



TRANSWESTERN

Lease Accounting

Accounting Standards:

Proposed Major Changes and the
Potential Impact on Commercial Real Estate Leases

Proposed Accounting Standards & the Effects on Our Industry

The Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) are working together to create a common standard on lease accounting to ensure that the assets and liabilities arising from lease contracts are recorded and recognized on the financial statements in a consistent manner. Under the current regulations, similar transactions can be accounted for very differently, reducing both the transparency and comparability for users of financial statements.

Many industries utilize leasing as an important source of finance to the business. The proposed lease accounting standard would require that all operating leases be treated as capital leases and that assets and liabilities arising from lease contracts are recognized on the balance sheet as a "Right of Use"¹ asset and an obligation. It has been estimated that this change could add over \$1 trillion onto U.S. company balance sheets² in increased assets and liabilities. The proposed standard, if adopted, will impact all publicly traded companies and all companies who produce financial statements in accordance with Generally Accepted Accounting Principles (GAAP). While under the proposed rules, the timing for implementation by lessees and lessors may differ, eventually both will be impacted.

The proposed regulations are expected to be adopted in 2011, but [at the time of publication of this document] timing on implementation is uncertain. Once implemented, accounting for leases from the lessee and lessor perspective, financial reporting for the commercial real estate industry, as well as any industry where leasing is utilized, will change.

The purpose of this White Paper is to illustrate the potential impact on the Lessee's or Lessor's financial statements.

Under the proposed standard, a lessee would likely see the following results:

- Interest and depreciation will be recorded instead of rent expense.
- Due to the declining nature of interest, higher expense incurred during the first half of the lease term, but lower expense during the second half of the lease term as the effect reverses.
- Less of a financial impact on short-term leases, which results in less of an impact to the balance sheet. However, if a renewal is likely, the standard may require capitalization of the renewal period.
- "Right of Use" asset and an obligation to pay rent liability will be recorded on balance sheets.
- Impact to EBITDA³, financial ratios and company valuations.
- More complex accounting and administration due to calculating and reporting the leases.
- Eliminate all operating leases for companies reporting on a GAAP basis.

Lessees will need to evaluate the financial impact of a short-term lease compared to a long term lease and lessees may consider purchasing instead of leasing

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- 1 "Right of Use" asset represents the lessees' right to use the property for the term of the lease and there is a corresponding obligation to pay the rentals.
 - 2 SEC study in 2005 estimated the undiscounted cash flow of "off" balance sheet leases in the U.S. could be as high as \$1.25 trillion.
 - 3 (EBITDA) Earnings Before Interest, Taxes, Depreciation and Amortization.

Comparison of Lease Costs / Lease Term

EXAMPLE A: Comparison of the current treatment to the proposed standard and the impact to the income statement (excluding any tax impact) – a lessee, with an incremental borrowing rate of 7.5 percent, signs a 10-year lease with annual rent of \$144,000:

EXPENSE OF LEASE COSTS					
Year	Current Treatment	Proposed New Standard			Difference
	Rent Expense	Depreciation	Interest	Total	Difference
1	\$144,000	\$101,726	\$72,477	\$174,203	\$(30,203)
2	144,000	101,726	67,033	168,758	(24,758)
3	144,000	101,726	61,174	162,900	(18,900)
4	144,000	101,726	54,869	156,595	(12,595)
5	144,000	101,726	48,085	149,810	(5,810)
6	144,000	101,726	40,783	142,509	1,491
7	144,000	101,726	32,926	134,652	9,348
8	144,000	101,726	24,471	126,197	17,803
9	144,000	101,726	15,373	117,098	26,902
10	144,000	101,726	5,553	107,279	36,721
TOTAL	\$1,440,000	\$1,017,255	\$422,745	\$1,440,000	\$0

As the above example illustrates, under both methods the total expense recorded over the lease term is the same, but varies by expense type and timing of expense recognition. Under the proposed standard, the lessee will recognize greater expense over the first five years of the lease term and less expense over the second five years of the lease. Some observers of the proposed rules suggest that tenants may want to sign shorter term leases in order to minimize the impact on their income statement in the earlier years, but that decision may not fit their long-term business strategy.

Using the prior example, note the difference in a five-year lease compared to a 10-year lease. If the lessee should elect to sign a five-year lease instead of a 10-year lease, the annual difference in expense recognition is much less under a short-term lease compared to a long-term lease:

EXPENSE OF LEASE COSTS					
Year	Current Treatment	Proposed New Standard			Difference
	Rent Expense	Depreciation	Interest	Total	Difference
1	\$144,000	\$120,521	\$40,227	\$160,748	\$(16,748)
2	144,000	120,521	32,460	152,981	(8,981)
3	144,000	120,521	24,112	144,633	(633)
4	144,000	120,521	15,139	135,660	8,340
5	144,000	120,521	5,455	125,976	18,024
TOTAL	\$720,000	\$602,607	\$117,393	\$720,000	\$0

Even with a short-term lease, the proposed standard may require the lessee to capitalize any option to renew, if renewal is determined to be most likely.

EBITDA / Interest Coverage Ratio Comparison

EXAMPLE B: Comparison of the current treatment to the proposed standard detailing the impact to EBITDA and the interest coverage ratio – lessee, with an incremental borrowing rate of 7.5 percent, signs a 10-year lease with annual rent of \$144,000:

EARNINGS BEFORE INTEREST, TAXES, DEPRECIATION AND AMORTIZATION (EBITDA)						
	Current Treatment			Proposed New Standard		
	Year 1	Year 5 - Cum	Year 10 - Cum	Year 1	Year 5 - Cum	Year 10 - Cum
Revenues	\$5,000,000	\$25,000,000	\$50,000,000	\$5,000,000	\$25,000,000	\$50,000,000
Expenses	1,000,000	5,000,000	10,000,000	1,000,000	5,000,000	10,000,000
Rent	144,000	720,000	1,440,000	-	-	-
TOTAL EXPENSES	1,144,000	5,720,000	11,440,000	1,000,000	5,000,000	10,000,000
EBITDA	\$3,856,000	\$19,280,000	\$38,560,000	\$4,000,000	\$20,000,000	\$40,000,000
Taxes	25,000	125,000	250,000	25,000	125,000	250,000
Interest - Debt	250,000	1,250,000	2,500,000	250,000	1,250,000	2,500,000
Interest - Lease	-	-	-	72,500	303,600	422,700
Depreciation	-	-	-	101,700	508,500	1,017,000
NET INCOME	\$3,581,000	\$17,905,000	\$35,810,000	\$3,550,800	\$17,812,900	\$35,810,300
INTEREST COVERAGE	15.42	15.42	15.42	12.40	12.87	13.69

Results for Year 5 and Year 10 are cumulative.
 Interest coverage ratio - EBITDA / interest expense.
 Some loan covenants may use EBIT as the numerator in the calculation.

As this example illustrates, EBITDA is higher under the proposed standard because rent is no longer a reduction to EBITDA. Under the current lease treatment, the interest coverage ratio remains constant with the straight-lining of rent expense over the term, but the interest coverage ratio is lower under the proposed standard with the increase in interest expense.

Balance Sheet / Debt-to-Equity Ratio Comparison

EXAMPLE C: Comparison of the current treatment to the proposed standard detailing the impact to the balance sheet and the Debt-to-Equity Ratio – lessee signs a 10-year lease with annual rent of \$144,000:

Based on the net present value (NPV) of the rental payments, again assuming the same incremental borrowing rate, under the proposed standard the balance sheet is grossed up with the addition of the asset and liability. However, by lease termination the balance sheet is again equal under both methods. As a result, the debt-to-equity ratio is substantially higher under the proposed standard during the early years of the lease term, but is equal at lease termination.

BALANCE SHEET						
	Current Treatment			Proposed New Standard		
	Year 1	Year 5	Year 10	Year 1	Year 5	Year 10
ASSETS						
Cash	\$2,000,000	\$2,000,000	\$2,000,000	\$2,000,000	\$2,000,000	\$2,000,000
Accounts Receivable	900,000	900,000	900,000	900,000	900,000	900,000
Right-of-Use Asset	-	-	-	1,017,300	1,017,300	1,017,300
Right-of-Use Asset, accm Depreciation	-	-	-	(101,700)	(508,500)	(1,017,300)
TOTAL ASSETS	\$2,900,000	\$2,900,000	\$2,900,000	\$3,815,600	\$3,408,800	\$2,900,000
LIABILITIES						
Accounts Payable	\$250,000	\$250,000	\$250,000	\$250,000	\$250,000	\$250,000
Obligation to Pay Rent	-	-	-	1,017,300	1,017,300	1,017,300
Obligation Rental Payments	-	-	-	(71,500)	(416,400)	(1,017,300)
Debt	500,000	500,000	500,000	500,000	500,000	500,000
TOTAL LIABILITIES	750,000	750,000	750,000	1,695,800	1,350,900	750,000
Shareholders' Equity	2,150,000	2,150,000	2,150,000	2,119,800	2,057,900	2,150,000
TOTAL LIABILITIES & SHAREHOLDERS' EQUITY	\$2,900,000	\$2,900,000	\$2,900,000	\$3,815,600	\$3,408,000	\$2,900,000
DEBT-TO-EQUITY	0.23	0.23	0.23	0.68	0.53	0.23

Debt to equity ratio - long term debt/shareholders' equity.
Balance sheet presents year-end account balances.

Leasing Compared to Purchasing

EXAMPLE D: Comparison of a lessee executing a 10-year lease with annual rent of \$144,000, as opposed to purchasing a small office building for \$800,000:

INCOME STATEMENT								
Year	Proposed New Standard			Purchase				Expense Difference
	Depreciation	Interest	Expense Total	Depreciation	Interest	Taxes & Op. Exp ¹	Expense Total	Expense Difference
1	\$101,726	\$72,477	\$174,203	\$20,000	\$41,731	\$72,000	\$133,731	\$(40,472)
2	101,726	67,033	168,758	20,000	41,116	72,000	133,116	(35,643)
3	101,726	61,174	162,900	20,000	40,452	72,000	132,452	(30,447)
4	101,726	54,869	156,595	20,000	39,737	72,000	131,737	(24,857)
5	101,726	48,085	149,810	20,000	38,967	72,000	130,967	(18,843)
6	101,726	40,783	142,509	20,000	38,137	72,000	130,137	(12,372)
7	101,726	32,926	134,652	20,000	37,242	72,000	129,242	(5,410)
8	101,726	24,471	126,197	20,000	36,278	72,000	128,278	2,081
9	101,726	15,373	117,098	20,000	35,239	72,000	127,239	10,141
10	101,726	5,553	107,279	20,000	34,120	72,000	126,120	18,841
TOTAL	\$1,017,255	\$422,745	\$1,440,000	\$200,000	\$383,020	\$720,000	\$1,303,020	\$(136,980)

Cash Outlay - Lease		Cash Outlay - Purchase		
		Down Payment Year 1	\$240,000	
		Debt Service Years 1 - 10	496,602	
		Operating Expenses	720,000	
		Estimated Capital Improvements	120,000 ²	
Cash Out in 10 Years	\$1,440,000	Cash Out in 10 Years	\$1,576,602	\$136,602

Equity Value - Lease		Equity Value - Purchase		
		Purchase Price / Value	\$800,000	
		Debt Balance after YR 10	446,418	
Equity Value after YR 10	\$ -	Equity Value after YR 10	\$353,582³	\$(353,582)⁴

The expense recorded under the lease is greater than under the purchase option over the 10-year period, but the cash outlay for the purchase is greater than under the lease. At the end of the 10-year period, under the purchase option, the buyer will have equity value.

- 1 Assumes no increases to be consistent with lease example.
- 2 Assume 15% of purchase price for years 1 - 10.
- 3 Assumes no change in Fair Value after 10 years.
- 4 Financed over 25 years at 7.5 percent.
- 5 Example does not consider any risk of ownership vs. leasing.

Sublease Comparison

Under the proposed standard, accounting for subleases will most likely change for both the lessor and lessee. There are three methods currently under consideration for lessor sublease accounting, but the FASB and IASB have not reached a preliminary view on any of the approaches:

- (1) Continue to use existing lessor accounting standards to subleases but provide additional guidance.
- (2) Exclude the lessor sublease from the scope of the proposed standard.
- (3) Develop a right-of-use model to deal strictly with subleases.

All three of the suggested approaches have advantages and disadvantages which will be addressed as the FASB and IASB consider issuing a new standard to account for subleases.

Impact on the Landlord (Lessor)

The proposed standard would mean that more leases could also be capitalized and brought onto balance sheets for landlords. The proposed standard outlines two approaches for lessor accounting. Under the first approach, the lease contract transfers a portion of the leased asset and a lessor could experience the following results:

Under the proposed new standard, a lessor may experience the following results (depending on the method or approach that may be adopted):

Method One:

- The lease contract transfers a portion of the leased asset.
- A residual interest in investment property and lease receivable will be recorded to the balance sheet as separate assets, subject to different risks.
- Interest and changes in the fair value of the investment property will be recorded instead of rental income.

Method Two:

- The lease creates a new right and obligation.
- The ongoing right of the lessee to use the leased asset is now viewed as a service provided by the lessor.
- The performance obligation would be reduced as the lessor satisfies its service obligation and would record rental revenue and interest income over the term of the lease.

Residual Interest with Lease Receivable (Method One)

EXAMPLE E: A buyer purchases an office building for \$1,000,000 financed 60 percent by debt. Buyer then executes a 10-year lease with a new lessee at an annual rent of \$120,000:

BALANCE SHEET				
	Current Treatment		Proposed New Standard	
	Beginning of Year	End of Year	Beginning of Year	End of Year
ASSETS				
Cash	\$500,000	\$575,000	\$500,000	\$575,000
Investment Property	1,000,000	1,000,000	-	-
Residual Interest in Investment Property	-	-	352,300	416,400
Lease Receivable	-	-	847,700	783,600
TOTAL ASSETS	\$1,500,000	\$1,575,000	\$1,700,000	\$1,775,000
LIABILITIES				
Debt	\$600,000	\$600,000	\$600,000	\$600,000
TOTAL LIABILITIES	\$600,000	\$600,000	\$600,000	\$600,000
Shareholders' Equity	900,000	975,000	1,100,000	1,175,000
TOTAL LIABILITIES & SHAREHOLDERS' EQUITY	\$1,500,000	\$1,575,000	\$1,700,000	\$1,775,000

INCOME STATEMENT		
	Current Treatment	Proposed New Standard
INCOME		
Rental Revenue	\$120,000	-
Interest Income	-	55,900
EXPENSES		
Change in FV of Investment Property	0	(64,100)
Interest Expense	45,000	45,000
TOTAL EXPENSES	45,000	(19,100)
NET INCOME	\$75,000	\$75,000

As Example E illustrates, the lessor's net investment is recognized as a lease receivable measured at the present value of the annual rentals. Assuming a discount rate of 7.5 percent, the lease receivable is \$352,300. The lease receivable will be reduced by rental payments and after one year, the principal of \$64,100 will have been repaid, and \$55,900 in interest income recognized. The lease receivable is deducted from the book value of the investment property and reported as a separate asset. Rental income is then replaced with interest and capital repayments, which would be a shift in current accounting practice.

CALCULATION OF CARRYING AMOUNT OF RESIDUAL INTEREST IN INVESTMENT PROPERTY			
	Beginning of Year	Change	End of Year
Investment Property Cost / Fair Value	\$1,200,000	0	\$1,200,000
Less: Lease Receivable Separately Recognized	(847,700)	64,100	(783,600)
	\$352,300	\$64,100	\$416,400

Lease Receivable and Performance Obligation (Method Two)

Under Method Two, the lease creates a new right and obligation. The ongoing right of the lessee to use the leased asset could be viewed as a service provided by the lessor. The performance obligation would be reduced as the lessor satisfies its service obligation and records rental revenue and interest income over the term of the lease.

EXAMPLE F: *Using the same facts as in Method One, a buyer purchases an office building for \$1,000,000, financed 60 percent by debt. Buyer then executes a 10-year lease with a new lessee with annual rent of \$120,000:*

BALANCE SHEET					
	Current Treatment		Proposed New Standard		
	Beginning of Year	End of Year	Beginning of Year	End of Year	
ASSETS					
Cash	\$500,000	\$575,000	\$500,000	\$575,000	
Investment Property	1,000,000	1,000,000	1,000,000	1,000,000	
Lease Receivable	-	-	847,700	787,300	
TOTAL ASSETS	\$1,500,000	\$1,575,000	\$2,347,700	\$2,362,300	
LIABILITIES					
Performance Obligation	-	-	847,700	787,300	
Debt	600,000	600,000	600,000	600,000	
TOTAL LIABILITIES	\$600,000	\$600,000	\$1,447,700	\$1,387,300	
Shareholders' Equity	900,000	975,000	900,000	975,000	
TOTAL LIABILITIES & SHAREHOLDERS' EQUITY	\$1,500,000	\$1,575,000	\$2,347,700	\$2,362,300	

INCOME STATEMENT		
	Current Treatment	Proposed New Standard
INCOME		
Rental Revenue	\$120,000	\$55,900
Interest Income	-	64,100
EXPENSES		
Interest Expense	45,000	45,000
NET INCOME	\$75,000	\$75,000

As Example F illustrates, the lessor will record a new asset with a lease receivable and a corresponding liability for the performance obligation. The lease receivable is measured at the present value of the annual rents using an interest rate of 7.5 percent and assumes the lease receivable is equal to the performance obligation. The new asset and liability are treated separately from the ownership right that the lessor has over the leased asset; therefore, the lessor will also recognize the underlying asset.

Method Two is more consistent with the FASB and IASB's initial conclusions on lessor accounting. The lessee records a right-to-use asset and the lessor records a liability for the obligation to the lessee over the lease term.

Summary

Under the proposed lease standard, there will be new considerations that will affect commercial real estate lease arrangements. Adoption of this standard is expected by 2011, but timing on implementation is uncertain at the time of publication of this document. While timing for implementation by lessees and lessors may differ, eventually both will be impacted.

Companies will want to proactively structure real estate transactions to fit their financial profile and avoid unexpected effects from accounting for leases. In order to avoid any unexpected covenant and ratio issues, companies should communicate as early as possible with prospective and current lenders to ascertain that financial statement covenants appropriately reflect the proposed changes. It is also recommended that business leaders and corporate executives discuss possible scenarios with their accounting and real estate advisors in order to obtain strategic advice on how the new standard will impact current or future leasing and financial decisions.

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For a more in-depth discussion about the implications of the proposed accounting standard, please contact:

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