



An Avison Young White Paper

FASB planning sweeping changes to GAAP rules

An in-depth analysis of what the new standards will mean for your business and how companies can prepare

EXECUTIVE SUMMARY

As the convergence of Generally Accepted Accounting Principles (GAAP) and International Financial Reporting Standards (IFRS) progresses, U.S. companies need to be prepared to implement the converged standards upon issuance. Convergence was determined to be necessary and, in many respects, a requirement due to the globalization of the capital markets and increasing stakeholder concerns over the current lack of convergent standards. Additionally, the G20¹ reinforced this urgency by calling on standard setters – including the Financial Accounting Standards Board (FASB) and International Accounting Standards Board (IASB) – to work urgently with supervisors and regulators, including the U.S. Securities and Exchange Commission (SEC), on improving current standards. Andy Corsini, KPMG's National Real Estate Audit Sector Leader, says, "While the details and timing of convergence are still unclear, we believe that change in some form is inevitable. The results may impact companies' financial ratios, loan covenants, EBITDA and reporting processes. Early preparation and planning are required for corporations to determine the effects of these changes."

To keep our clients apprised of the convergence efforts, Avison Young will provide periodic reports on the status of these sweeping changes and provide in-depth analysis of the effect the convergence will have on current financial standards and what the new standards will mean for your business.

OVERVIEW

In November 2009, the FASB and IASB (collectively, the Boards) agreed to redouble their efforts to complete the active convergence projects described in their Memorandum of Understanding (MoU) by June 2011 and also committed to provide regular updates of their progress against the MoU. This aggressive timeline would have led to an unprecedented number of new accounting pronouncements being issued and would have required extraordinary efforts to complete on schedule. In addition, significant constraints would have been placed on stakeholders' personnel, information systems, and perhaps more broadly may have led to confusion in the capital markets as stakeholders sought to interpret, evaluate, and understand what changed and how those changes affect their companies and clients.

The response to such concerns, combined with continued deliberation on certain projects resulted in the Boards developing a modified strategy in June 2010 that enabled them to focus on improving the aspects of GAAP and IFRS that, in their judgment, require the most improvement. The modified strategy enables broad-based and effective stakeholder participation in the Boards' due process to issue high-quality standards for their high priority projects, which include:

- Financial instruments
- Revenue recognition
- Leases
- Presentation of other comprehensive income
- Fair value measurement

¹"G20" refers to the Group of Twenty Finance Ministers and Central Bank Governors, which was established in 1999 to bring together systematically important industrialized and developing economies to discuss key issues in the global economy.

While the target completion date for these projects remains June 2011 or earlier, it is consistent with the Boards' original timeline and will encompass the issuance of exposure drafts in 2010. The modified strategy shifts the targeted completion date for several other projects (e.g., consolidation and discontinued operations) until after June 2011 and establishes the Boards' commitment to issue no more than four significant or complex exposure drafts per quarter and a separate consultation document to seek input about effective dates and transition methods. Perhaps more significantly, the modified strategy acknowledges that many of the joint projects may not result in fully convergent standards. However, the SEC has indicated that the release of the modified strategy will not alter their plans related to its evaluation of whether or not to incorporate IFRS into the financial reporting system for U.S. public companies, which is most profoundly exhibited through the SEC's August 2010 request to public companies to provide comments on three of the six topics related to its work plan².

IMPACT ON LEASE ACCOUNTING

The joint project on leases, which is intended to address the complexities associated with lease accounting under both GAAP and IFRS and off-balance sheet treatment by lessees, will have the most significant implications for the real estate industry – it is not “just another FASB/IASB exposure draft”. The Boards originally released their views in a Discussion Paper entitled *Leases: Preliminary Views* in March 2009, and formalized those views in an exposure draft issued on August 17, 2010 with comments due from constituents on December 15th, 2010 with a final standard to be issued in 2011. Although, at this point, Avison Young is in the process of interpreting the provisions of the recently released exposure draft, included in the forthcoming sections of this document is an overview of the guidance along with what the changes mean.

The exposure draft proposes a single “right-of-use” lessee model for all leases that would eliminate off-balance-sheet accounting and require most leases to receive similar accounting treatment – classifying a lease as operating versus capital will be a thing of the past. The proposed approach (i.e., the “right-of-use model”) would require a lessee to recognize an asset that represents the lessee's right to use the lease property, and a liability, which represents the lessee's obligation to pay rentals for the use of the property. The initial lease obligation would be measured based on estimates of the lease term, contingent rentals, and residual value guarantees, using the lessee's incremental borrowing rate to discount future payments to present value. The right-of-use asset would be amortized over the shorter of its useful life or the lease term and lease payments would be allocated to interest expense and a reduction

of the lease obligation using the effective interest method rather than be recognized as rent expense under the straight-line method.

The exposure draft proposes two models for lessors, each to be used in different circumstances depending on the terms of the lease and their effect on the lessor.

The first model, the performance obligation approach, would be used when the lessor retains exposure to significant risks or benefits associated with the leased asset and results in an accounting treatment that is essentially symmetrical to that of the lessee. Pursuant to this model, the lessor would recognize a lease receivable and a corresponding lease liability in an amount that is the same as the lease receivable. The lessor would continue to recognize the leased asset and related depreciation expense. In addition, it would amortize its lease liability and recognize revenue over the lease term with lease payments received being allocated between interest income and a reduction of the lease receivable using the effective interest method.

The second model, the derecognition approach, would be used when the lessor is not exposed to significant risks or benefits associated with the leased asset. Under this approach, the lessor effectively “sells” a portion of the leased asset and recognizes a net profit (or loss) at lease commencement equal to the difference between the present value of the lease payments and the carrying amount of the portion of the leased asset that is derecognized. Over the lease term, the lessor also recognizes interest income using the effective interest method.

WHAT THIS MEANS FOR YOU

Although the timing of the effective date of the new leases standard is unknown, the changes that would be required based on the exposure draft issued would have broad implications and apply to all companies. According to Andy Corsini, KPMG's National Real Estate Audit Sector Leader, “the implications extend beyond the preparation of financial statements, as the new leases standard will have significant implications on the way companies do business, structure transactions, communicate expectations to the capital markets and negotiate loan covenants.” While the extent of impact on an individual company would, of course, vary depending on the extent of a company's lease transactions, these implications may include, but are not limited to, the following:

- *Changes and refinements to financial reporting processes* – Certain provisions of the new leases standard would require significant judgments and estimates to be made by management, which will

²The work plan is designed to help the SEC determine whether, and if so, how and when, IFRS should be incorporated. The SEC is seeking input about investors' understanding of IFRS, its implications for public companies' contractual arrangements and corporate governance, and the implications for certain aspects of the regulatory environment including statutory dividend and stock repurchase restrictions, which are issues that focus on how and when to incorporate IFRS into the U.S. financial reporting system.

require changes and refinements to be made to companies quarterly and annual financial reporting processes. Such estimates may include determining the longest possible lease term that is more likely than not to occur based on lease options, whether a purchase option is more likely than not to be exercised, and the expected amount of lease payments to be received, which includes contingent rentals.

- *Changes in lease administration process* – The new leasing standard will require all active leases to be accounted for under the new leasing standard; that is, there will be no grandfathering clause for existing leases. This provision will require extraordinary efforts and will place significant constraints on companies’ personnel and information systems.
- *Changes in historical business practices* – In light of the requirement to record the financial reporting effects of all leases on a company’s balance sheet, business practices of lessees will likely change. Such changes may involve negotiation of shorter lease terms in order to minimize the effects on an entity’s purported financial position. Alternatively, given that operating leases will be “on balance sheet”, companies may elect to own their facilities rather than leasing them as they may have historically.
- *Changes in financial metrics* – Accounting for leases pursuant to the guidance in the exposure draft will impact corporate financial performance metrics such as return on equity and return on assets. Accordingly, alternative profitability measures, as well as leverage, operating efficiency, and liquidity, will likely be developed in order to appropriately portray the financial condition, operational efficiency, and profitability of an enterprise in a fashion that most closely resembles the underlying economics of a business.
- *Impact on Capital Markets* – With shorter-term leases likely to be required by lessees, real estate capitalization rates may be driven higher given exposure to lease rollover will become more pronounced, which consequently could have a ripple effect on mortgage finance rates and reversionary capitalization rates. As a result, predicting the future cash flows of properties with short-term lease terms will become more complex as the forecast period extends further into the future.
- *Increased coordination* – The changes to historical lease accounting that would occur as a result of the new leases standard will require increased coordination between all functions of an entity. Given the significance of the judgments and estimates that will need to be made as well as changes in business practices, coordination between all levels of an organization should not be underestimated.

HOW TO PREPARE — WHAT YOU CAN DO NOW

In light of the implications described above and many others, sitting on the sidelines until the final standard is issued is the wrong way to go – companies should begin the discussion and preparation process today. Components of this process may include:

- *Creating an internal adoption team* – Companies should consider creating an internal adoption team to increase their awareness of the new lease standard and how the provisions of the standard will impact their organization. The team should share the results of their analysis with all levels and functions within the organization in order to enhance the effectiveness and efficiency with which the new standard is adopted once issued.
- *Lease Administration* – The new standard will require lessees to estimate their lease term and periodically assess that estimate taking renewal, expansion and purchase options into account. It will become imperative for companies to properly administer their real estate portfolios. Those companies with an administration system in place will need to modify the system and those that don’t will need to put one in place, not only to track the size, rental obligations and options of their properties but also to track lease term estimates.
- *Seek assistance from business advisors* – There is no question that the new leases standard will place constraints on companies’ personnel. Accordingly, companies should consider reaching out to their business advisors to obtain assistance with not only obtaining an understanding of the new standard and what it means but also with reviewing existing leases to determine the appropriate accounting under the new standard.
- *Discuss the effects of the adoption with all stakeholders* – The financial reporting changes that will result from the adoption of the new leases standard will lead to changes in companies’ purported financial position, results of operations, and cash flows. Accordingly companies should begin discussing these effects with all stakeholders, which include, but are not limited to, lenders, investors, shareholders and analysts. Keeping them informed will mitigate the risk of inappropriate conclusions being drawn.

Although the effective date of the new leases standard, as well as the other high priority projects, may not occur until after 2011, the Boards’ agenda remains extremely ambitious and the fact remains that there still will be significant new accounting pronouncements issued in the near term and the need for active stakeholder participation cannot be underestimated. Avison Young will monitor the convergence efforts as they further progress and will continue to keep you informed of the timeline, process, and changes that may result.



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