



New lease accounting standard for lessees

Is your client's organization prepared to cope with these new standards?

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Contents for Today

- Key Issues regarding the New Lease Accounting (“NLA”)
- Example of the NLA – 5 years without/with renewal and the debits and credits, build to suit model
- Impact on your client’s company
- Coping with the change by area within your client’s company

Key issues

- New lease accounting standards - jointly by IASB and FASB – equipment and real estate leases
- Increase more transparency in reporting for leases
- It eliminates all “operating leases” and requires them to be capitalized on the company’s balance sheet.
- It replaces rent payment expense with interest and amortization expense.
- Some industry projections estimate over \$1.3 trillion transferred to U.S. corporate balance sheets, roughly 70% real estate leases (about 60% of that retail).



Key issues (cont.)

Significant lessee accounting changes

- Lessee recognizes the “right-of-use” as the asset and the “obligation to pay rentals” as the liability
- Right-of-use asset initially recorded based on the present value of lease payments including initial direct costs (e.g., commissions, legal fees, etc.)
- Lease payments are updated each reporting period to include changes in projected contingency (e.g., percentage retail) rents
- Present value interest rate to utilize the lessee’s “incremental borrowing rate” implied in the lease, or internal borrowing rate
- Carve out services (e.g., operating expenses and taxes)

Key issues (cont.)

Significant lessee accounting changes (cont.)

- Contingent rents that are based on an index (e.g., CPI) or rate would be determined using readily available forward rates, if available. Subsequent changes to the rates do not get recapitalized.
- The right-of-use asset is amortized straight-line over the lease term along with declining interest expense based on the obligation to pay rentals liability
- Accounting lease term is the longest possible lease term that is “more likely than not to occur”. Probability analysis will be a likely method of determination.
- Right-of-use asset is to be evaluated for impairment under existing standards for intangible assets
- No grandfathering of existing leases (i.e., all leases would need to be reflected on the balance sheet upon adoption)
- If leases have less than 12 months remaining then use actual dollars rather than discounted amounts
- Subleases are to be accounted for like landlord accounting, net within the Right-of-use asset

Example of new lease accounting for 5-year lease without renewal

- Net base rent — \$1,000 per year (net of operating expenses and taxes)
- Lessee's incremental borrowing rate — 5% (compounded annually)
- Lease term 5 years, no renewal

Year	Rent payment cash Pay	Right of use asset		Interest Int = Val x i%	Total annual expense Amort + Int	Obligation to pay rentals		
		Amortizaion Amort = Val/Term	Declining balance Val — Amort			Annual reduction Pay — Int	Declining balance (rounded) Val — Pay — Int	
			\$ 4,329	Val			\$ 4,330	Val
1	\$ 1,000	a	\$ 866	\$ 216	\$ 1,082	\$ 784	\$ 3,545	
2	1,000	b	866	177	1,043	823	2,722	
3	1,000	c	866	136	1,002	864	1,858	
4	1,000	d	866	93	959	907	951	
5	1,000	e	866	48	914	952	0	
Total	\$ 5,000	sum a to e	\$ 4,329	Val	\$ 670	\$ 4,999	\$ 4,330	
Present value	\$ 4,329	Val (PV of a..e)						

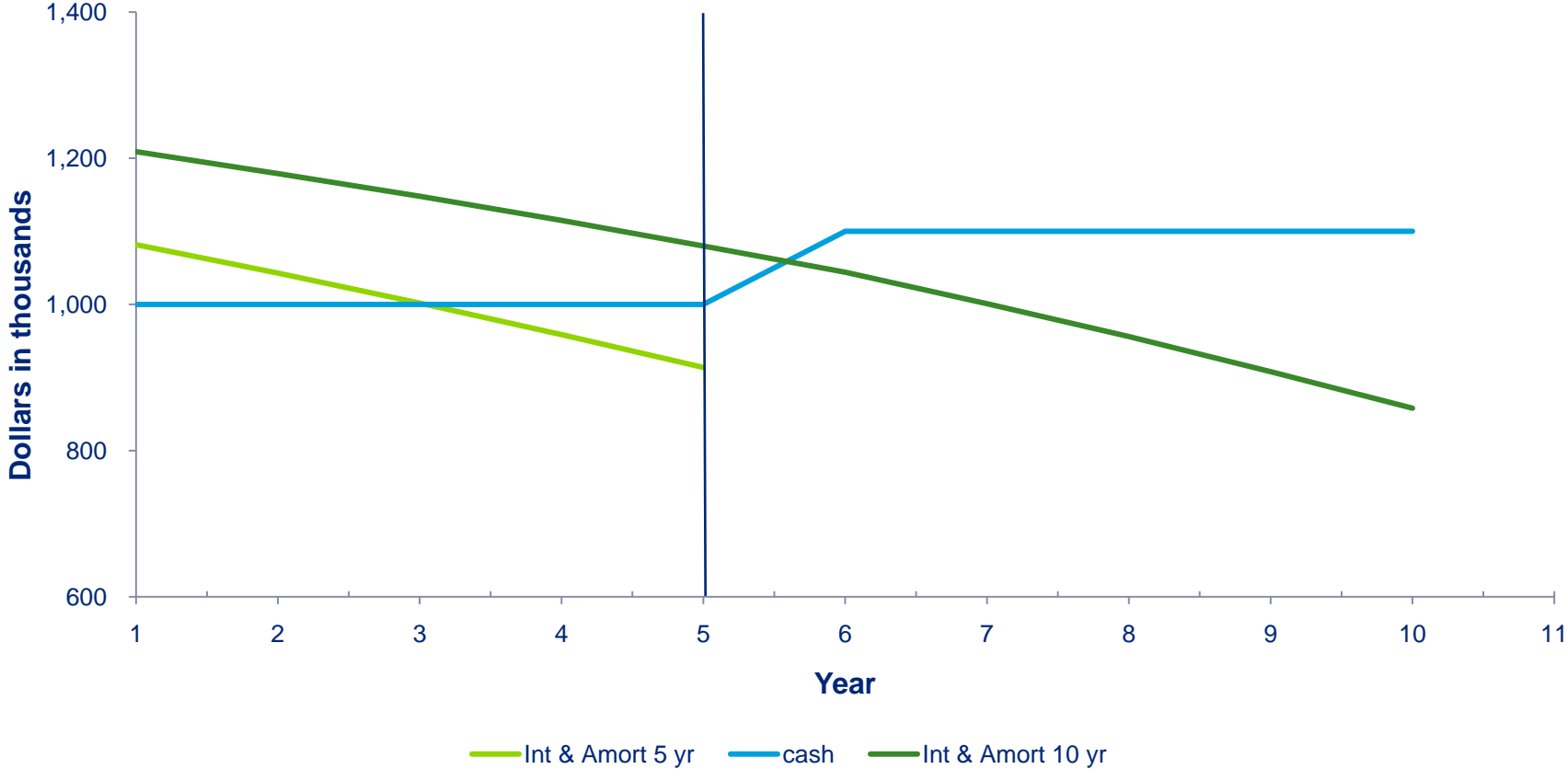
Example of new lease accounting for 5-year lease with renewal

- Rent escalates — 10% in the 6th year
- Lease term 5 years with 1- 5 year renewal “more likely than not to occur” — 10 years

Year	Rent payment cash Pay		Right of use asset		Interest Int = Val x i%	Total annual expense Amort + Int	Obligation to pay rentals	
			Depreciation Amort = Val/Term	Declining balance Val — Amort			Annual reduction Pay — Int	Declining balance (rounded) Val — Pay — Int
				\$ 8,061	Val			\$ 8,061
1	\$ 1,000	a	\$ 806	\$ 7,255	\$ 403	\$ 1,209	\$ 597	\$ 7,464
2	1,000	b	806	6,449	373	1,179	627	6,837
3	1,000	c	806	5,643	342	1,148	658	6,179
4	1,000	d	806	4,837	309	1,115	691	5,488
5	1,000	e	806	4,031	274	1,080	726	4,762
6	1,100	f	806	3,225	238	1,044	862	3,900
7	1,100	g	806	2,419	195	1,001	905	2,995
8	1,100	h	806	1,613	150	956	950	2,045
9	1,100	i	806	806	102	908	998	1,047
10	1,100	j	806	0	52	858	1,048	0
Total	\$ 10,500		\$ 8,060	Val	\$ 2,438	\$ 10,498	\$ 8,062	
Present value	\$ 8,061	Val (PV of a..e)						

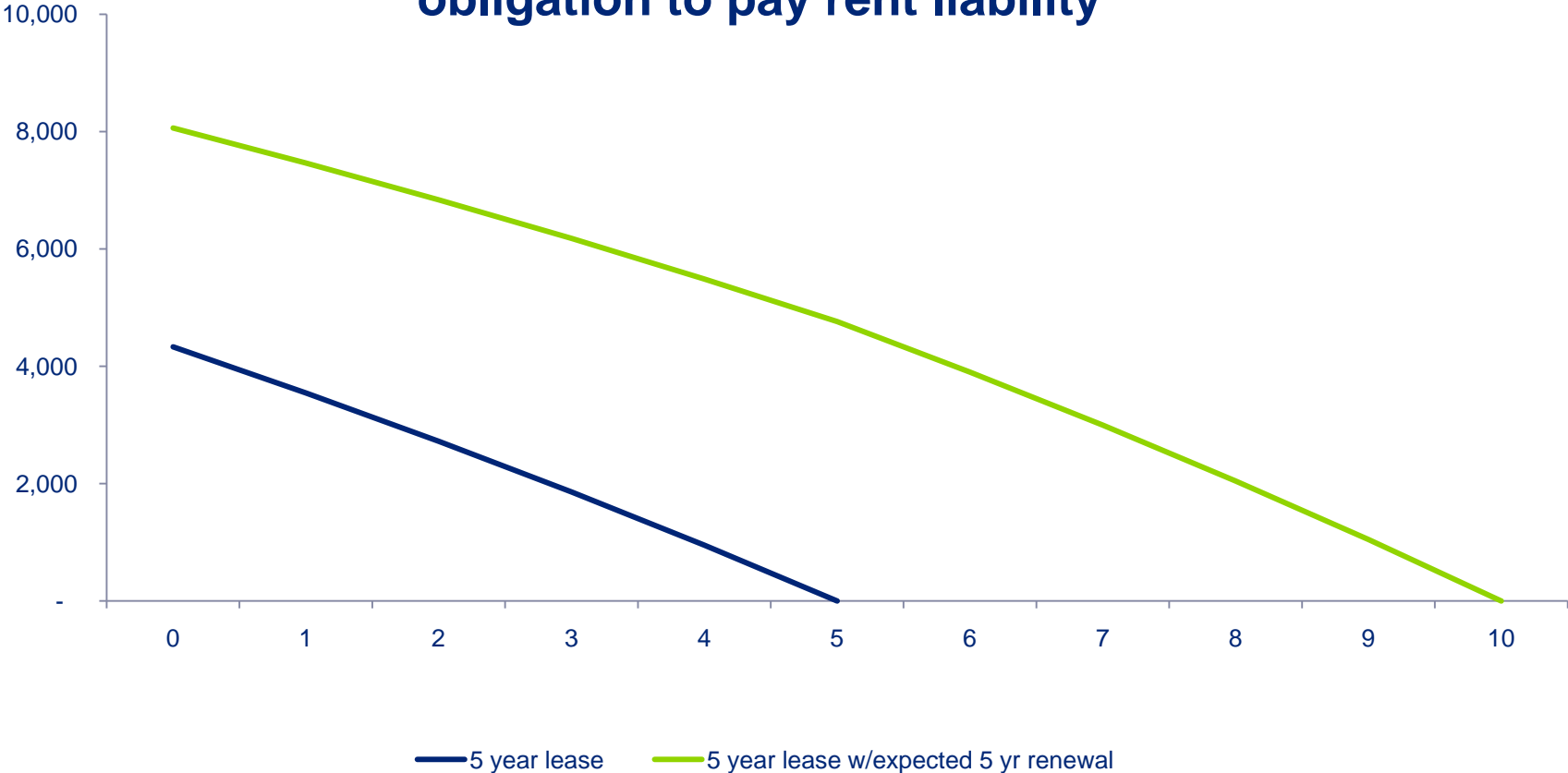
Example of new lease accounting for 5-year lease only and 5-year lease with the 5-year renewal

P&L Impact interest and amortization



Example of new lease accounting for 5-year lease only and 5-year lease with the 5-year renewal

Balance sheet impact obligation to pay rent liability



Example of new lease accounting journal entry

[1] dr	Right of use Asset		\$4,329
cr	Obligation to pay rentals		\$4,329
[2] dr	Interest Expense		216
dr	Obligation to pay rentals		784
cr	Cash		1000
[3] dr	Amortization Expense		866
cr	Right of use Asset		866

Balance sheet — asset

Right of use Asset

[1]	\$	4,329	
	\$	866	[3]

Cash

\$	1,000	[2]
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Balance sheet — liabilities

Obligation to pay rentals

	\$	4,329	[1]
[2]	\$	784	

Expenses

Interest	
Amortization	

Income Statement

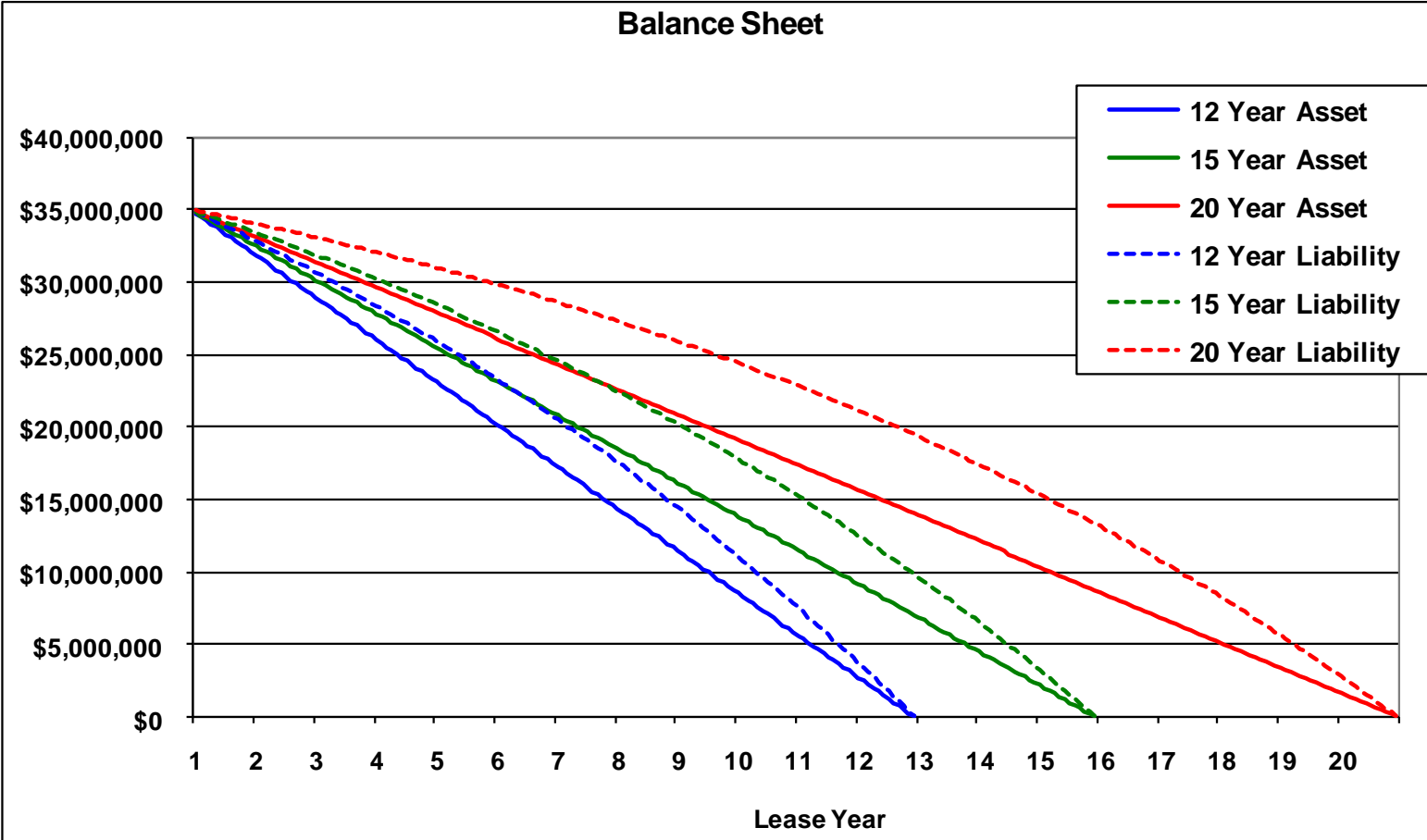
[2]	\$	216
[3]		866

[1] Set up asset and liability at present value of rent payments over likely term using tenant's borrowing interest rate

[2] Each rent period make payment and record reduction in obligation (liability) and interest expense on outstanding balance

[3] Simultaneously record reduction in asset (right of use) and recognize the amortization of that asset

- Example of Build-to-Suit - \$35M



Impact

Significant lessee financial and operational impact

- “Rent” would disappear from the income statement
- Net Operating Income (NOI) would decrease in early years as compared to current operating lease treatment and increase in later years
- EBITDA would increase as rent is replaced by interest and amortization
- Financial ratios potentially affected due to newly inflated balance sheet
 - Debt-to-Equity
 - Interest Coverage
 - Return on Assets
 - Operating Margins
 - Enterprise Value/EBITDA
- Potential renegotiation of existing loan agreements especially for firms with capital adequacy concerns
- Business unit charge backs for departmental space usage expense would be greater in the early part of the lease potentially impacting HR issues surrounding executive performance metrics

Impact (cont.)

Significant lessee financial and operational impact (cont.)

- Although lessees may consider shorter term leases in order to reduce the balance sheet effects, they would need to balance this consideration against effects of a shorter term lease, including
 - Increased rents due to market uncertainty and
 - Reduced landlord concession for tenant improvements due to shorter recovery periods
- Potential reconsideration of “buy” versus “lease” decisions for real estate, driven by more tenants wanting control of their own space now that the balance sheet impact is no longer a distinguishing factor
- Potentially more “condo-izing” of space (similar to some buildings in NYC)
- Unclear how rating agencies will treat lease related debt: Will they adjust the number?

Impact (cont.)

Major impact on corporate business units

- Corporate Real Estate
- Lease Administration
- Finance/Accounting
- Tax
- Information/Technology
- Human Resources

Key dates

- Exposure Draft issued August 17, 2010
- Final Standard issued by end of 2011 (estimate)
- Effective Date — Not yet discussed. Unlikely to be earlier than 2013



Coping with these changes by area

Corporate real estate

The new accounting standards may shine the brightest light on the corporate real estate function. Several issues which may have broad implications of intended and unintended consequences including:

- Buy versus lease decisions
- Long versus short-term leases
- Impact of renewals and contingent rents on lease obligations (see next 3 slides)
 - Collecting data for lease renewal based on the probable likelihood
- Full Service (“Gross”) versus “Net” leases for reporting
- Sublease issues
- Quarterly reporting based on changes from lease renewals and contingency rents (CPI and Percentage Rent escalation projections)



Renewal probabilities

A lessee enters into a 15 year lease with three 5 year options to renew. Based on their past history and property specific considerations the entity has assigned the following probabilities to each of the potential lease terms:

25% probability of 15 year term

25% probability of 20 year term

40% probability of 25 year term

10% probability of 30 year term

What lease term should the lessee use to record their right-of-use asset and liability?

- 15 Year term
- 20 Year term
- 25 Year term
- 30 Year term

Contingent Rents - probabilities

- Company A enters into an arrangement to lease a retail outlet in an office building.
- 15 year non-cancellable lease with no renewal options.
- Annual lease payments of \$2 million per year plus an additional contingent rent of 2 percent of gross revenue per year.
- Company A's incremental borrowing rate is 8 percent.
- No purchase option or residual value guarantee.

Calculations

Expected Contingent Rentals

	Outcome 1 Constant Revenue	Outcome 2 Revenue Growth 5%/Year	Outcome 3 Revenue Growth 8%/Year	Outcome 4 Revenue Decline 2%/Year	Total
Sales over 15 years, assuming \$10M in year 1	\$ 150,000,000	\$ 215,785,636	\$ 271,521,139	\$ 130,715,449	
Total contingent rent 2%	3,000,000	4,315,713	5,430,423	2,614,309	
Present value	1,711,896	2,297,568	2,777,778	1,534,344	
Probability	40%	25%	25%	10%	
	\$ 684,758	\$ 574,391	\$ 694,444	\$ 153,434	\$ 2,107,027

Right-of-Use Asset/Obligation

Contingent rentals	\$ 2,107,027
Annual lease payments (PV of \$2M/year for 15 years)	17,118,957
Total right-of-use asset/obligation	\$ 19,225,984

Coping with these changes by area

Finance, accounting and reporting

- Financial modeling on how each of these issues will affect your organization's balance sheet and P&L statement including preparation of projections and pro formas
- Calculating interest and amortization expense for each active lease over its anticipated term
- Determining their interest rate implicit in the lease versus tenant's incremental borrowing rate
- Assessing impact on EBITDA (earnings before interest, taxes, depreciation and amortization)
- Assessing affect on financial ratios (debt/equity, interest coverage) and potential impact on loan covenants including potential restructuring of outstanding notes
- Validating current lease data integrity, accuracy and relevance for critical rents, dates and renewals

Coping with these changes by area

Finance, accounting and reporting (cont.)

- Bifurcating lease payments into rent and service components (e.g., Opex/CAM/Tax “carve-outs” by determining net rent from gross leases)
- Developing process tools to determine renewal probabilities and contingent rent projections for quarterly reporting
- Recalculating allocated business unit charge backs for facility costs



Coping with these changes by area

Information technology and human resources

- Developing and implementing real estate strategy plans and decision making tools, and with enabling technologies
- Identifying potential system enhancements
- Assisting in the developing new processes and procedures to capture, record and report required new lease data and attributes
- Developing organizational process maps to implement “change management” for large lease portfolios
- Evaluating impact on KPI’s (key performance indicators) to measure executive performance relative to new space cost charge backs
- Staff training and resource planning for the upcoming transition/conversion effort and increased reporting burden

Coping with these changes by area

Tax

- Financial impact on increased buy versus leased portfolio
- Sale leaseback analysis
- Overall tax structures and liabilities — federal, state and local taxes
- Early lease terminations or cancelations affecting potential capital gains/losses
- Impact of GAAP (and any related tax) changes on the company's deferred tax position
- Impact on company's property taxes (including valuation issues)
- Impact of closing and transaction costs (e.g., attorneys, accountants, appraisers, other specialists, mortgage recording taxes, transfer taxes, etc.)
- Examine use of like-kind exchanges to reduce tax impact of adjusting to the new rules



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