Demystifying the Proposed Lease Accounting Changes

December 1, 2011
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You have heard about them. Perhaps you have sat in a seminar and heard them decried with near-hysteria as heralding Armageddon for the real estate industry. Or you have half-slept through a Power Point presentation with unreadable graphs and a droning accountant "explaining" them. You might even be one of the few who actually find them interesting. More likely, you secretly hope that they will all just go away.

But whatever your reaction, this much is true: They are coming. "They" are the proposed changes to the lease accounting rules. And regardless of whether you are a CPA, someone who uses an HP 12c every day or someone who still has nightmares about high school calculus, you need to know something about them and what they will mean for commercial real estate.

The Basics

Before we can talk about changes to lease accounting, we need to understand the basics as it currently stands. The first thing to understand is that when accountants talk about leases, they are talking about both real estate leases and equipment leases. In fact, there are far more equipment leases in the world than there are real estate leases, though in total rent paid, the real estate leases outstrip the equipment leases.

Under current GAAP rules, leases fall into two categories: operating leases and capital leases. Most plain-vanilla real estate leases, where the tenant leases part of an office building or a store in a shopping center for a few years, are currently classified as operating leases. Leases that begin to look more like a purchase — many equipment leases, sale-leasebacks, long term ground leases, etc. — are classified as capital leases. Currently, operating leases do not appear on the balance sheet, and the income (profit/loss) statement simply shows the average rent as an expense, in an equal amount for each year of the lease term (a horizontal line over time). Capital leases, on the other hand, are treated more like a purchase. They do appear on the balance sheet, with the asset being the right to use the item/space in question (often set at the full market value of the item, if the underlying transaction really is very similar to a purchase) and the corresponding liability being the net present value (NPV) of the full rent stream over the term of the lease. Capital leases also appear on the income statement, but instead of showing as a horizontal line, they are treated more like a mortgage, with level amortization plus (imputed) interest on the unamortized balance, which leads to an overall downhill line (since, like a mortgage, there will be more interest in the early years and less in later years). Of course, the actual cash flow in real estate leases usually slopes uphill over time, as the rent increases over the term of the lease.

What Is the Problem?

You may wonder what is wrong with the current accounting. Nothing, if you ask most real estate professionals. Many still pine for the good old Enron days, when purchases could be transformed through sleight of accounting into off-balance-sheet transactions. It was a sure sign that hubris had reached terminal proportions when the structure was actually called a "synthetic" lease, though, and the Enron abuses clearly had some impact on the push for changes in lease accounting. But long before Enron, both FASB (the U.S. accounting standards board) and IASB (the international accounting standards board) were pushing to have all leases appear on the balance sheet to reflect the actual financial picture of companies more accurately and to permit meaningful comparisons between companies that lease and companies that purchase. Where the leases really are akin to purchases (*e.g.*, leasing vs. buying computer equipment), this makes a lot of sense, but many have questioned whether this "one-size-fits-all" model really fits most real estate leases.

After all, an office building or a mall has a useful life of a lot more than the typical five-year lease term, and the average space tenant has very little control over the entire building; just ask anyone who has represented a small tenant in a lease. So to say that the lease of 3,500 rsf (rentable square feet) for five years is akin to a purchase does not really make a lot of intuitive sense; unlike equipment lessees or tenants under long-term ground leases, companies that are leasing this kind of space do not have the option of buying instead. Furthermore, the transparency and equal comparison arguments ignore the fact that off-balance sheet leases are currently noted in footnotes to financial statements, and many Wall Street analysts already take them into account when evaluating companies.

Accordingly, many real estate professionals argue that the appropriate solution is merely to tighten up the rules, so that operating lease treatment can only be applied to leases that truly are different from sales, rather than throwing out the operating lease baby with the bathwater.

Alas, FASB and IASB do not agree. And so they published an exposure draft of new lease accounting rules that eliminated the distinction between operating leases and capital leases, requiring all leases to appear as an asset and a liability on the balance sheet and to show on the income statement as a downhill sloping line over time. They invited public comment on this exposure draft for a period which ended in December 2010. In that time, they got over 700 comments, including very detailed analyses from all of the major brokerage houses and real estate trade groups.

The exposure draft went further than simply requiring that all leases be treated as capital leases. Its two most notable features, and the ones that elicited howls of protest from the real estate community, were: 1) a requirement to book contingent rent; and 2) a requirement to book any option that was "more likely than not" to be exercised. Contingent rent (such as percentage rent in a retail lease) is called "contingent" for a reason: It cannot be determined in advance because the underlying conditions (the amount of sales) are not yet known. So a requirement to book contingent rent in advance on the balance sheet requires very complex, and constantly changing, analyses of past data patterns and current conditions in order to predict what the future contingent rent might be. It is wildly imprecise at best, and any calculation is built on rapidly shifting sands and therefore must be constantly updated.

Similarly, the obligation to book any option that is "more likely than not" (*i.e.*, has at least a 51% chance) to be exercised requires a constant re-evaluation as business plans and market conditions change. Furthermore, at least in the case of public companies, disclosing whether an extension or expansion option is more likely than not to be exercised acts to tip the hand of the disclosing tenant, thereby putting it at a significant disadvantage at the negotiating table. So the exposure draft contained provisions that would have required companies to have a crystal ball, would have required huge amounts of record-keeping and data analysis, would have required constant restating of financial reports, and would have required companies to disclose their best negotiating points ahead of time. At least, that is what a lot of those 700 comments said.

The good news — as of this writing — is that the two most hated features of the exposure draft (the obligation to book contingent rent and the obligation to book any option that is "more likely than not" to be exercised) appear to be off the table. However, despite some interim reports to the contrary, the obligation to show all leases on the balance sheet appears to be with us for good, as does the obligation to show lease expenses on the income statement as a downhill line.

All of this is still subject to change; the current sense is that FASB and IASB are going to publish another exposure draft in 2011, and invite the public to weigh in again. That will lead to another round of comments and deliberation by the boards, which may or may not lead to significant changes. Stay tuned — the roller coaster ride is not over yet.

So what exactly is going to change? In a nutshell, and as nearly as we can tell right now, all leases will have to be treated essentially the way that capital leases currently are — they will appear on the balance sheet as matching assets and liabilities, and lease expenses will be shown on the income statement in greater amounts at the beginning of the lease term than at the end (a downhill line over time). However, only "true" rental expense will have to be booked; this means that amounts that are payable for services (such as operating expenses or CAM and taxes) or other items (such as the amortized amount of landlord-provided TI [Tenant Improvement] allowances) will not appear on the balance sheet. This will be true whether these items are separately stated from base rent or included in it (though it does get complicated to tease them out of a composite base rent).

Practical Impact

What does that mean in practical terms? Consider a single, run-of-the-mill lease: 10,000 rsf for five years at $38/rsf NNN (Triple Net) and without any TI allowance. Leaving aside NPV analysis (to keep the math simple), the total rent for this single pretty basic lease is $1.9M — rent numbers get big fast. With the new accounting rules (and again ignoring NPV for simplicity), the tenant under this lease will have to book an asset of $1.9M (the right to occupy the space for five years) and a corresponding liability of $1.9M (the total rent due), and reduce them both over the term of the lease. Initially, the asset equals the liability — a 1:1 ratio. Since lenders want to see value in the companies they lend to over and above liabilities, most financial covenants require a higher asset to liability ratio (perhaps 1.25:1). Assume that we have a company with assets (under the current accounting rules) of $9M and liabilities of $7M. That means that retained earnings and owner equity equal $2M, and the asset to liability ratio is $9M/$7M, or 1.29:1. Under the new accounting rules, for just this one lease, we have to increase both assets and liabilities by $1.9M. Our new asset to liability ratio is $10.9M/$8.9M, or 1.22:1. You can see how the mere application of the new rules can throw a company into instant default of its financial covenants, despite the fact that absolutely nothing has changed in the company's economic dealings. This reflects the impact of just one lease; for companies with a lot of real estate leases, and hence large amounts of assets and liabilities added in a 1:1 ratio, the problem will be particularly severe.

In addition to this impact on the balance sheet, the new accounting rules also act to front-load expenses on the income statement (creating the downhill line discussed above, with more of the expenses at the beginning of the term and less at the end; this is in contrast to the current horizontal line that averages expenses over the term). The implications of this are complicated (it might have tax benefits, and will improve Earnings Before Interest, Taxes, Depreciation and Amortization [EBITDA], among other things) and

are beyond the scope of this introductory article, but one thing is certain — the snapshot of profitability one gets from looking at a company's income statement will be negatively affected in the early years of a lease, as expenses will be higher in this period under the new accounting, but revenue will stay the same.

Furthermore, since actual lease expenses tend to be paid out on an uphill line (that is, the rent increases over time), the difference between cash flow and the income statement at the beginning of the lease will be quite dramatic. As with the balance sheet effect, the more real estate a company leases, the bigger the impact.

Effective Date

The current best guess on the timeline for implementing these changes is that final rules will be issued relatively early in 2012 and the effective date will be the beginning of 2015. (There is a strong incentive to have the rules become effective at the beginning of a calendar year.) Before you breathe too big a sigh of relief, however, consider this: 2015 is much closer than it sounds for two reasons. No leases will be grandfathered, no matter when the lease was signed or when the term began. If the lease exists on the effective date, the new rules will apply from that date forward. Moreover, many companies have to show a three-year comparison in their financial statements. These companies will have to perform the new accounting (in addition to the current accounting) for years 2013 and 2014 just to create these comparison numbers.

Broader Implications

Even if you are not an accountant, you still need to know the broader implications of these changes for leases. Some are saying this means that everyone will buy instead of lease — is that true? Will lease terms suddenly get dramatically shorter? What other changes are there likely to be in how leases are structured?

Will there be a big shift away from leasing in favor or purchasing real estate? Remember: most real estate that is the subject of traditional leases — space in a multi-tenant office building, or one store in a shopping center — simply is not available for purchase, so those spaces will continue to be leased. (And for those who think commercial condominiums are the answer, do you want your office in a building where the other owners can delay or veto repair of the roof leak that is dripping water into your server room?) Still, there are leases that are for real property that could easily be purchased instead — leases of entire buildings, for example. Will we see a flight away from leasing to purchasing for these properties? Perhaps. But leasing offers advantages over purchasing beyond the current off-book accounting treatment.

To buy a building, a company needs to commit significant cash up front, either out of its cash reserves or, more likely, in the form of a loan. But that loan will be "counted" against the company's total debt capacity (*i.e.*, it will come out of a finite line of credit, or will be counted against covenants that limit a company's total amount of permitted debt). Even if leases are required to be booked, they still will not "count" in this way, giving them a distinct advantage to many companies. Furthermore, most users of real estate — even users of large blocks of real estate — do not have real estate as their primary business, and many would rather leave the headaches, and the risk, of real estate ownership to others. And finally, leases can be more flexible than ownership. They provide an easy out at specified, fairly frequent intervals, without the hassle of waiting for property to sell or the risk of taking a loss for selling in a down market. So the bottom line is that while certain users of large blocks of real estate who have very strong balance sheets (and therefore lots of cash and/or borrowing capacity) may shift from leasing to purchasing, there is not likely to be a broad movement in this direction for real estate in general.

Conventional wisdom also has it that lease terms will get shorter, as tenants seek to minimize the impact on their balance sheets. (If our five-year lease example above were shortened to three years, $1.9M would shrink to $1.14M.) There is certainly logic to this, and it may happen to some degree. But there are at least two countervailing forces. First of all, remember that it is very rare for a tenant to lease real estate and occupy it without some construction being done. That construction may be done by the landlord or tenant and may be paid for by the landlord, the tenant or both. Regardless of who pays for the improvements, the cost must be amortized over the initial term of the lease. On the landlord side, this is because landlords view TI allowances as loans, and want to be sure they are paid in full by the time the lease ends. On the tenant side, any improvements installed by the tenant will almost certainly have to be left on the premises at the expiration of the term, so accounting rules require the tenant to amortize them over the term of the lease.

Construction is expensive; office build-outs in the range of $65/rsf are quite common and retail build-outs can run much more. Leaving aside interest (to keep the math simple, but note that it also makes the numbers significantly smaller than they actually are), if the term is five years, then $13 per rsf per year (65/5=13) will have to be added to the rent to amortize $65/rsf construction costs. Shorten the term to three years, and the amount jumps to $21.67 (65/3=21.67), an increase of more than 65%. Since few tenants want to pay the steep rents (or steep improvement costs, in the case of self-funded improvements) this will entail, this will act as a real damper on shortening lease terms.

Moreover, tenants cannot get around this by having a short term with several extension options. If a landlord provides funds for tenant improvements, it will insist on recouping them entirely during the initial term, since the tenant may elect not to exercise any extension options. If the tenant funds the improvements itself, it must amortize them over the term of the lease. But if the tenant has the unilateral

right to extend the term, could it take that into account, and amortize the TI costs over the initial term plus one renewal, for example? The answer may be yes, but if the tenant does so, it has created an economic incentive for exercising the renewal. And if there is an economic incentive for exercising the renewal, then the renewal period must be shown on the balance sheet just as the initial term is. (In other words, while the requirement to book any option that is "more likely than not" to be exercised has gone away, there is still a requirement to book options where there is an economic incentive to exercise, or an economic disincentive to fail to exercise.)

Furthermore, landlords are under great pressure from their lenders to have longer term leases as a means of stabilizing the rent streams from their buildings; in fact, many loan covenants require lender approval for shorter term leases. Landlords will therefore be unwilling to shorten lease terms significantly. In addition, tenants want certainty about where they will hang their hats, so if they enter into shorter leases, they will want additional extension options to provide that certainty. But landlords hate options of all sorts, and are unlikely to be receptive to this structure. Faced with the choice between a three-year lease (at an inflated rent to cover the tenant improvement costs, as described above) with one three-year extension option, or a five-year lease (at a more measured rent) with one five-year option, tenants may well opt for the latter — especially because if you interview 10 tenant-side brokers, at least seven will tell you that landlords do not fairly account for the existing improvements and lack of down time in determining fair market rent for extension periods. Consequently, accordingly to these brokers, tenants often wind up paying again in the extension term for the things they already paid for in the initial term.

Real Changes

So what will change as a result of the accounting changes? Savvy tenants will realize that it is only "true" rent that must be booked, and they will push to separate out all other costs from gross rent, to minimize the number they have to book. Tenants will push for a clear accounting of the components of a gross rent number. How much is attributable to operating expenses? Taxes? TI allowances? With respect to operating expenses and taxes, the simplest way to do this is to switch to a fully net rent — that is, one with no base year concept, where the tenant simply pays its pro rata share of the full amount of these costs. Some landlords are already moving toward fully net leases (and they are common in retail), but there is one major disadvantage to this structure for landlords. If a landlord adds $14.75 in base year expenses and taxes onto a base fixed rent of $30.00, for a total of $44.75, and the fixed rent then increases by 3% per annum, the landlord gets that 3% increase on the base year costs (the $14.75) in addition to on the "true" base rent (the $30.00). If the lease is fully net, the landlord only gets the 3% increase on the base rent (the $30.00). So, while tenants will push for fully-net leases, landlords may well push back. In any event, tenants will push for clear statements of the amount of operating expenses, taxes and TI allowances included in base rent, and there may be a movement to separate out other costs of leasing (brokerage fees, legal fees, etc.) from base rent in order to minimize the amount that tenant has to reflect on its balance sheet.

What about landlord accounting? Everything we have discussed above relates to how tenants will have to treat leases on their books. What will happen to how landlords account for leases? The short answer is that it is even less certain than the changes in tenant accounting. Basically, FASB and IASB are focusing on tenant-side accounting first, and leaving the landlord side for later. And since there have been lots of fireworks in the tenant-side discussion, all attention has been focused there. Furthermore, remember that unlike tenants (who use real estate instead of holding it for profit), most landlords already treat real estate as an asset, so the changes for them are likely to be less dramatic. Bottom line? Wait and see.

What to Do

So what should tenants do now? As noted above, there have been a lot of changes in the proposed rules, and their final form is by no means certain. Accordingly, it probably does not make sense to rush out and implement plans and procedures to comply with specific features of the currently proposed rules, since those features may change. (Just ask anyone who bought the "crystal ball" software designed to satisfy the obligation to predict percentage sales rent that was in the rules as initially proposed — an obligation that as noted above has since mercifully been deleted.) However, it does make sense for tenants to monitor the situation to keep abreast of the current proposals, and to comment on the next exposure draft if they are so inclined. It also makes sense to be sure that the appropriate individuals in the tenant company are aware of the issue, and to begin to allocate responsibility for collecting the data that will be needed for each of the leases (*e.g.*, term, rent, what amount of the base rent is actually attributable to base year OpEx/CAM and taxes, whether there was a landlord TI allowance, etc.). Finally, tenants should of course discuss the matter with their accountant and consider his or her recommendations as well.

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