

Lease Accounting: Are you prepared?



In this paper, Savills Studley describes the importance of being prepared for the financial reporting changes for leases under the new FASB standards. For most companies, the most significant leases relate to real estate. In this paper, we outline:

- 1** | The potentially significant impact to the balance sheet that the new standard will have and how this can affect debt covenants and other financial instruments.
- 2** | The ability of a lease administration/accounting system to generate all the information necessary to comply with the new standard.

Most organizations must now prepare for the new lease accounting standard by reviewing current and contemplated leasing arrangements with their real estate service provider and public accounting firm. You should evaluate the potential impact on your financial statements and ensure your lease administration/accounting systems are equipped to collect the financial information you will need to comply.

Savills Studley is the world's leading commercial real estate firm specializing in tenant representation. We can help implement the lease administration/accounting systems necessary to gather, track and report the information required. You need high quality research and in-depth analysis to re-evaluate and optimize your leasing strategies.

This paper does not address the accounting standards required by the International Accounting Standards Board (IASB) under IAS 17. These standards are significantly different from the FASB standards. For those companies impacted by the IASB, Savills Studley can also help implement the necessary lease administration systems to gather, track and report the information these standards require.

New Accounting Standard

The new accounting standard, ASC 842 (ASC), will require lessees, that is, companies that lease assets including real estate, to treat all leases with terms greater than 12 months as assets and liabilities on the balance sheet.

The ASC also will require disclosures to help those who read and analyze financial statements better understand the amount, timing and uncertainty of cash flows arising from leases.

Effective Date

For public companies, the ASC is effective for fiscal years and interim periods within those fiscal years, beginning after December 15, 2018. For calendar year companies, it would be effective January 1, 2019.

For all other companies following generally accepted accounting principles, the ASC is effective for fiscal years and interim periods within those fiscal years, beginning after December 15, 2019. For calendar year companies, the ASC would be effective January 1, 2020.

The first step a company must take is to figure out the present value of its future rent payments.

Example

Lessee Corp and Lessor Corp execute a 10-year office lease.

- Annual rent is \$1,000,000
- 3% annual escalation
- Tenant Improvement Allowance of \$500,000 paid at the beginning of year 2
- Lessee Corp's incremental borrowing rate is 5%. The rate Lessor Corp charges Lessee Corp in the lease is not readily determinable by Lessee Corp.

The first step a company must take is to figure out the present value of its future rent payments. This will determine the value of the right-of-use asset and the lease liability. During subsequent periods, the asset and liability are amortized in a similar fashion to a loan. The "principal" part becomes the annual amortization of the right-of-use asset and the "interest" part impacts the lease liability. The last piece is the actual cash paid for rent to the landlord and reduces the lease liability.

Accounting entries for this illustration would be as follows:

The following accounting entry would be made at lease commencement:

Entry type	Debit	Credit
Right-of-use Asset	\$8,424,506	
Lease Liability		\$8,424,506

During the first year, the following entry would be made to reflect amortization of the asset:

Entry type	Debit	Credit
Rent Expense	\$688,613	
Amortization of Right-of-use Asset		\$688,613

During the first year, the following entry would be made to reflect the interest component:

Entry type	Debit	Credit
Rent Expense	\$407,775	
Lease Liability		\$407,775

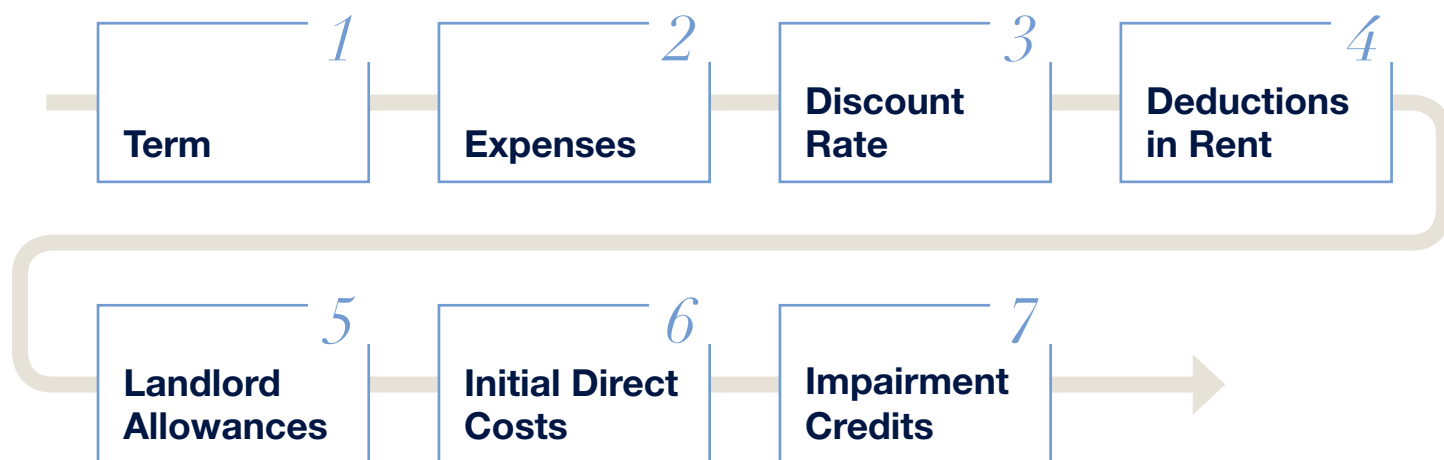
During the first year, the following entry would be made to reflect the cash paid:

Entry type	Debit	Credit
Lease Liability	\$1,000,000	
Cash		\$1,000,000

The amount of rent expense will remain constant at \$1,096,388 per annum.

Lease Administration

Lease Administration closely aligned with Finance and Accounting is the key foundation for meeting the requirements of the ASC. Complete and accurate abstraction of every real estate lease is imperative. In order to capitalize a lease (i.e., record the asset and liability on the balance sheet for an operating lease), the following information is necessary:



In addition, once you have created your capitalization schedule, a change in your financial obligation will require you to restate your lease obligation and revise your capitalization schedule **from the date you recognize the change** to the end of the lease term. The following are examples of typical changes.





What should your company be doing now?

You should determine whether your current software for lease management/accounting has the required reporting functionality and document repository to support the new standards. Many companies will discover that their lease management system and processes are totally inadequate to comply with the new standard.

However, there is no need to panic. We have the expertise and platforms to help you navigate this issue. Your existing lease portfolio will have to be abstracted, obtaining information on rents, other charges, COI adjustments, renewals and other required information. The incremental borrowing rate for each lease at its lease commencement date will have to be determined to generate the capitalization schedules that determine the balance sheet amounts. Policies will have to be established for centralizing all future lease documents and gathering capitalization schedule information. Procedures will have to be developed for the review of lease modifications, exercise of options and adjustments due to changes in CPI.

Balance Sheet Implications

If you lease real estate, implementing the new standard will significantly increase the assets and liabilities recorded on your balance sheet. This, in turn, may affect your bank relationships. Although your net worth won't change, additional liabilities may make your balance sheet appear weaker, which may increase your borrowing costs or reduce your bonding capacity.

Another potential concern is that the new standard will negatively impact loan covenants that place limits on the total amount of debt you may incur or that require you to maintain certain debt-to-equity levels. To avoid causing companies to violate loan covenants, the ASC specifies that lease liabilities should be treated as other liability and not debt. The actual impact on your company will depend on your loan agreement's language and the specific financial ratios used. You should talk to your lenders and sureties to discuss the impact of the ASC on your outstanding debt.

Preparing for and complying with the ASC is not all bad news. Companies should treat the implementation of the new standard as an opportunity to reevaluate and then optimize their leasing strategies. Companies should closely examine their current leasing contracts. They should reevaluate whether and how shorter terms or longer terms impact their financial situation.

By discussing strategies with a real estate professional, companies may find opportunities to renegotiate leases with more favorable terms in light of the new standards. To reduce amounts that must be capitalized, lessees should consider:

- Requesting appropriately indexed escalations in lieu of any stated amount rent bumps (for example, to a percentage of some CPI)
- Separating operating expenses and escalations from rent
- Isolating electric/utilities, gym, cafeteria & other landlord services, which should then be **billed separately**
- Refusing designated parking spaces
- Asking for any Tenant Improvement Allowance to be funded up front

“Winter Is Coming”

The potential financial reporting requirements are significant, and the amount of information that needs to be gathered and analyzed to be compliant could be enormous. Companies that are organized and prepared can seize opportunities to reduce their obligations under the new accounting standards.



Gerry Prager

Senior Vice President, Head of U.S. Research

GPrager@savills-studley.com

212.588.3433