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Prepare for Impact

Get prepared NOW for the fast-approaching FASB lease accounting changes

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Do you have a sense for the magnitude of the changes being discussed by the Financial Accounting Standards Board (“FASB”) and the International Accounting Standards Board (IASB) (collectively “the Boards”) related to lease accounting? It will have an unprecedented, one-time impact on your balance sheet by creating a tremendous increase in assets, representing the right to use real estate property, and a corresponding increase in liabilities, representing the commitment over the lease term to pay for the right to use.

We have left the discussions of the conceptual accounting changes to the accounting experts. Instead, this white paper will focus on what we think are important activities to initiate during each phase of the proposed regulation rollout. Attention to these initiatives will help you and your business preemptively prepare for the potentially drastic impacts of these lease accounting changes. Acting on these initiatives now will ensure you have enough time to implement the changes to your business processes, leasing policies, staffing levels and system capabilities that will provide better choices and help you avoid last minute panic when those who did not pay attention to these upcoming changes are scrambling to catch up.

Lease accounting hasn't changed much since November 1976 when the most recent Statement of Financial Accounting Standards or FAS No. 13, entitled Accounting for Leases, was first released; however, that is almost certain to change soon. Due to a steady stream of issues with the existing lease accounting standards, perceived abuses of the off-balance sheet handling of real estate leases, the need to harmonize with international accounting standards and the desire for more lucid, up-front financial reporting, FASB is poised to radically change the way companies account for all leases.

The impact to real estate leasing will be amplified due to the size of real estate leases.

When discussions conclude with the anticipated final ruling in 2011, FASB is expected to release sweeping changes required to implement the "financing model" of lease accounting. During this period of uncertainty, it's easy to put things off, but there are several action items savvy managers can be doing now to prepare themselves and their company.

FASB Schedule

<i>Time Frame</i>	<i>Deliverable</i>
March 2009	Discussion Paper — This paper introduced an initial draft of standards and initiated a public comment period which ended in July 2009.
August 2010	Exposure Draft — This revision and expansion of the prospective standards initiated a second comment period which ended in December 2010.
Ongoing 2010	There was an overwhelming response from companies affected by the changes. Almost 800 comment letters were received by the Boards, to which they have been responsive and have modified some of their original proposals. The Boards are currently pursuing research and outreach to further their dialog with stakeholders.
Before 2012	In April of 2011, the Boards announced they would extend the original June 2011 target date and take a few additional months to release final standards for their current priority projects which also include revenue recognition, insurance and financial instruments. They originally set the end of 2011 as their goal to release all four standards, but have not stated the order in which they expect to complete these projects. Revenue recognition will be re-exposed, making this goal unlikely for this project.
Unknown	The Boards have not yet stated an effective date for the prospective standard, but have stated, "We will allow ample time for [constituants] to understand the requirements and to plan for an effective transition to the new standards. . ." (Source: Podcast Summary of the joint FASB/IASB Board Meeting, April 12-14, 2011)

Source: FASB.org website; June 2011

Financial Reporting Impact

Under the current standard, operating leases enabled some companies to misrepresent their financial health by keeping large capital commitments off the balance sheet and only represented in the financial footnotes. In the new proposal, leases that are currently classified as operating leases will no longer be reported only in the financial footnotes. Leases will be reported on the balance sheet as both an asset and a liability to better report the financial impact and commitment they represent. The asset represents the rights the tenant has to use the asset. This is referred to as the right-of-use asset. To enjoy this right of use, the tenant must make payments to the lessor. This is referred to as the obligation-to-make payments. This obligation is recorded on the books as a liability. Here is the important aspect: To determine the value of the

asset and the liability, you must total all of the expenses of the lease, less non-executory costs such as insurance and utilities. To allow for the idea that money available today is worth more than the same amount in the future, also known as the time value of money, future cash flows should be discounted to arrive at a Present Value (PV). Even after discounting future payments, the value of the asset and liability can be quite large. Large rent payments, long lease terms and large portfolios amplify the effect. Based on a June 2005 study by the U.S. Securities and Exchange Commission (SEC), assets and liabilities reported by public corporations could increase by to over 1.3 trillion dollars. While those numbers make great headlines, the most important thing for you to know is how large the impact will be to your balance sheet and financial ratios.

Virtual Premise Client Examples

<i>Company Type</i>	<i>Number of Leases Affected</i>	<i>Present Value (PV) of Leases (Amount of "New" Assets)</i>
Corporate Client	500	\$200,000,000
Corporate Client	520	\$217,000,000
Corporate Client	665	\$2,088,000,000
Retail Client	248	\$983,094,000
Retail Client	2,226	\$1,633,426,000
Retail Client	327	\$737,473,000

The Retail Client numbers do not include percent rent coverage. All calculations were done using a 5% discount rate for comparison purposes. Note the variations in the present values per lease due to average remaining lease term and size of the lease. There is no "rule of thumb". You must analyze your own portfolio.

Other Impacts

Most corporate borrowings contain substantial financial covenants including debt-to-equity ratios. If these debt ratios change, interest rates may be increased and credit lines altered, reduced or refused. The availability of credit is critical to all industries, but particularly to retailers that depend on the balance sheet flexibility provided by leasing. To prepare for the shift in financial ratios, review credit line arrangements now while there is time to renegotiate without pressure. Don't overlook any internal performance criteria for individuals or departments tied to financial ratios; those may require recalibration and a good communication plan.

Anticipated Financial Effect

Will Increase:

- Balance Sheets (assets and liabilities) since many more leases will be on the financial statement
- Debt Ratios; these are used to determine the dependency of the company on financing
- EBITDA, financing model will show more interest expense
- Amount of data tracked pertaining to a lease
- Workload to maintain leases and financial assumptions

Will Decrease:

- Net Income due to initial financing expense and amortization
- Debt coverage measures
- Lease terms may be shortened to reduce the balance sheet impact of lease arrangements

To get a feel for the impact to your financial reporting, take a present value of the current lease obligations in your portfolio. The report you usually use as your rent obligation report may be a good start. As a general rule, only include accounts that are rent accounts. Use the current incremental borrowing rate for your company to discount future cash flows; this is your imputed interest rate. The PV (Present Value) that results will approximate the increase to total assets.

Any effort invested in developing this report or process will be a useful investment. You will need to have an easy, fast way to do these calculations in the future; they will probably be required for most leases.

Financial Statement Example – Before and After

	<i>Before*</i>	<i>After**</i>	<i>Change</i>	<i>Comments</i>
Balance Sheet - in thousands				
Assets	\$11,363,000	\$14,417,423	27%	Added asset value of leases
Liabilities	\$4,624,000	\$7,678,423	66%	Added PV of lease payments
Equity	\$6,739,000	\$6,739,000	0%	
Liabilities / Equity	69%	114%		Increased liabilities affect debt coverage ratios
Profit and Loss (P&L) - in thousands				
Revenues	\$16,389,000	\$16,389,000	0%	
SL Rent	\$765,000	-		New standard replaces FAS-13; straight-line rent will be discontinued for leases over 12 months in term.
Non-Rent Expenses	\$13,547,000	\$13,547,000	0%	
EBITDA	\$2,077,000	\$2,842,000	37%	Increase in EBITDA
Depreciation / Amortization	\$541,000	\$1,151,885		Higher due to the amortization of right to use assets
Interest	-	\$244,354		Higher due to imputed financing expense
Net Income	\$1,536,000	\$1,445,761	-6%	Lower due to amortization and interest charges

* Before numbers based on FY 2009 annual report for a major retailer.

** After numbers assumed a remaining lease term of 5 years and a discount rate of 8%.

Operational Impact

What changes should be made in your lease approval process to reflect the impact leases will have on the balance sheet? If the financing model of lease accounting is adopted, there will be little difference between the accounting of leasing and ownership financing. There are some who think the increased administrative burden imposed by options and longer leases may result in decreased lease terms. Many, however, feel leasing will continue to be driven by business goals and risk management, along with cost management. One thing is certain — it will be even more important to develop, confirm, communicate and share the strategy for each location and the assumptions underlying that strategy.

Lease administration will become more intensive. It will require more effort to compile the required data and more judgment to make decisions required to implement the new standard for every lease. Lease administrators will need to record the following data during the abstracting process:

- Direct costs or expenses incurred to acquire the lease.
- Lease options such as renewal, automatic renewal, termination, purchase and the financial implications. (Capture these data elements in separate fields for easy access when establishing the value of the lease on the balance sheet.)

- Other lease stipulations which might create additional capital expenses, such as residual value guarantees and asset return or surrender clauses.

Review your lease abstracting policies now to avoid as much rework as possible. Adding more tasks to the lease administration process will not be the only additional work item. There will be an enormous effort to ensure the accuracy of the lease inventory and lease data, as this data will now be presented on the balance sheet and have more visibility and affect more people and departments at your company. Lastly, the real estate department will be closely involved with the financial restating effort needed to adjust prior financial reports to the new standard for comparison purposes.

If your current lease administration staff does not have the overhead to take on the additional work imposed, you might consider outsourcing to keep your transition project on track. Start looking now for reliable vendors knowledgeable in real estate who can step in to help level your capacity while keeping your permanent staffing levels as low as possible. Forming relationships before the rush will help you make better decisions and negotiate better rates. To ease the burden on Lease Administration, make sure your software vendor is prepared to quickly issue new versions of its lease accounting package after the changes have been finalized. Software as

a Service (SaaS) vendors have an advantage in quickly deploying changes that are immediately available to their customers, but all software development and testing is a time-consuming process. The quicker your vendor can make the needed changes to your lease accounting system, the more time you will have to transition data. Users of spread sheets or home-grown systems have the additional burden of making sure they have the technical resources to make the necessary changes and ability to handle the additional requirements and complexity.

Additional system functionality will be needed to:

- Gather relevant lease clauses, options, payments and dates needed to value the lease.
- Bring in data that is not stated in the lease, but is needed in the valuation process; such as discount rate and direct costs.
- Compile all relevant payments and calculate the present value of the lease.
- Calculate the amortization schedule and the resulting journal entries to amortize the asset over time.
- Record and maintain a snapshot of all the data and calculations used to initially value the lease for accounting purposes.
- Detect significant changes to lease circumstances or lease payments and repeat this process each time the lease is revalued, making sure to record a snapshot of all the data and calculations used and the reason for the changes(s).

While these are proactive initiatives that you should act on or start planning for now, there are many aspects of these lease accounting changes that are simply unknown at the time of this writing. Rest assured that Virtual Premise is your watchdog for this topic as we all progress together toward learning what the final determination will be.

Summary

The impact of the upcoming lease accounting changes cannot be overstated. And, while the list of to-do's may seem overwhelming at this time, there is also a great upside for commercial real estate executives. Due to their size, real estate leases will be particularly affected by the new standards. The accounting changes will underscore the strategic impact and value of real estate to the overall company, as well as showcase your ability to manage change and lead the way by reaching out to other parts of the organization that are affected.

We will know more as the Boards continue to update us on their deliberation efforts. Until then, now is the time to seize the initiative and commit to a proactive approach to the challenge. Get involved in the conversation that is going on at your company at the highest levels, plan your project early and tackle tasks that you can knock out now.

Virtual Premise, Inc. is a leading SaaS provider of real estate information management solutions for corporations, retailers, restaurants, landlords and commercial real estate service providers. With Virtual Premise, companies have a smart, easy way to collect, manage and report on complex real estate information from anywhere, at anytime. Virtual Premise technology solutions include strategy and analytics, portfolio management, lease management, lease administration, project management, transaction management, and document management. Virtual Premise also offers a wide range of supporting services to include lease abstracting, document management services, data validation, due diligence support, and best practices consulting. In addition, the company is taking a thought leadership role in preparing its solution for the upcoming FASB lease accounting changes. Virtual Premise is wholly owned by CoStar Group.

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