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An Avison Young White Paper

MAY 2017

The Big Change to the Lease Accounting Standards

New rules will significantly impact a company's enterprise value unless firms act now

Executive Summary

Public and private companies will face significant balance sheet and P&L impacts once new U.S. and international financial reporting standards concerning leases are fully implemented by 2019. Although they seem a long way off, these new standards already threaten to catch many companies unaware. Furthermore, companies could suffer significant enterprise value impacts if they do not act before the new rules take effect.

Leases will need to be capitalized

The Financial Accounting Standards Board (FASB) new lease standard will take effect for fiscal years, and interim periods within those fiscal years, beginning December 15, 2018 for the following:

1. A public business entity;
2. A not-for-profit entity that has issued, or is a conduit bond obligor for, securities that are traded, listed, or quoted on an exchange or an over-the-counter market;
3. An employee benefit plan that files financial statements with the U.S. Securities and Exchange Commission (SEC). [1]

For all other organizations, the new lease standard will take effect for fiscal years, and same-year interim periods, beginning after December 15, 2019.

The effective date for the International Accounting Standards Board (IASB) will be January 1, 2019. A company can choose to apply IFRS 16 before that date but only if it applies to IFRS 15 *Revenue from Contracts with Customers.* [2] This will apply to all companies that report their financial results under IFRS (International Financial Reporting Standards). IFRS 16 *Leases* will provide guidance for companies with headquarters outside the U.S. and for U.S. companies with international locations to account for leases on their financial statements.

Both the FASB and IASB standards will require leases with a maximum term longer than one year to be capitalized on a company's balance sheet. With the exception of leases with maximum terms of less than 12 months, no leases will be grandfathered in, so the impact will be immediate and, in many cases, material to financial statements.

A lease will create a right-of-use asset and a lease liability on the balance sheet, which are primarily derived from the net base rent charges in the lease term, plus any renewal or termination options that may be exercised because of economic incentives or strategic necessity. The difference between the new right-of-use asset and the lease liability will have a meaningful impact on shareholder equity.

[1] Financial Accounting Standard Board (FASB), *Accounting Standards Update No. 2016-02 Leases (Topic 842)*, February 2016, p.7.

[2] IFRS. Effects Analysis: IFRS 16 Leases. IFRS, January 2016, p.3

Lease Classification

Under the IASB's standard, all leases will be classified as a finance lease. Under FASB's standard, there will be operating and finance leases. Operating leases are recorded on the income statement as straight-line rent expenses – similar to today's operating lease model, but nonetheless capitalized onto the balance sheet. Finance leases are similar to the current capital lease model. The following factors will trigger a finance classification under the FASB rules: [3]

a. The lessor transfers ownership of the underlying asset to the lessee by the end of the lease term;

b. The lease grants the lessee an option to purchase the underlying asset, and the lessee is likely to exercise that option;

c. The lease term is for the major part of the remaining economic life of the underlying asset. However, if the commencement date falls at or near the end of the economic life of the underlying asset, this criterion shall not be used for purposes of classifying the lease;

d. The present value of the sum of the lease payments and any lessee residual value guarantee not reflected in the lease payments are equal to or, exceed, "substantially all" of the underlying asset's fair value; and,

e. The underlying asset is expected to have no alternative use to the lessor at the end of the lease term.

New lease classifications will have real impacts on financial statements, influencing everything from cash flow presentation, balance sheet metrics, net income and earnings before interest taxes, depreciation and amortization (EBITDA). Below are examples that demonstrate how the new rules will affect financial statements.

- A finance lease will be categorized as a financing activity on the statement of cash flows whereas operating lease payments are recorded under operating activities.
- The liability for a finance lease will be classified as debt, having a detrimental impact on a company's debt-to-equity ratio and threatening loan covenants.
- Shareholder equity will take more of a hit from a *finance*, versus *operating*, classification because the asset – also known as the aforementioned right-of-use asset – will be amortized differently than an operating lease on the income statement.
- For finance leases, expense reported on the income statement will include a combination of amortization of the right-of-use asset and front-loaded interest expense assessed against the outstanding lease liability.

These impacts translate into big changes to balance sheet metrics like debt-to-equity ratios or return on assets metrics [4] and will also have a significant impact on net income and EBITDA. This case will be especially true for finance leases.

Operating leases, in contrast, result in straight-line rent expense being reflected on the income statement – a method that most companies deploy today when recording leases.

Lease Structure

Under the new rules, a gross lease will trigger the inclusion of operating expenses on the balance sheet. As a result of this change, companies that are focused on EBITDA may find gross leases classified as finance leases to be more advantageous. Finance leases allow taxes and insurance to flow through the income statement as interest and amortization – instead of selling, general and administrative (SG&A) expenses. In contrast, companies concerned about the balance-sheet implication of a lease classification will prefer operating leases because of their limited impact on shareholder equity.

Operating expenses are often included in rent payments, but will need to be segregated from gross rental costs for purposes of calculating the asset and liability associated with any lease, while property tax and insurance costs in a gross lease – which may be part of an aggregate operating expense value – will have to be included in the capitalization calculation after the effective date of the new standards. Failing to bifurcate service components from "rent," or entering into gross leases as opposed to net leases, will result in the balance sheet being materially and unnecessarily overstated.

Under the new standards, FASB and IASB have provided guidance for renewal and termination options within a lease. "An entity shall determine the lease term as the non–cancelable period of the lease, together with all of the following:

a. Periods covered by an option to extend the lease if the lessee is reasonably certain to exercise that option;

b. Periods covered by an option to terminate the lease if the lessee is reasonably certain not to exercise that option;

c. Periods covered by an option to extend (or not to terminate) the lease in which exercise of the option is controlled by the lessor. [5]

[3] Financial Accounting Standards Board (FASB), *Accounting Standards Update No. 2016-02 Lease (Topic 842)*, 842-10-25-2, February 2016, p. 30-31.

[4] PWC, *The Overhaul of Lease Accounting: Catalyst for Change in Corporate Real Estate*, PWC, April 2016, p.4.

[5] Financial Accounting Standards Board (FASB), *Accounting Standards Update No. 2016-02 Lease (Topic 842),* 842-10-30-1, February 2016, p.34.

If it is reasonably certain that a significant economic incentive exists, then the renewal periods will go on the balance sheet as if they were exercised. A 10-year lease with a five-year renewal option may be considered a 15-year lease on the balance sheet. The first consideration will be whether the presence of discounts and penalties are significant to the lessee. If so, then they will have a significant economic incentive to exercise the options. However, tenants can define "significant" for themselves, but this practice must be reasonable and consistent. Secondly, if tenants make space alterations and improvements that will continue to have a useful life beyond the initial lease term, then they may have an incentive to exercise their renewal options. Finally, if a facility has a strategic value, such as being a highly profitable flagship location, then it would likely qualify as a significant incentive to exercise the renewal option.

The sale-leaseback transaction has been dramatically changed under the new lease accounting standards. "Different accounting outcomes can exist depending on the structure of the transaction. In addition, the accounting treatment can be complex." [6]

Under the new lease accounting standards – both for GAAP and IFRS – the linkage between the sale and the leaseback is effectively eliminated. The "leaseback" after the sale will be required to go on the balance sheet, eliminating a previous form of off-balance-sheet financing for many companies. U.S. companies that compile their financial statements under generally accepted accounting principles (GAAP) must avoid the "finance" classification or no sale will be recognized. Instead, the transaction will be accounted for as a form of financing. Another clause that can nullify a sale-leaseback is the existence of an option to purchase the building – even at "fair market value" – in the future. Currently, one of the primary benefits of a sale-leaseback is to defer the capital gains or losses over the term of the lease. Once the new standards take effect, 100% of any gain, or loss, will be booked on the sale date. The elimination of the deferral of gains or losses will completely alter the P&L profile of the "leaseback" and may render the deal untenable from earnings-per-share (EPS) and EBITDA perspectives.

The End of Sale-Lease Back

SLB today	SLB after new rules
"Leaseback" is off balance sheet	***Leaseback*** is on balance sheet
Capital gain IS deferred, straight line, over lease back period	***Capital gain*** is NOT deferred - all recognized on date of sale
Deferral of capital gain serves to (1) eliminate one-time spike in earnings, and (2) cushion the increase in the P&L "run rate" from low depreciation expense vs. higher rent expense under leaseback	Lack of ***deferral*** means major increase in "run rate" on P&L

842-40-25-4 If the transfer of the asset is a sale in accordance with paragraphs 842-40-25-1 through 25-3, both of the following apply:
a. The seller-lessee shall:

1. Recognize the transaction price for the sale at the point in time the buyer-lessor obtains control of the asset in accordance with paragraph 606-10-25-30 in accordance with the guidance on determining the transaction price in paragraphs 606-10-32-2 through 32-27
2. Derecognize the carrying amount of the **underlying asset**
3. Account for the lease in accordance with Subtopic 842-20.

b. The buyer-lessor shall account for the purchase in accordance with other Topics and for the lease in accordance with Subtopic 842-30.

> Transfer of the Asset Is Not a Sale

842-40-25-5 If the transfer of the asset is not a sale in accordance with paragraphs 842-40-25-1 through 25-3, both of the following apply:
a. The seller-lessee shall not derecognize the transferred asset and shall account for any amounts received as a financial liability in accordance with other Topics.

b. The buyer-lessor shall not recognize the transferred asset and shall account for the amounts paid as a receivable in accordance with other Topics. [7]

[6] PWC, *Leases* 2016, Section 6.1, PWC, March 31, 2016.

[7] Financial Accounting Standards Board (FASB), *Accounting Standards Update No. 2016-02 Lease (Topic 842)*, 842-10-30-1, February 2016, p.148.

When FASB and IASB were close to finalizing the rules, the organizations were reminded that existing subleases – at least those where the sublessor recognized a loss on the sublease – were already impacting the balance sheet of the sublessor. As a result, bringing the underlying lease onto the balance sheet would effectively result in two liabilities for the same obligation. FASB and IASB revised the proposed standards late in the process to account for new and existing subleases. The result of that change is that leases that have previously been subleased will reappear on the balance sheet and income statement of the sublessor. The new sublease accounting rules will look nothing like current sublease accounting requirements, which are already fairly complex, causing even more challenges when the time comes to adopt the new standards.

> Subleases

842-40-25-1 If the nature of a **sublease** is such that the original **lessee** is not relieved of the primary obligation under the original **lease**, the original lessee (as sublessor) shall continue to account for the original lease in one of the following ways:

a. If the sublease is classified as an **operating lease**, the original lessee shall continue to account for the original lease as it did before commencement of the sublease. If the lease cost for the term of the sublease exceeds the anticipated sublease income for that same period, the original lessee shall treat that circumstance as an indicator that the carrying amount of the **right-of-use asset** associated with the original lease may not be recoverable in accordance with paragraph 360-10-35- 21.

b. If the original lease is classified as a **finance lease** and the sublease is classified as a **sales-type lease** or a **direct financing lease**, the original lessee shall derecognize the original right-of-use asset in accordance with paragraph 842-30-40-1 and continue to account for the original **lease liability** as it did before commencement of the sublease. The original lessee shall evaluate its investment in the sublease for impairment in accordance with paragraph 842-30-35-3.

c. If the original lease is classified as an operating lease and the sublease is classified as a sales-type lease or a direct financing lease, the original lessee shall derecognize the original right-of-use asset in accordance with paragraph 842-30-40-1 and, from the sublease **commencement date**, account for the original lease liability in accordance with paragraphs 842-20-35-1 through 35-2. The original lease shall evaluate its investment in the sublease for impairment in accordance with paragraph 842-30-35-3. [8]

Companies still not prepared for new rules

The new lease accounting rules were debated publicly and within FASB and IASB for more than nine years, and that lengthy process lulled companies into a false sense of security. Many chief financial officers took an I'll-believe-them-when-I-see-them approach to the standards, which was understandable after the rules seemed stuck in limbo for so long. When the rules were finally approved, many companies were in the throes of dealing with the new revenue recognition standards that take effect in 2018. For many companies, preparing for the new lease accounting changes has not been a top priority.

The deadline of January 2019 remains set. Public companies that have yet to turn their attention toward this issue should consider that they will have comparative reporting in their 2019 financial statements that would reflect 2017 and 2018, and the window is quickly closing for them to invest the time and resources required to understand and mitigate the impact of the new rules. Also, companies subject to SEC reporting requirements would be wise to remember that the SEC requires public companies to disclose

[8] Financial Accounting Standard Board (FASB), *Accounting Standards Update No. 2016-02 Lease (Topic 842),* 842-10-30-1, February 2016, p.147.

the impact of new accounting standards that have been issued – but not yet adopted – before those rules go into effect.

One of the biggest obstacles to readiness is the availability of information about existing leases. Many rent payment components are not tracked under existing accounting standards. The new lease accounting standards will add complexity to the already time-consuming process of reviewing lease structures and expenses. Many companies with legacy lease administration software are finding that they cannot use these applications to run lease accounting analysis under the new standards. Consequently, firms are either re-abstracting lease data or finding ways to blend that data with other reporting data in order to move forward. For many chief financial officers, this situation has become a major compliance obstacle.

How to Mitigate the Impact of New Lease Accounting Rules

Re–examine the terms of existing leases before the new standards take effect

Understand how the changes will impact financial statements

Start planning now

New rules equal a strategic opportunity

The rules are both a scourge and a potential blessing. Chief financial officers will have to invest considerable time and resources into complying with the new standards, but the upside is a chance to better understand how lease obligations truly impact the bottom line. There is a tremendous strategic opportunity for companies to improve financial performance if they scrutinize their leases – especially those that are being negotiated, or will be soon.

The longer companies wait to get started, the more difficult compliance becomes. Wishful thinkers may be hoping that FASB and IASB will delay the compliance deadline, but there is no indication that will happen. Strategic planners, however, are looking for ways to adjust their leases and use the information that they are generating to improve performance. Those planners that choose the latter approach are more likely to be prepared and position their companies to thrive under the new rules.

Immediate action required

The following actions when structuring and negotiating a real estate lease can protect or improve the enterprise value of a company:

1. Complete a strategic review and analysis of existing leases under the new lease accounting standards;
2. Understand and manage impacts on the financial statements BEFORE the lease is signed; and,
3. Start now – hire an expert.

Conclusion

Many U.S. and international companies are not adequately prepared for the forthcoming new FASB and IASB lease reporting standards. The new lease classifications will have real impacts on financial statements, ultimately affecting EBITDA and enterprise value. Companies need to prepare for the impacts beforehand and obtain expert advice.

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