or not to exercise, an option upon a change in any relevant factors.

It is apparent, given the subjective nature of the new definition of a lease term, that a company will be best served to address this aspect of the proposed requirement up front with its auditors. Once a methodology is conceptually agreed upon, it should be applied consistently to all applicable leases.

### Lease Classification

In the Original Exposure Draft, the Boards proposed a single methodology for the accounting treatment applied to ALL leases, as it was the Boards’ contention that all leases represent a form of financing. This methodology resulted in a front-end-loaded expense pattern, akin to today’s capital/finance leases. In other words, the annual expense associated with a lease will be greater in the early years of the lease and lower in the later years.

After hearing from a multitude of stakeholders about the financial implications of this methodology and the inequity of applying one methodology to all leases, the Boards finally acknowledged that not all leases are created equal – a point argued by CBRE in our 2010 comment letter. The

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proposed solution, now detailed in the Revised Exposure Draft and originally agreed to in concept by the Boards last summer, represents a dual approach for lessee accounting. This approach affirms the Boards' realization and acknowledgement that not all leases are a form of financing.

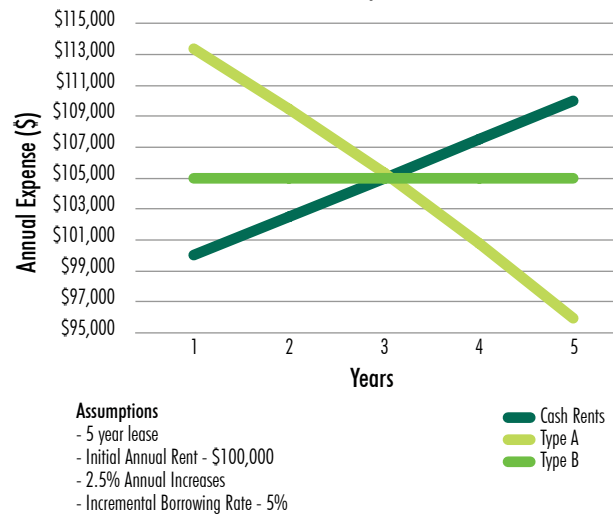
The Revised Exposure Draft now requires a lease to be classified, on the lease commencement date, as either a Type A or a Type B lease, each with its own expense recognition methodology. The determination of whether a lease is a Type A or a Type B lease will be based upon whether the "lessee is expected to consume more than an insignificant portion of the economic benefits embedded in the underlying asset." However, rather than relying on this subjective metric for the initial hurdle, the Boards have stated as a practical matter of expediency the classification of a lease will be driven by the nature of the underlying asset.

Fortunately for the real estate industry, the Boards have stated in the Revised Exposure Draft that leases of "Property" (i.e., "land or a building; or part of a building; or both") are presumed to be Type B leases. Type B leases will follow an expense recognition pattern similar to the current accounting treatment for operating leases (i.e. straight-line expense pattern), unless it is determined:

1. The lease term is for the major part of the remaining economic life of the underlying asset, or
2. The present value of the fixed lease payments accounts for substantially all of the fair value of the underlying asset at the commencement date.

If either of these two conditions exists, a lease is considered to be a form of financing, which will require the lease be classified as a Type A lease. Type A leases will have the front-end loaded expense recognition pattern similar to that proposed in the Original Exposure Draft (Equipment leases are generally presumed to be Type A leases, but in some cases may be classified as Type B leases).

Cash Rent vs Type A vs Type B Lessee Example



It is important to note that once a lease is classified at the lease commencement date, the classification is not to be reassessed.

For companies following International Financial Reporting Standards (IFRS) accounting requirements, these two criteria are similar to portions of the current IAS (International Accounting Standard) 17 criteria, the international accounting standard for leases. For companies in the U.S. complying with U.S. GAAP, these criteria should also have a familiar ring as they are very similar to two of the four tests currently applied in determining if a lease is a capital lease. The only components missing are the percentages associated with the language. These percentages are what the FASB considers "bright lines," which have allowed for a lease to be financially structured in a certain manner to avoid being treated as a capital lease. The proposed changes to lease accounting intentionally eliminates these bright lines for U.S. companies with the intent that leases will now be classified based on substance over form.

As a refresher for those who follow U.S. GAAP, there are currently four criteria for classifying a lease in FASB Accounting Standards Codification (ASC) 840 (previously known as FAS 13). If a lease meets one or more of the criteria, it is considered a capital lease (i.e., recorded on the balance sheet). The four criteria are as follows:

1. The lease transfers ownership of the property to the lessee by the end of the lease term.
2. The lease contains a bargain purchase option.
3. The lease term is **equal to 75% or more** of the estimated economic life of the property.
4. The present value of the minimum lease payments **equals or exceeds 90%** of the fair value of the property.

As (3) and (4) appear that they will continue to be key components of the proposed changes to lease accounting, sans the percentages, it does not take a significant leap of logic to presume the bright line metrics will still serve as an implicit guide in the U.S. in determining whether a lease is Type A or Type B.

As only a small percentage of today's real estate leases are classified as capital/finance leases, it is reasonable to assume most Property leases will be classified as Type B leases. The exception could be leases of single-tenant buildings with extremely long lease terms, as they may have issues with the present value test or the economic life test in the event of an older property. Again, going forward the test will be more substance versus form and, as a result, the judgment applied should be reviewed and understood with a company's auditors well in advance with, perhaps, a need for a corporate accounting policy for consistent application and auditor signoff.

### Initial Measurement of Lease Liability

Whether a lease is classified as Type A or Type B, the measurement of the initial liability to be recorded on the balance sheet is the same. This includes determining the present value of the following using the lessee's incremental borrowing rate (assuming the rate implicit in the lease is unknown):

1. Fixed payments to be made over the lease term, including payments to be made in any option periods if the lessee has a significant economic incentive to exercise an option to renew or not to exercise an

### U.S. HAS DIFFERENT ATTITUDE TOWARD ACCOUNTING RULES

"Leslie Seidman, outgoing chairwoman of the Financial Accounting Standards Board, provides insight into the reason the U.S. is increasingly diverging from international accounting practices. 'We Americans like our rules,' not principles, she says. Regarding proposed changes to the lease-accounting standard, Seidman said, 'It was not surprising to me that the letters we received over the course of this project from U.S. stakeholders said we need more guidance and more examples, whereas the letters from people in the rest of the world said that we have gone too far and we should have a more principles-based standard with not so many examples and not so much guidance.'"

Source: Wall Street Journal, June 2013

option to terminate the lease (Note: Exclude any lease payments made at lease commencement)

2. Variable lease payments that depend upon an index or rate, including CPI increases (Discussion to follow)

Once the present value of the above is determined, the lessee is to deduct any lease incentives receivable from the lessor, if applicable. The resulting figure is recorded on the lessee's balance sheet as the initial liability.

Lease incentives are costs paid by the lessor as an inducement to sign a lease and includes such items as tenant improvement allowances, moving costs, etc. Under current accounting requirements, lease incentives are amortized over the lease term on a straight line basis and are an offset to rent expense. For accounting purposes, free rent is technically not considered a lease incentive.

### Initial Measurement of the Right-of-Use Asset

As with the lease liability, the measurement of the initial RoU asset is the same no matter the lease type. The determination of the RoU asset includes the following:



1. The initial amount of the lease liability.
2. Any lease payments made to the lessor at or before the lease commencement date, less any lease incentives received from the lessor.
3. Plus any initial direct costs incurred by the lessee (Discussion to follow).

The result will be recorded on the lessee's balance sheet as the initial RoU asset.

### Subsequent Measurement of Type A Leases

It is the subsequent measurement of the two lease types where differences occur relative to both the balance sheet impact and expense recognition pattern.

As referenced previously, Type A leases will follow what is essentially the same approach proposed in the Original Exposure Draft, which considers a lease a form of financing and results in the front-end-loaded expense pattern caused by the use of the Effective Interest Method (i.e., interest expense declines over the term of the lease in the same manner the interest component of a traditional mortgage payment declines over time). In addition to the initial measurement of the RoU asset and the liability as previously reviewed, lessees of Type A leases will be required to do the following:

1. Subsequently measure the liability to make lease payments using the Effective Interest Method. In layman's terms, this means the lease payment will be split between the interest expense associated with the liability for the period (i.e., initial incremental borrowing rate x outstanding balance of the liability) and a reduction in the balance of the outstanding lease liability.
2. Amortize the RoU asset on a straight-line basis over the lease term.
3. Recognize both interest expense and amortization expense separately in the income statement.

As rent expense for Type A leases will be replaced with interest and amortization expense, a company's earnings

before interest, taxes, depreciation and amortization (EBITDA) will increase as both interest and amortization expense fall below EBITDA on a company's income statement.

When considering the impact of a stand-alone Type A lease, a company will experience an increase in EBITDA in the early years of a lease, while net income and earnings per share (if applicable) are negatively impacted due to the front-end-loaded expense pattern. Of course, this impact is "smoothed" to some extent once a company begins to layer in the numerous leases in its portfolio with varying commencement and expiration dates.

### Subsequent Measurement of Type B Leases

The Type B classification and its corresponding methodology "treats lease contracts as paying for access to, and use of, the underlying asset over time." In contrast to the methodology for Type A leases, this approach does not consider a lease a form of financing. In addition to the initial measurement of the RoU asset and the liability as previously reviewed, lessees of Type B leases will be required to do the following:

1. Similar to Type A leases, subsequently measure the liability to make lease payments using the Effective Interest Method.
2. "Recognize a single lease cost, combining the unwinding of the discount on the lease liability with the amortization of the right-of-use asset, on a straight-line basis." In other words, a lessee will record a lease expense on a straight-line basis over the lease term.
3. The amortization of the RoU asset will be a "balancing figure" that will generally increase each year. When added to the "unwinding of the discount rate" that generally declines over time, a straight-line expense will be achieved.
4. Recognize lease expense as one amount in the income statement (Note: There will be no interest expense or amortization expense associated with Type B leases). As with current accounting requirements, this expense

will continue to be included in the determination of a company's EBITDA.

From a profit and loss perspective, the net impact of Type B leases on a company's EBITDA and net income will be similar to today's operating leases.

The outstanding liability throughout the lease term will be the same whether a lease is classified as a Type A or a Type B lease. This is a result of both lease types following the Effective Interest Method.

One additional item worth noting relative to Type B leases is that the balances of the RoU asset and the corresponding liability will be reduced in lock-step over the term of the lease (i.e., the RoU asset and the liability will generally equal each other at each reporting period) assuming there are no initial direct costs. However, **this will only be the case if there are no rent increases and/or free rent during the lease term.** In cases where a lease has rent increases and/or free rent, the RoU asset and liability will only be equal at the commencement date of the lease (assuming there are no initial direct costs) and at the expiration of the lease term when both will have a zero balance.

### Percentage/Contingent Rent

The Original Exposure Draft required lessees with percentage/turnover rent clauses to use an "expected outcome approach" to estimate future sales volume for each "reasonably possible outcome" to determine, on a weighted average and present value basis, the estimated percentage rent to be paid over the lease term, including any "more likely than not" renewal options. The end result of this complex calculation was to then be added to the RoU asset and liability.

Once again, the Boards felt the wrath of various stakeholders on this topic, especially retailers, and were barraged with disapproving comments about the subjectivity and administrative burden this requirement would place on lessees. Thankfully, the Boards took the criticism to heart, as this requirement is not a part of the Revised Exposure

Draft. This is a positive development for the real estate industry.

However, the Boards are aware companies may try to take advantage of this decision and financially engineer a lease to avoid capitalization. As a result, any leases structured where the payments are in-substance fixed-lease payments, but are structured as variable-lease payments will come under further scrutiny. Any portion of the payments deemed to be fixed-lease payments must be capitalized. Although, it appears that lease payments driven purely by sales/turnover, without a minimum requirement or other complicating factors, could be excluded from the capitalization requirement. This may require further clarification from the Boards.

While the percentage rent quagmire has been averted, the Revised Exposure Draft requires the RoU asset and lease liability to include "Variable Lease Payments" (VLPs) that depend on an index or rate (such as increases tied to the Consumer Price Index (CPI)). This will require the RoU asset and liability to be reassessed at each reporting date utilizing an updated CPI. This requirement by itself places an incredible administrative burden on any company with a significant number of leases with CPI clauses.

### Executory Costs/Operating Expenses

Executory costs (i.e., operating expenses) can be excluded from the capitalization calculation. This means for any type of lease other than a triple-net lease (i.e., the lessee pays a specific amount for rent and an additional amount for expenses), a lessee will want to segregate the monthly rental payment into an amount paid for rent and an amount paid to reimburse the lessor for operating expenses. The amount capitalized should only include the amount directly associated with renting the specific space identified in the lease.

While this may be a relatively straightforward process for most leases, other leases such as "full service gross leases" (i.e., the landlord pays for all expenses and the payment by the tenant is a lump sum amount that includes both an amount attributed to rent and an amount attributed to the



reimbursement of operating expenses) may prove more of a challenge. If confronted with this situation, a lessee's first option would most likely be to request the lessor to provide the requisite operating expense information. If this proves unsuccessful, then reliance on third-party market reports, such as those prepared by CBRE or other real estate service providers, that include estimated operating expenses for similar type buildings could potentially be used to segregate the amount paid between that associated with rent and the reimbursement of operating expenses. This procedure should be discussed with and agreed to ahead of time by a company's auditors.

✓ We believe most companies will find bifurcation of the rent payment (separating out the operating expense component of the rent) an endeavor worth undertaking.

It should be pointed out that a company is not required to separate out the operating expense component of the rent payment. However, if gross rent payments are used for capitalization, the RoU asset and lease liability will be artificially inflated. We believe most companies will find bifurcation of the rent payment an endeavor worth undertaking.

### Initial Direct Costs

The Revised Exposure Draft requires any "initial direct costs" be capitalized by adding them to the balance of the lessee's RoU asset. Initial direct costs are those directly attributable to negotiating and arranging a lease that would not have been incurred without entering into the lease. For example, this could include, but is not limited to, costs associated with preparing and processing lease documents, evaluating and recording guarantees, space planning, and leasing commissions paid by the lessee.

### Sale/Leaseback Transactions

One item unchanged from the Original Exposure Draft is the proposed accounting treatment for sale/leaseback transactions. For companies following U.S. GAAP, this is one of the few bright spots for the real estate industry and one that brings U.S. GAAP further in line with current IFRS.

While current U.S. GAAP requires immediate recognition of a loss associated with a sale/leaseback and the amortization of any gain over the lease term, the proposed accounting treatment in the Revised Exposure Draft allows for the immediate recognition of both a gain and loss from a sale/leaseback.

However, to garner this treatment the transaction must meet the requirements for satisfying a performance obligation, and thereby be accounted for as an asset sale, in accordance with the Accounting Standards Update on Revenue Recognition, which will reportedly be finalized later this summer. Indications are

that the threshold for meeting the requirements of a sale will be less stringent than that currently in place for real estate transactions.

One of the key considerations for determining whether the requirements for a sale have been met will be if the leaseback provides the seller/lessee (i.e., transferor) with the "ability to direct the use of and obtain substantially all of the remaining benefits from the asset." If so, then the buyer/lessor (i.e., transferee) is not deemed to obtain control of the asset and therefore the transfer is not a sale.

The seller/lessee is "considered to have the ability to direct the use of and obtain substantially all of the remaining benefits from the asset, if either of the following occurs:

- a. The lease term is for the major part of the remaining economic life of the asset, or
- b. The present value of the lease payments accounts for substantially all of the fair value of the asset."

If the transaction is in fact considered a sale, the seller/lessee will "derecognize" the underlying asset (i.e., remove the asset from the balance sheet) and capitalize the new lease in accordance with the requirements of the Revised Exposure Draft.

## LESSOR PERSPECTIVE

As it relates to lessor accounting, the Boards also evolved from their initial methodology put forth in the Original Exposure Draft. Consistent with lessee accounting, the Boards now outline two approaches in the Revised Exposure Draft for lessor accounting. As with the lessee proposal, the lessor options for lease accounting are described as follows:

1. The Type A approach, where a lease is essentially treated as a financing arrangement.
2. The Type B approach, where the accounting generally follows current operating lease treatment.

It should be noted that for those companies following IFRS, if a lease is for a property that meets the definition of an investment property (i.e., the property is held to earn rentals or for capital appreciation (or both), versus owner-occupied) the Revised Exposure Draft proposes that the lessor must adopt the requirements of International Accounting Standard (IAS) 40, Investment Property.

### Lease Classification

To determine the appropriate methodology to apply, a lessor first determines if the lease includes a purchase option with a significant economic incentive for the lessee to exercise. While the Boards did provide some high-level examples of the topics that should be considered in making the determination of the existence of a “significant economic incentive to exercise,” the specifics around this definition are still somewhat unclear. However, the Boards did note the determination should include consideration of...

*“all factors relevant to that assessment – contract-based, asset-based, market-based and entity-based factors.”*

If a significant economic incentive to exercise the purchase option does exist, the lease is treated as a Type A lease by the lessor and the relevant term and payment streams are adjusted to assume the option is exercised. If not, the lessor must next determine if the underlying asset meets

the definition of “property”. If so, the lease is presumed to be a Type B lease and is treated similar to an operating lease under current accounting requirements. However, if it is determined one or both of the following criteria are met, the lease must be accounted for as a Type A lease:

1. The lease term is for a major portion of the asset’s remaining economic life, or
2. The present value of the lease payments accounts for substantially all of the assets fair value.

If the lease is not for “property,” the lessor needs to determine whether the lessee acquires and/or consumes “more than an insignificant portion of” the leased asset. The Boards have decided that a lease of non-property assets is presumed to be a Type A lease unless one of the following criteria is met:

1. The lease term is determined to be for an insignificant portion of the asset’s remaining economic life, or
2. The present value of the lease payments accounts for only an insignificant portion of the fair value of the underlying asset.

If either of these two preceding criteria are met the lease would then be classified as a Type B lease.

### Type A Leases

For Type A leases, the lessor essentially follows an approach based on the concept that the lessor has sold a portion of the underlying asset to the lessee and is thus required to do the following:

1. Derecognize (i.e., remove) the underlying asset from their balance sheet.
2. Recognize a lease receivable measured as the present value of the lease payments discounted using the rate the lessor charges the lessee. The lease receivable will be subsequently measured at amortized cost applying an Effective Interest Method.

3. Recognize profit or loss on the transaction related to that portion of the underlying asset that is effectively being sold.
4. Recognize a gross residual asset (in order to reflect the lessor's right to receive the return of the asset at lease completion), equal to the present value of the future expected gross residual value of the leased asset at the end of the lease term discounted at the rate that the lessor charges the lessee.
5. Subsequently measure the gross residual asset by accreting to the estimated residual value at the end of the lease term using the rate the lessor charges the lessee.
6. The lessor would not recognize any of the unearned profit (that portion of profit related to the residual asset) in profit or loss until the residual asset is sold or re-leased, is determined to be impaired or until there is a reassessment that impacts the residual value of the asset.
7. Present the gross residual asset less the unearned profit together as a net residual asset.

Needless to say, the Type A approach is complex and will pose a particular challenge for lessors with a significant number of Type A leases, which, fortunately for the real estate industry, will primarily be lessors of assets other than "Property."

### **Type B Leases**

For Type B leases, the lessor will:

1. Continue to recognize the underlying leased asset on their balance sheet.
2. Recognize lease income using the straight-line method.
3. Recognize depreciation expense for the underlying leased asset.

### **Subleases**

The Boards define a sublease as a transaction in which the underlying asset is re-leased by the original lessee (who will then become the sublessor) to a third party while the original lease remains in effect. In this situation, the original lessee/sublessor will retain the original RoU asset and liability on their balance sheet, and will be required to account for the sublease using the appropriate lessor methodology. When classifying a sublease, a company is to evaluate the sublease with reference to the underlying asset. This means in the case of a sublease of real estate (i.e., "property"), the sublease would in most circumstances be considered a Type B lease and accounted for using current operating lease accounting treatment. Type A treatment would only be triggered if either of the two criteria discussed previously are met.

## **II. WHAT COMPANIES SHOULD BE DOING NOW**

If new rules are coming (and it appears they 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 should 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:

- Lease Management
- Processes
- Systems
- Administration

### **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.

### 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 VLPs, such as future 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 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.

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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.

As discussed previously, Executory Costs (i.e., operating expenses) can be excluded from the calculation of the RoU asset, but Initial Direct Costs 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.

## 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.

## 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

✓ 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.

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 and result in the market unfairly punishing 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.

✓ Tenants should request from landlords the expense-related component of their rent during lease negotiations.

### III. STRATEGIC CONSIDERATIONS TO ADDRESS IN ADVANCE OF THE ISSUANCE OF THE FINAL STANDARD

At first glance, the thought of capitalizing all leases—whether for a company's headquarters or for the copier on the fifth floor—seems like it will necessitate a change in corporate strategy. However, once the initial shock of capitalization wears off, CBRE does not believe it will have a significant impact on real estate transactions. At the margins, deals may be structured differently, but the vast majority of real estate leasing should emerge unscathed.

#### Lease Versus Own Decision

The proposed changes to lease accounting will alter the "lease versus own" strategy for a company...or will they? While accounting treatment has always been a consideration in real estate transactions, it has rarely been the driver. The main objective was, and will continue to be, the efficient use of capital. For core single-tenant assets, there may be a higher likelihood of ownership once the new standard becomes effective. This is especially true for entities with stellar credit, because a company's cost of capital may be considerably lower than the landlord's projected yield on the lease. Under today's ASC 840 (previously FAS

13) and IAS 17 rules, a trade-off in the "lease versus own" dilemma means giving up residual benefits for off-balance sheet treatment. The new guidelines eliminate this dilemma.

The global financial collapse of a few years ago made corporations cautious. Firms are doing more with less and creating stockpiles of cash. For most, this cash is not earning a real return, making real estate investment a wise option to consider. Couple this with historically low interest rates, owning core real estate assets may prove beneficial. Plus, the opportunity for monetization down the road remains.

Today, and under the new standard, most corporate real estate needs are being met by leasing, not owning. The thought that "occupied space will be on the balance

sheet, so why not own?" seems simple and logical on the surface. However, while some companies might find ownership more compelling for core assets they fully occupy, condominiumizing and re-condominiumizing (as it is known in the U.S.) multi-tenant buildings could prove burdensome and costly and may outweigh any benefits a tenant may perceive from taking an ownership position in a multi-tenant building.

#### Occupier Strategies

The new guidelines create additional scenarios for tenants to consider when pricing leases. Because the new standard makes navigating around the capital-lease pylons in ASC 840 and IAS 17 for off balance sheet treatment somewhat obsolete, tenants may consider revisiting forgone strategies, such as bargain renewal and purchase options. However, it should be noted that employing a bargain renewal or purchase option, which implies a significant economic incentive may exist to exercise the option, could result in a lease being classified as a Type A lease with the front-end-loaded expense pattern. In the case of a bargain purchase option, the purchase price must also be included in the amount to be capitalized, and the RoU



asset must be amortized over the useful life of the underlying asset. The impact of this must be weighed against the potential benefits.

Many lessees enter into gross or full-service leases, where the payment includes rent for the space as well as operating expenses and taxes associated with the property. In these cases, as previously discussed, the gross rent payments need to be segregated, and only the net rent portion capitalized. Any expense-related component included in the gross payment will be accounted for as a current operating expense. As such, tenants should request this information from landlords in their lease negotiations. CBRE research teams around the globe compile this data on a regular basis and can provide estimates if landlords do not.

The proposed lease accounting standard will motivate companies to establish processes and controls to ensure real estate facilities acquired are consistent with overall corporate objectives. CBRE expects the balance sheet impact of leases will now be under the watchful eye of corporate finance departments, adding an additional voice to real estate transactions. Leasing will have a larger role within corporations; transactions will more closely resemble capital expenditures. No company wants to miss its return-on-assets metric thanks to an ill-timed early renewal and extension.

Real estate related occupancy costs associated with new hires are part of a company's budget process. The balance sheet effects of new space will become part of this process as well. For example, the difference in the capitalization between a 5- and a 10-year lease will be weighed. CBRE believes the new standard may encourage more companies to fund tenant improvements (TIs) in order to capture the spread between its corporate cost of funds and the interest rate embedded in the lease. Self-funded TIs, and those incorporated into a lease will be accounted for differently on a company's books.

Firms may create new internal measures to ensure that lease transactions bypass certain aspects of the new

standard. For example, as previously discussed, a fairly common feature in the U.S. is to tie rent increases to an index like the CPI. CBRE believes this practice will wane under the new standard because basing rent bumps on an ever-moving target, like CPI, will place an increased administrative burden on the lessee. This is because the new standard requires any lease containing CPI-based rent increases be reassessed at each reporting period using an updated CPI. CPI rent increases are not often used by companies that report under IFRS.

Under the new guidelines, companies will likely request more alternatives from a landlord when contemplating a lease. Pricing for multiple terms, like 5, 10, and 15 years, with varying TI packages and several renewal options will give a tenant a matrix of scenarios from which to choose. This process will produce varying capitalization results. These differing amounts will be a factor in selecting the best term and TI combination, but probably not the sole determining factor. The need for firms, like CBRE, to assist clients in analyzing their options and find the sweet spot—where the lease economics and the company's cost of and best use of capital intersect—will increase.

### **Monetization Strategies**

Sale/leasebacks have always been an effective vehicle to liberate capital locked in an illiquid asset. The new guidelines will not change this. The determination of whether a sale has occurred will be in accordance with the Accounting Update on Revenue Recognition. This is a broader definition than currently employed by U.S. GAAP, but a tightening of scope for those following IFRS.

What will change is the elimination of one hurdle in the process. Currently under U.S. GAAP, any gain on the sale of an asset is recognized ratably over the leaseback term; the same is true under IFRS if the leaseback is a financing lease. The new rules view a sale/leaseback as two distinct transactions, and call for any gain or loss to be recognized immediately. This may spur some companies to undertake a sale/leaseback. On the other hand, some firms look positively on spreading the gain over the leaseback term. They believe that if the entire gain is recognized at

once, rating analysts may eliminate it from their analysis. However, if the gain is spread over the leaseback term, it becomes a consistent source of income and is more likely to be used in computing critical financial metrics.

Another monetization alternative that may gain momentum as a result of the proposed changes in lease accounting is on-balance sheet lease financing. This is an intra-company structure allowing for monetization of an asset while still maintaining ownership and control. If an entity enjoys investment-grade credit, the economics are compelling. Utilizing a credit-based financing instrument like a Credit Tenant Loan (CTL), the high-credit entity becomes the lessee, a sub-entity takes on the role of lessor, and a lease is created between the two parties. Unlike traditional mortgage financing which uses the “bricks and mortar” as the basis for financing, a CTL monetizes the cash flow from the lease, which can be greater than the value of the building. The result is the company extracts money from a non-income producing asset while maintaining control and ownership.

### Other Considerations

EBITDA is a commonly used financial performance metric. Its weight can be felt throughout a company. Bonuses may be earned upon reaching an EBITDA target, many bank instruments feature EBITDA-based metrics, and it is often used as the starting point in valuing a business. As proposed in the Revised Exposure Draft, any leases classified as Type A leases will increase EBITDA when compared to today’s operating lease expense recognition because neither interest nor amortization is included in its calculation. This differs from leases classified as Type B leases, where the lease expense is above the line and will be deducted from income to arrive at EBITDA. Some companies may wish to recast their EBITDA targets once the impact of the new standard is quantified.

✓ The new standard’s impact on a company’s balance sheet should be communicated to its lenders, credit analysts, and Wall Street prior to implementation.

Another metric impacted by the changes will be earnings per share (EPS). Type B leases will have virtually the same effect on EPS as operating leases do today. Type A leases, however, will result in a greater reduction to EPS in the early stages of the lease term and a lesser impact toward the end of the term, thanks to the front-end-loaded expense pattern. Over the life of the lease, however, the total expense recognized will equal the lease payments.

A question many firms will be pondering is whether the capitalization of leases will alter access to and/or pricing of debt. If the addition of leases to a balance sheet deteriorates metrics a bank may use to compute debt

capacity or pricing (i.e., return on assets, debt to equity and debt coverage ratio), the implementation of the new standard may sting a little more. On the other hand, a company’s credit rating should weather the changes because the rating agencies usually take the current year rent expense from the notes to the financial statements and, using a multiplier, add an estimated lease liability to the balance sheet to arrive at a rating.

Interestingly, a managing director in Moody’s Investors Service spoke out against the proposed changes at a conference in May 2013, saying he does not believe putting leases on the balance sheet will satisfy many users of financial statements. He added that he would not mind seeing the entire proposal go away.

Companies will need to run financial models and prepare sensitivity analyses on existing leases to preliminarily assess the impact of the proposed changes. The new standard’s potential impact on a company’s balance sheet should then be communicated to its lenders, credit analysts, and Wall Street prior to implementation.

### IV. CONCLUSION

As with the Original Exposure Draft, **the Boards have provided a 120-day comment period, which ends**

**September 13, 2013.** During this period, we encourage any interested party to provide a comment letter to the Boards ([comment letter instructions](#)). These comment letters should address those portions of the Revised Exposure Draft you disagree with, and, equally as important, express your support for those sections you agree with as it is important the Boards do not regress on this topic and re-introduce requirements the real estate industry has fought so valiantly against over the past few years (e.g., accelerated expense recognition, inclusion of percentage/turnover rent, a lower threshold for the inclusion of option periods, etc.). As the seven-member FASB board voted 4-3 in support of issuing the Revised Exposure Draft, they are still a house divided, with some members desiring an approach more closely resembling the Original Exposure Draft. Additionally, the equipment leasing industry is pressuring the Boards as they are staunchly opposed to the Type A classification for most equipment leases.

Once the comment period has ended and the Boards have completed their outreach activities, they will resume deliberations on this topic. While no formal date has been communicated by the Boards, the final standard could be issued in mid- to late-2014 at the earliest. The effective date for the new standard is estimated to be no sooner than 2017 or 2018, as the Boards are sensitive to the amount of time it will take companies to prepare for this significant change. While this seems a long ways off, it is important to note a look-back period will be required for any comparable periods presented in a company's financial statements using either a full or modified retrospective approach. In the case of most publicly held companies, the look-back period will be for two years. For example, if the effective date is for calendar year 2017, any leases in place at any time during 2015 and 2016, including those that expire during this period, will have to be factored into the restatement.

In conclusion, changes to lease accounting will impact the balance sheets of lessees and a brighter spotlight will be placed on corporate real estate executives and real estate transactions. However, when the dust settles, the

### MITIGATING LEASE ACCOUNTING RISK WITH...WORKPLACE STRATEGY?

Companies' needs for real estate are not going to vanish with capitalization requirements, but they will add scrutiny to current leases, as well as future transactions. One method to lessen the blow of implementing the new leasing guidelines is to "right-size" a company's real estate portfolio. Are there blocks of space acquired in a merger that are no longer needed? Can some personnel situated downtown perform just as well in less expensive suburban space? May workplace strategy techniques be employed at the next renewal to reduce square footage? These and many other questions will be asked as real estate departments find themselves in a more integral role within corporations.

landscape is expected to look much the same. Leases will still be negotiated with the business' best interest in mind; capitalization will be a factor, but not the driving one.

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