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Lease accounting with the Gershwin Brothers and The Rolling Stones: Part 1

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ABSTRACT

The long awaited, and greatly debated, changes to lease accounting standards under GAAP and IFRS were finalised in early 2016. As corporate real estate executives, their advisers and their peers in corporate finance have now begun the first steps toward implementing these new standards, many are surprised by the financial statement outcomes. More specifically, due to the very subjective nature of many aspects of the new standards, companies are finding — and will increasingly find — two identical leases can have widely divergent accounting outcomes when accounted for by two different companies. This is true not only for a scenario where one company reports under GAAP and another under IFRS, but also for two different firms both of whom report under the same accounting standard. Despite the fact that the FASB's and IASB's stated intentions more than seven years ago were to achieve consistency and transparency in lease accounting, this paper discusses why companies should not expect



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either outcome. In Part 1, we explain how two identical leases can realistically yield very different accounting outcomes, and why it matters from a balance sheet, shareholder equity, net income and EBITDA perspective. The forthcoming Part 2 of this paper will focus on steps CRE directors, their advisers and counterparts in finance can take to optimise various financial impacts in light of the new standards.

Keywords: *lease accounting, FAS 13, IAS 17, ASC 842, IFRS 16, GAAP, IFRS, LeaseCalcs*

WHAT IF, ALL THOSE YEARS AGO, LOUIS ARMSTRONG AND ELLA FITZGERALD, OR MICK JAGGER AND KEITH RICHARDS, WERE SINGING A SONG ABOUT ACCOUNTING?

It has been nearly a year since the Financial Accounting Standards Board (FASB) finally published its version of the new lease accounting standards for entities reporting under Generally Accepted Accounting Principles (GAAP), in the United States.¹ The International Accounting Standards Board (IASB), which issues International Financial Reporting Standards (IFRS), preceded them in publishing their version of the new IFRS lease accounting standards by a few months.² The publication of the respective, and truly ‘final’, standards was long in coming, with the outcome often in doubt. In fact, if the tumultuous, years-long process the FASB and IASB (collectively the Boards) engaged in were to have a theme song, there can only be a couple of logical choices.

Although many who followed the Boards’ efforts certainly hoped, or suspected, the Boards would hear that famous Gershwin Brothers’ tune and say ‘Let’s Call The Whole Thing Off’, upon the official publication of the new standards that speculation was laid to rest. Importantly, however, the way in which the new standards were finalised represented

a departure from the Boards’ stated goals when they first proposed changing the existing standards. Specifically, one of the Boards’ primary objectives in pursuing new lease accounting standards was to end up with one ‘converged’ set of standards for both GAAP and IFRS. In fact, the very first set of proposals published by the Boards back in August 2010 represented a converged standard. Similarly, their revised proposals published in May 2013 also reflected one unified set of standards. On the way to the ‘alter’, however, the Boards did not end up being unified in their respective versions of the new standards, causing many to hear the Stones’ classic, ‘You Can’t Always Get What You Want’.

But the appropriateness of considering the Gershwins’ tune to be the theme song of the new lease accounting standards did not end there. Because the Boards did not end up with one unified standard, such that the new lease accounting standards under GAAP are very different from those under IFRS, the result is that almost every real estate lease will be accounted for very differently under GAAP than under IFRS, with significantly different implications on the financial statement results of a company reporting under GAAP as compared to a company reporting under IFRS. Moreover, due to the subjective nature of many elements of these new standards, it is possible — and very likely, whether by chance or intention — for the same lease to be accounted for very differently by two companies both reporting under GAAP or by two firms reporting under IFRS. In other words, one firm’s accounting for a lease can be very different from another firm’s accounting of the very same lease.

WHY SOME SAY ‘POTATO’ WHILE OTHERS SAY ‘POTAHTO’

From the very first set of proposals the FASB and IASB officially published back in

August 2010,³ continuing through until the first months of 2014, the Boards were very much aligned in their objective to achieve one converged standard for the way the new rules would work. A ‘potato’ would be a ‘potato’, and that was that. The original set of proposals, however, met with stiff resistance, particularly around the way the income statement of a company would be affected due to all leases effectively being treated in the way capital leases are accounted for today, with front-loaded interest and amortisation expense hitting net income for every lease. This was viewed by some as being detrimental, as a lessee’s profitability would be more significantly and adversely affected at the beginning of a lease’s term than it would at the end of the same lease’s term, all else being equal, even despite the fact the same set of ‘benefits’ was being derived from the lease throughout its term.

Consequently, in May 2013, the Boards issued a revised set of proposals known as the Revised Exposure Draft⁴ (herein called the RED). This RED proposed, much in the same way current lease accounting rules work, that there would continue to be two types of lease for accounting purposes, one resulting in front-loaded interest and amortisation expense (the same as a capital lease today), and the other resulting in straight-line rent expense (much like an operating lease today). The RED distinguished between the two lease classifications by labelling those leases utilising the interest and amortisation approach as ‘Type A’ leases, and those using the straight-line expense model as ‘Type B’ leases. Both Boards were aligned in the issuance of the RED, and it appeared this ‘dual model’ approach would end up being finalised as the new accounting standards.

Over the course of the ensuing several months, the Boards worked to refine the RED’s proposals and address various concerns raised about these new proposals. During that process, however, a rift appeared in the Boards’ ‘dual model’ proposal. The

Type B lease model that was included in the RED’s proposals was developed, in large part, to appease the critics of the original proposal that would have required all leases to be treated much like capital leases today, with front-loaded interest and amortisation expense having an impact on a company’s income statement. The Type B model, therefore, provided a straight-line rent expense to be reported on the income statement instead; however, because the Type B lease would be recorded on the balance sheet, in order to get the accounting to work — ie whereby the asset on the balance sheet has to be amortised and the liability has to be drawn down over the term of the lease — the Boards effectively had to invent a new way to amortise an asset. This newly developed amortisation method — which might be thought of as a ‘plug’ — would prove to be the source of the ‘rift’ in the dual model proposal.

Ultimately, in early 2014, following many discussions and analyses by the Boards (including the author’s consultation with IASB’s representatives and analyses provided to both Boards), the IASB concluded that the complexity of the Type B accounting model did not justify the perceived benefits. In large part this was due to the fact, supported by LeaseCalcs’ analyses provided to the Boards, that the purported harm to a firm’s net income from having all leases treated as Type A was greatly eliminated when viewed on a ‘portfolio’ basis. In other words, because some leases in a company’s portfolio would be at the beginning of their term while others would be near the end, the ‘average’ across the portfolio was, in any given year, nearly equivalent to what the Type B model’s straight-line rent expenses would have been. For the IASB this proved to be ample justification to avoid the contrived accounting for Type B leases altogether. The FASB, however, continued to believe the dual model approach was best. From this point on, despite the fact

the Boards had originally declared one of their primary objectives in revising the lease accounting standards was to end up with one 'converged' standard, the Boards began singing along with Ella Fitzgerald and Louis Armstrong:

'It looks as if we two will never be one
Something must be done ...'

When the Boards published their respective versions of the new lease accounting standards, the IASB's version required all leases to be accounted for in one way while the FASB's version of the new rules included the 'dual model' approach. These final standards also replaced the terminology of Type A and Type B leases that was used in the RED and during the Boards' subsequent deliberations. Those terms were replaced with 'Finance' and 'Operating' leases, respectively. For clarity, a capital lease today and the temporarily used terminology of a Type A lease are really the same as a finance lease. An operating lease under today's standards was temporarily referred to as what would be a Type B lease and is now referred to as an operating lease by the FASB, with the critical difference being that the old operating lease received 'off balance sheet' treatment while the new operating lease is on the balance sheet.

Due to the fact the overwhelming majority of real estate leases today are classified as operating leases under both the IASB's and FASB's current accounting standards, it is expected that the overwhelming majority of real estate leases will be classified as the new operating leases under FASB's new standards. But *all* leases will be accounted for as finance leases under the IASB's new rules. The implication of this is the very same lease accounted for by one firm reporting under IFRS and another firm reporting under GAAP will have completely different impacts on the respective companies' balance sheet, net income and earnings before

interest, taxes, depreciation and amortisation (EBITDA) results.

To help put this into perspective, consider the following example. Assume two different tenants, one reporting under IFRS and the other reporting under GAAP, sign identical leases. Assume further the terms of the lease are such that each tenant is leasing 100,000sqf for ten years commencing on 1st January, 2019, and that the first six months of base rent will be abated (ie free), after which the tenants will be charged \$42 per sqf per year in base rent charges, with annual increases of \$2 per sqf. For the sake of simplicity, this example will assume the lease is a 'net' lease (ie there are no service charges embedded in the base rental charges), and will ignore the effect of tenant improvement allowances, expenses or other up-front costs.

SHAREHOLDER EQUITY IMPACTS

Under both the IASB's and FASB's version of the new standards, all leases⁵ are to be recorded on a firm's balance sheet, with both a right of use asset and a lease liability being included in a firm's assets and liabilities, respectively. In the case of the example above, the lease liability resulting from these two leases would be exactly the same as one another, at all times, during the respective lease terms, under both IFRS and GAAP. The same is not true of the right of use asset, however. Under the new standards, a finance lease will be amortised on a straight-line basis over the term of the lease, meaning it is 'burning off' the balance sheet at a constant rate throughout the term. The FASB's operating lease model, however, does not result in the associated right of use asset amortising on a straight-line basis. Rather, the amortisation of an operating lease relies on the 'plug' method referenced above, whereby the periodic amortisation is equal to the difference between that period's straight-line rent expense and interest expense. Considering the interest expense is charged against the

outstanding liability balance — a balance that is declining over the term as rent payments are made — this means amortisation expense is not even, but rather increases over the term. Why does this matter? Because the difference between assets and liabilities on a balance sheet affects shareholder equity, and shareholder equity is akin to a company’s net worth.

So in the case of the example lease, because the finance lease’s right of use asset amortises evenly over the term, this means it amortises more quickly than an operating lease. Since the lease liability balances are identical for both the finance and operating lease examples, during every period of the lease term, this means the difference between the right of use asset and lease liability balances is greater under a finance lease than under an operating lease. Considering the liability balances will always be greater than the associated right of use asset balances for a lease that has increasing rents over its term, the implication is that finance leases will always result in a greater impairment to shareholder equity (which is equal to the difference between all assets and liabilities on the balance sheet) than an operating lease, as Figure 1 illustrates.

As illustrated in Figure 1, the differential between the asset and liability values is greater in every year for the finance lease than for the operating lease. Of critical importance, the cash flows for these two

leases are exactly the same, so the impact to shareholder equity is real. When a firm’s shareholder equity is impaired, all of the balance sheet reporting metrics — things like debt-to-equity, return on equity, etc. — are also adversely affected. In other words, companies reporting under IFRS will find their balance sheets — and particularly their shareholder equity results — will be affected in a materially worse way than if they were reporting under GAAP with their leases classified as operating leases. In other words, the same lease looks very different on the balance sheet under IFRS than it does under GAAP.

DEBT LEVEL IMPACTS

In addition to the more detrimental impact finance leases will have on shareholder equity for a company reporting under IFRS, the technical classification of the lease liability under IFRS is actually worse under IFRS than for operating leases under GAAP. Specifically, the new IFRS standards technically classify the liability for each lease as ‘debt’ on the balance sheet. Under GAAP, however, while operating leases will absolutely appear on the balance sheet, and in the example being use here will be equal to the finance lease’s liability, the liability balance itself is not technically classified as debt. Rather it is a long-term liability, but not specifically treated as debt under GAAP’s

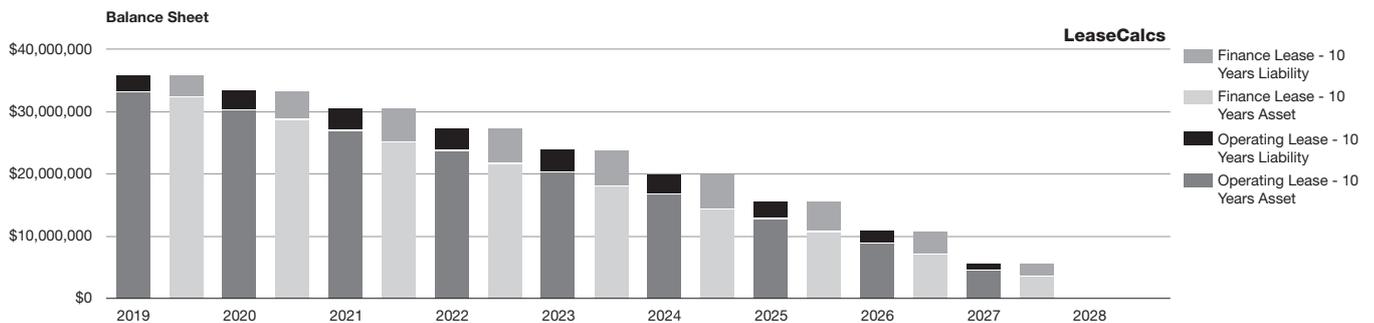


Figure 1 Balance sheet implications of a finance lease under IFRS as compared against an operating lease under GAAP.

new standards. Therefore, not only will the company reporting under IFRS have a greater impairment to shareholder equity, it will also report materially greater debt balances. The implication is that under IFRS both the ‘debt’ and the ‘equity’ components of a firm’s debt-to-equity ratios will be altered, with debt going up and equity going down (as compared to current accounting standards and as compared to what those results would be under GAAP). Accordingly, firms reporting under IFRS will find reason to pay far greater attention to the balance sheet implications of any lease — existing or contemplated — and will want to ensure they and their advisers understand different strategies that can be employed to minimise those impacts.

NET INCOME IMPACTS

Admittedly, on a lease-by-lease basis, companies reporting under IFRS may not find much to laugh about when it comes to the way in which finance leases will have an impact on net income under the new accounting standards. This is particularly true when those firms compare the new finance lease results against GAAP’s operating lease treatment. In short, the finance lease model is no different from today’s capital lease (either under IFRS or GAAP), whereby the way in which the lease affects a company’s

income statement is comprised of a combination of front-loaded interest expense and straight-line amortisation expense. This means, in combination, the expense profile of a finance lease is ‘front-loaded’, with more expense being recorded at the beginning of the lease term than is recorded at the end of the lease term.

Contrast this expense profile with the operating lease model under GAAP, which allows for straight-line rent expense to be reported on the income statement, just as occurs today for operating leases under both the IASB’s and FASB’s current accounting standards. This ‘averaging’ of the rent expense over the lease term for operating leases means the impact on net income in any year is different — arguably materially so in the early and later years of a lease — than for a finance lease, as illustrated in Figure 2.

When viewing the graph in Figure 2, there are two issues worth noting with respect to the differences in the way a finance lease affects net income as compared to an operating lease. First, because the two leases in question have identical cash flows over their respective terms — both on an annual basis and in the aggregate — the total P&L impact over the entire lease term is the same (ie the P&L is merely a different representation of cash expense). The timing can make a big difference, however, particularly

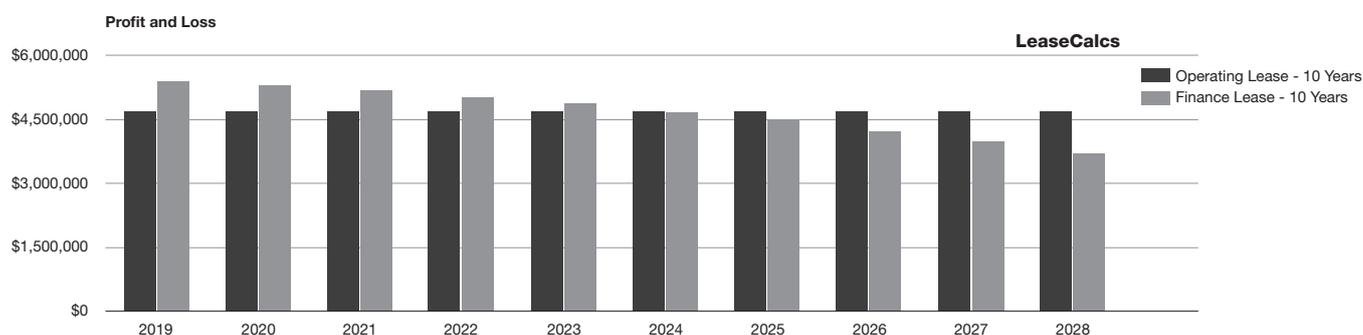


Figure 2 Annual income statement profile of two leases with identical cash flows, one classified as a finance lease under IFRS and the other as an operating lease under GAAP.

for a company with a small lease portfolio or when dealing with a significant lease, such as a corporate headquarters. Second, as alluded to above, this graph and the associated impact compares one finance lease against one identical operating lease. On a portfolio-wide basis, however, where a company may have a large number of leases, all with different lease terms, rental rates, concessions, tenant improvement costs, etc., these differences on the P&L are greatly muted.

For example, in the analyses LeaseCalcs provided to the IASB in early 2014, for a portfolio of 50 leases with varying terms, rental rates, etc., the annual variance on the P&L in any year was no greater than 3 per cent when those 50 leases were all classified as finance leases as compared to when they were all classified as operating leases. Moreover, in some years the finance lease portfolio had a worse impact on net income, due to a higher expense profile, while in other years it had a better impact on net income. Nonetheless, on an individual lease basis, there is a significant difference to be aware of, and that difference could be particularly important as companies reporting under IFRS think about the timing of when leases — or even amendments — take effect.

EBITDA IMPACTS

Many companies, across a wide variety of industries, have a particular focus on a financial metric known as EBITDA (earnings before interest, taxes, depreciation and amortisation). This metric is essentially a different ‘view’ of net income which effectively pretends those four expense items — interest, taxes, depreciation and amortisation — were never incurred by the company, thereby providing a different view of what the company’s net income would have been in the absence of those costs. Moreover, it is not unusual for a company that is focused on EBITDA performance to design employee bonus structures around EBITDA results.

Here, again, the new accounting standards result in vastly different EBITDA outcomes for a company reporting under IFRS than one reporting under GAAP, even when considering the very same lease. In simple terms, when the new standards take effect, companies reporting under IFRS will realise a very significant increase — ie improvement — in their EBITDA results, whereas if the same company were reporting financial results in accordance with GAAP, their EBITDA results would be materially worse than their IFRS-reporting counterpart.

The reason for this disparity — and it is an important one, especially from the perspective of corporate valuations — is that companies reporting under IFRS will see all of their leases classified as finance leases, while companies reporting under GAAP will find the overwhelming majority of their real estate leases classified as operating leases. Due to the fact finance leases result in interest and amortisation expenses running through the firm’s P&L, while operating leases yield ‘straight-line rent’ expense, the very same lease being accounted for under IFRS as compared to GAAP will have completely different impacts on EBITDA. Put another way, because finance leases result in a company reporting interest expense and amortisation expense on their income statement, when a company calculates its EBITDA results, those expenses are effectively ignored. Meanwhile, if that same lease is accounted for as an operating lease under GAAP, the straight-line rent expense is not part of the acronym of EBITDA, and therefore those expenses cannot be ‘ignored’ when a firm reports its EBITDA results. Hence, going forward companies reporting under IFRS will have different — in many cases materially different — EBITDA performance results than their peers reporting under GAAP, all due to the fact the new IFRS standards only have finance leases. Critically, this means there are also implications for corporate bonus structures, corporate valuations and M&A activities.

Using the same example as described earlier, Tables 3 and 4 illustrate the materially different ways a finance lease affects a firm's EBITDA results as compared to the very same lease classified as an operating lease under GAAP.

As shown in Figures 3 and 4, based on the details of this particular example, a company reporting under IFRS will report EBITDA results that are \$4,700,000 higher than the company reporting under GAAP. This is all due to the fact the new IFRS's finance lease results in interest and amortisation expense being reported on the income statement while GAAP's operating lease model yields straight-line rent expense.

DIFFERENT ACCOUNTING RESULTS EVEN UNDER THE SAME ACCOUNTING STANDARD

Perhaps one of the greatest ironies in the new lease accounting standards is the fact

one of the Boards' stated objectives at the beginning of their initiative to revise the lease accounting standards was to achieve a 'converged' standard, providing consistency in the accounting for leases, where, in the lyrics of the Gershwins' song, a 'potato' would always be a 'potato'. The new lease accounting standards, however — under both IFRS and GAAP — include a number of highly subjective judgments to be made by a company as it accounts for any lease. These subjective aspects of the new standards are perhaps the most critical thing for CRE and finance executives — and their advisers — to understand as the subjective aspects of the new standards make it possible for a the exact same real estate lease to be accounted for entirely differently by two different companies — even when they are both reporting under IFRS or both under GAAP. In other words, the Gershwins' song is wholly appropriate *across* the different accounting standards, and also *within* each standard.

Calendar Year	Profit & Loss Reporting						
	2019	2020	2021	2022	2023	2024	2025
Right of Use Amortization	3,603,243	3,603,243	3,603,243	3,603,243	3,603,243	3,603,243	3,603
Interest	1,814,118	1,718,471	1,586,011	1,436,542	1,269,193	1,083,050	877
Total	5,417,361	5,321,715	5,189,255	5,039,785	4,872,437	4,686,294	4,480
*EBITDA Expenses →	-	-	-	-	-	-	-

Figure 3 Snapshot of a portion of a LeaseCalcs report showing the income statement — ie P&L — impacts of the subject finance lease, illustrating the total expense hitting the P&L and the expense affecting EBITDA results. In the case of this finance lease, which is a simplified example that omits other costs a tenant might have to pay for such as service charges, utilities and the like, none of the lease-related P&L expenses reduce a firm's EBITDA results since all of the interest and right of use amortisation expenses are 'below the line' for EBITDA purposes.

Calendar Year	Profit & Loss Reporting						
	2019	2020	2021	2022	2023	2024	2025
FAS13 / IAS17 / SLE Rent Expense	4,700,000	4,700,000	4,700,000	4,700,000	4,700,000	4,700,000	4,700
Total	4,700,000	4,700,000	4,700,000	4,700,000	4,700,000	4,700,000	4,700
*EBITDA Expenses →	4,700,000	4,700,000	4,700,000	4,700,000	4,700,000	4,700,000	4,700

Figure 4 Snapshot of a portion of a LeaseCalcs report showing the income statement — ie P&L — impacts of the same lease as in Figure 3, but classified as an operating lease under GAAP, illustrating the total expense hitting the P&L and the expense affecting EBITDA results. Note that the entirety of this lease's P&L expense is affecting — ie reducing — the subject company's EBITDA results. The nominal difference between the finance lease in Figure 3 and the operating lease in Figure 4 equates to \$4.7m per year, meaning the company reporting under GAAP will report materially lower EBITDA results than if it were reporting under IFRS, even though both are reporting the accounting results for identical leases.

ARE YOU ‘REASONABLY CERTAIN?’

During the course of the Boards’ process to develop the new accounting rules, one of the most contentious and debated issues revolved around how renewal and termination options would affect the accounting outcomes. Ultimately, the final standards issued by both the IASB and FASB require renewal and termination options to be included in the accounting for any lease if the tenant is ‘reasonably certain’ to exercise those options. Realising the subjective nature of the phrase ‘reasonably certain’, the Boards included guidance in their respective standards stating that a company would determine whether they were reasonably certain to exercise an option ‘based on the presence of significant economic incentives to do so’.⁶ In other words, the way in which one company views the significance — let alone the presence — of an economic incentive can vary from another company’s determination, even when evaluating the same lease, and that variance can result in material differences in accounting outcomes.

In short, the Boards concluded the economic incentives a company is to look for and evaluate in establishing whether or not it is reasonably certain to exercise an option include the following:⁷

- (1) **Discounts:** Does the option include a discount or economic incentive for the tenant to exercise the option? For example, does the tenant have the right to renew for 95 per cent or 90 per cent of fair market value at the end of the initial term?
- (2) **Penalties/restoration:** Does the option include an economic penalty to the tenant if it does not exercise the option? Would not exercising the option cause the tenant to incur significant costs for restorations or dilapidations, or otherwise require the tenant to incur significant expenses to relocate which

would not be recouped through other cost savings (ie lower rents) at a new facility?

- (3) **Improvements:** Are improvements installed in the leased premises expected to have remaining useful life and/or value at the end of the initial term of the lease? Would those improvements or alterations need to be replicated if the tenant were to relocate, thereby causing the tenant to incur added expense if it were to relocate?
- (4) **Business considerations/strategic value:** Are there business-related issues that indicate the tenant would exercise its option, such as a location having important strategic value to a tenant’s business due to its proximity to another facility or perhaps because other comparable properties are not available?

Each of these categories or types of incentive requires judgment to be applied in order to determine if the incentive is present in a given lease and if it is present, whether it is significant. Needless to say, this means that two different companies evaluating the very same lease could reach entirely different conclusions as to whether or not they were ‘reasonably certain’ to renew or terminate their lease due to the presence — or absence — of significant economic incentives to do so. These differences in judgment, which undoubtedly will occur, will result in vastly different accounting outcomes, even with firms reporting under the same accounting standards, as the following examples illustrate.

RENEWAL OPTIONS

In meeting with hundreds of CRE and corporate finance executives over the past two years, asking the same questions about what would constitute a significant economic incentive for a particular firm yielded

very different answers. For purposes of the examples that follow, assume the same lease is placed in front of two different companies, Company 1 and Company 2, both of which report under GAAP. These firms have established their accounting policies such that they are reasonably certain to exercise a renewal option if the following incentives exist:

Company 1: If the renewal option provides a discount on the renewal rate *equal to or greater than* 5 per cent of the fair market value rents at lease renewal, it is deemed to be a significant economic incentive.

Company 2: If the renewal option provides a discount on the renewal rate of *more than* 10 per cent of the fair market value rents at lease renewal, it is deemed to be a significant economic incentive.

Now, assume both companies have signed the same 10-year lease utilised in the earlier examples, but assume further the lease includes a 10-year renewal option whereby the tenant can renew for 90 per cent of the fair market value rental rates in effect when the lease is renewed. The presence of this 10 per cent discount in the renewal option means Company 1's accounting policy will require it to include the 10-year renewal period in its accounting from Day 1 of the

initial lease term. Company 2, however, will not be required to include the option period in its accounting, as its policy requires it to include renewal options in its accounting if the discount received is *greater than* 10 per cent. Cue the music ...

CASH FLOWS

In the scenario where Company 1 includes the renewal option in its lease accounting and Company 2 does not, the cash expenses for each company are exactly the same during the initial term of the lease. Company 1 will need to make some assumption, backed up by its accounting policies, as to what it believes its rents will be during the renewal period. For simplicity purposes, the illustrations in Figure 5 assume the rent during the renewal period is equal to the last rental rate paid during the initial term of the lease (ie \$58 per sqf per year).

SHAREHOLDER EQUITY

Despite the fact the cash flows during the first ten years of the lease term are exactly the same for Company 1 and Company 2, Company 1 is going to realise a significantly worse impact on its shareholder equity by virtue of having accounted for its lease as a 20-year lease as opposed to Company

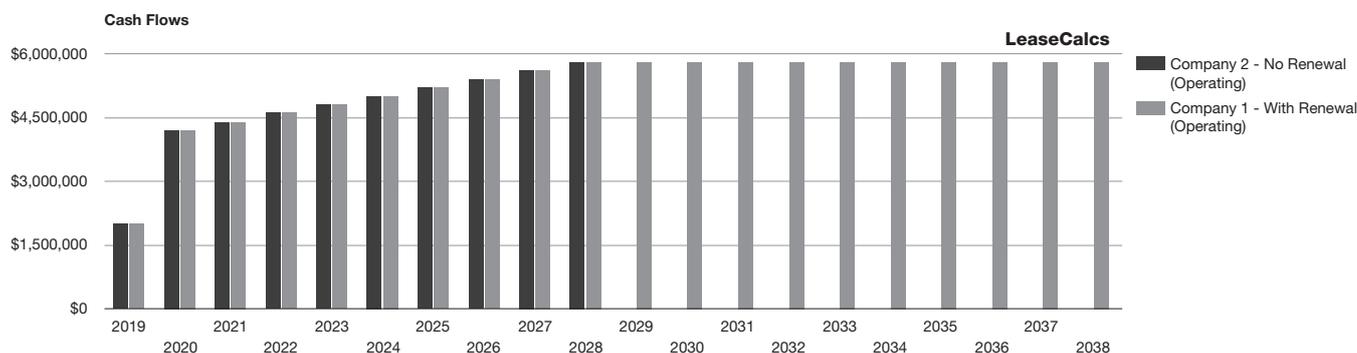


Figure 5 Graph comparing the cash flows of Company 1's lease, accounted for as a 20-year lease, and Company 2's lease, accounted for as a 10-year lease.

2's conclusion that it was merely a 10-year lease. The reason Company 1 realises a larger impairment to shareholder equity — even despite the fact it is paying the same cash rent expense — is due to the fact (without getting overly technical) that it is carrying a materially greater right of use asset and lease liability on its balance sheet than Company 2 is carrying. Shareholder equity, which is essentially the difference between total assets and total liabilities on a firm's balance sheet, is impaired for both companies in this example because the liability balances each company reports are greater than the corresponding asset balances; however, the impairment for Company 1 is greater than Company 2.

Take, for example, the values in 2021 shown in Figure 6; the difference between the right of use asset and lease liability for Company 1 is equal to \$5,150,000 (\$62,820,447 of lease liability less \$57,670,447 of right of use asset). That \$5,150,000 differential serves to reduce Company 1's shareholder equity balance. Company 2, on the other hand, will only realise a \$3,500,000 reduction in shareholder equity (\$30,551,034 of lease liability less \$27,051,034 of right of use asset), because its lease-related asset and liability balances are less. So even though both companies signed the same lease, and both firms are making the exact same cash

rent payments during the initial 10-year lease term, Company 1 will have a larger impairment of its shareholder equity than Company 2 (and that will hold true for every year during the lease term), simply because the two companies had different judgments as to whether they were 'reasonably certain' to exercise the renewal option.

NET INCOME

Keeping in mind both Company 1 and Company 2 are reporting under GAAP, this example also reveals that the accounting differences for these two firms extend to the income statement. Despite the fact both companies are reporting under GAAP, and assuming both firms have classified their respective leases as a new operating lease from FASB's new standards, the way these leases affect each firm's profitability will be quite different. This is due to the fact that FASB's operating lease model results in straight-line rent expense being reported on the P&L, but the calculation of straight-line rent for Company 1 will be different from that for Company 2. As a result of Company 1 having concluded it was reasonably certain to exercise its renewal option, the rents associated with the renewal period are required to be included in their calculation of straight-line rent.

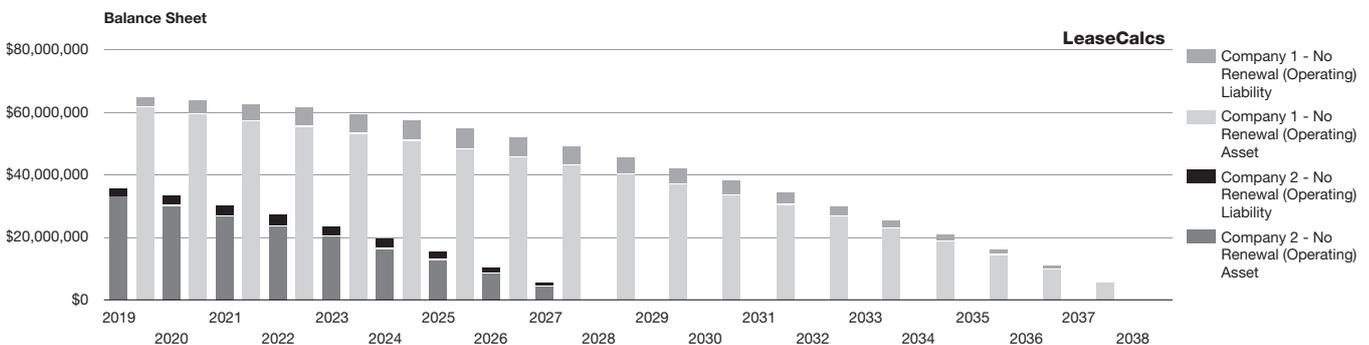


Figure 6 Balance sheet impacts for Company 1 and Company 2, the first accounting for the lease with a renewal option included in the accounting, the second only accounting for the initial lease term in its accounting results.

Bearing in mind the renewal option in this example is based on ‘fair market value’ rents ten years in the future, Company 1 will have to again use its judgment as to what rental rate(s) to use for those calculations. For purposes of this example, Company 1 has an accounting policy that says for renewal options based on some function of fair market value rents in the future, its assumption for the rental rate it will pay in that renewal option is whatever its rental rate is in the last year of the initial term. (Most companies will find their ability to predict future rents to be haphazard at best, and will therefore want to create accounting policies around this issue.) Therefore, this example assumes the base rental rate during the 10-year renewal period is equal to \$58 per sqf per year. The consequence of this is that Company 1’s straight-line rent — which in an oversimplified example like this one is its average rent — over the entire 20-year period is higher than Company 2’s straight-line rent, as shown in Figure 7. The annual difference of \$550,000 could be enough to cause Company 1 to hear Mick Jagger singing in the background.

To illustrate how these differences in accounting outcomes for the very same lease would apply to two firms reporting under

IFRS instead of GAAP, consider Figure 8 and Figure 9 below for the balance sheet and P&L impacts, respectively. Figures 8 and 9 demonstrate that even though the new IFRS standard has a single ‘model’ for lease accounting, whereby all leases are classified as finance leases, two different companies accounting for the identical lease can have widely different outcomes. In Figure 8, the difference between the lease liability and right of use asset for Company 1 — and thus its impairment to shareholder equity — is materially greater in every year than the difference for Company 2. Focusing on just 2021 for example purposes, Company 1 will realise a \$8,577,160 reduction in shareholder equity, while Company 2 only realises an impairment of \$5,328,330, even though both companies pay the exact same rental charges for the initial term of the lease. Moreover, Company 1 will have a materially larger liability on its balance sheet during the term of the lease than Company 2, and under IFRS that liability is technically classified as debt. Hence, even though both firms signed identical leases, Company 1 will appear to have significantly higher leverage, lower shareholder equity and worse debt-to-equity performance than Company 2 will appear to have.

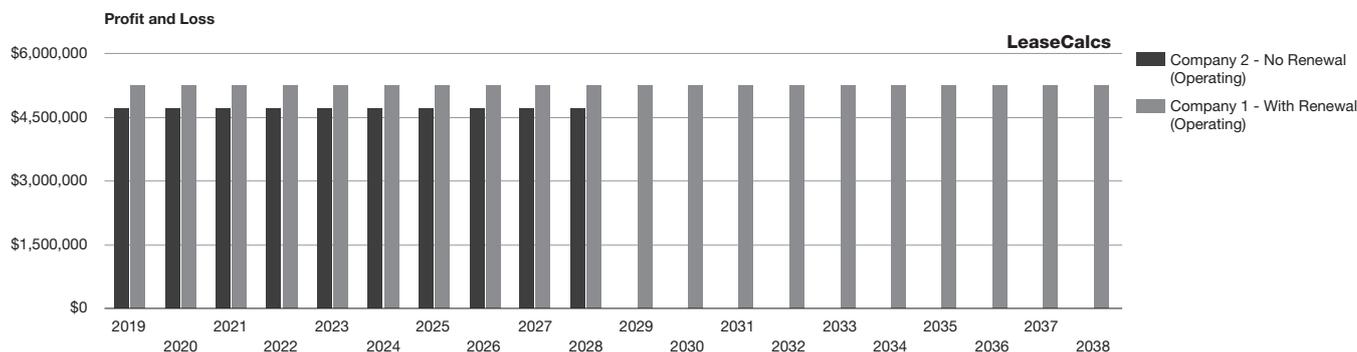


Figure 7 Income statement impact, showing total expense profile of the same lease being accounted for by Company 1, which determined it was reasonably certain to exercise its renewal option, and Company 2, which determined it was not reasonably certain to do so. The annual P&L expense for Company 1 equals \$5,250,000 while Company 2 only reports \$4,700,000 of expense.

On the P&L, if these two firms were reporting under IFRS there would be an even more pronounced difference in net income as a result of Company 1 concluding it was reasonably certain to renew. With all leases under IFRS classified as finance leases, the materially larger right of use asset and lease liability carried on Company 1's balance sheet causes a significantly higher expense profile on the P&L as compared to Company 2. This is due to the fact that finance leases result in interest expense and amortisation expense being reported on the income statement, and the greater the liability, the higher the interest expense and the greater the asset, the higher the amortisation expense. Therefore, as Figure 9 clearly

illustrates, in every year during the term Company 1 will report significantly higher expenses on its P&L than Company 2, and the differences between their total reported expenses actually increases every year. Thus, these two companies, having signed the exact same lease, will definitely be singing a different profitability song.

EBITDA IMPACTS

As discussed earlier in this paper, two companies accounting for the very same lease will have very different EBITDA results if one is reporting under IFRS while the other uses GAAP. This is due to the fact that the IASB's 'finance leases only' approach means

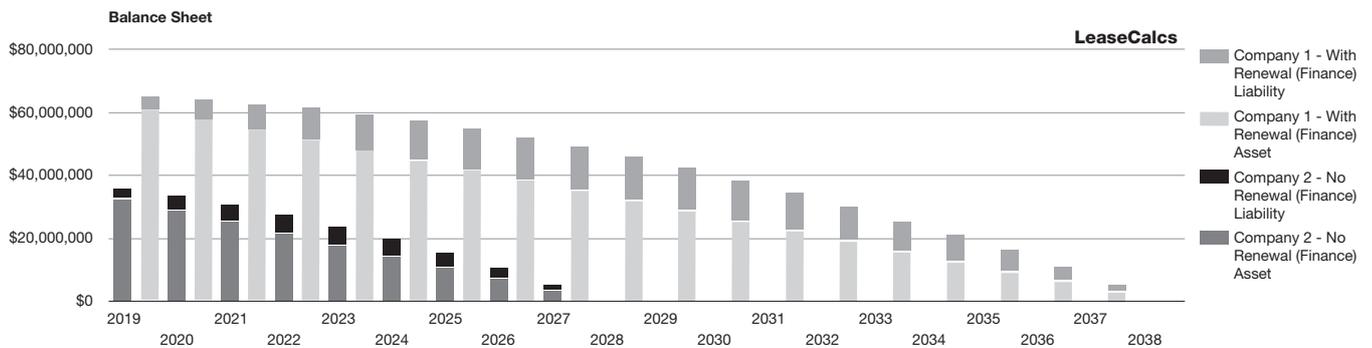


Figure 8 Balance sheet impacts for Company 1 and Company 2 if both report under IFRS, the first accounting for the lease with a renewal option included in the accounting, the second only accounting for the initial lease term in its accounting results.

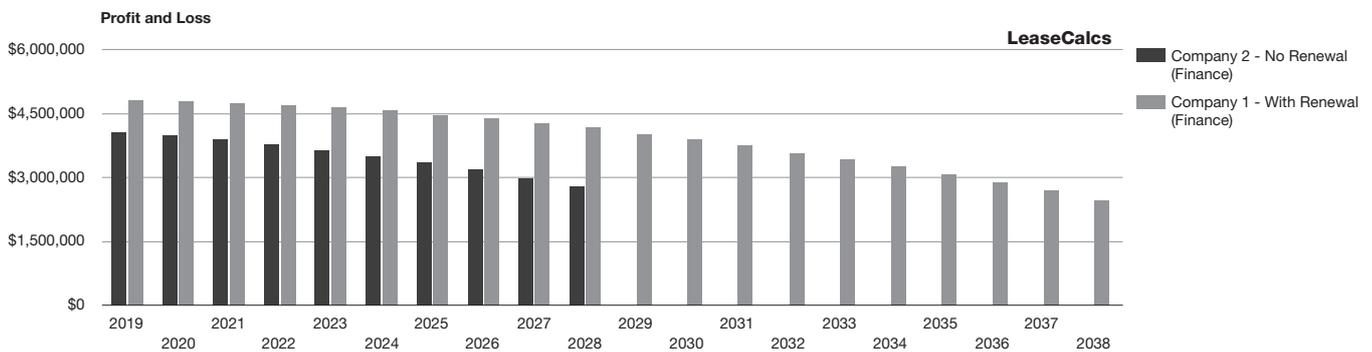


Figure 9 Income statement impact for finance leases under IFRS, showing total expense profile of the same lease being accounted for by Company 1, which determined it was reasonably certain to exercise its renewal option, and Company 2, which determined it was not reasonably certain to do so.

all leases under IFRS result in interest and amortisation expenses affecting net income, while FASB's dual model approach, where most all real estate leases will be treated as operating leases, results in straight-line rent expense flowing through the P&L. The EBITDA differences do not only apply, however, in scenarios where one company reports under IFRS and another uses GAAP. Rather, under the new GAAP standards it is entirely possible — and probable — that Company 1 and Company 2 can have vastly different EBITDA results tied to the identical lease.

In light of the fact that the FASB's new standards include the 'dual model' approach with both finance leases and operating leases, the subjective aspects of the new standards may very well result in Company 1 concluding its lease is properly classified as a finance lease while Company 2 determines its lease — because it was not reasonably certain to exercise the renewal option and therefore was only accounted for as a 10-year lease — is an operating lease under the FASB's standards. By way of example, where Company 1 concluded it was reasonably certain to exercise the 10-year renewal option in its lease, it would be required to include that renewal period in its calculations to determine whether it had a finance or an operating lease under the FASB's new standards.

In keeping with the details of the lease used throughout these scenarios, Company 1 would find that the present value of its net base rent charges to be equal to \$63,815,631 (assuming an incremental borrowing rate of 5.0 per cent with monthly payments made in advance). If Company 1's accounting policies under the new GAAP standards were to stipulate finance lease treatment would apply in any instance where the present value of the minimum lease payments was equal to or greater than 90 per cent of the fair market value of the building (ie excluding land value), the lease

in question would be classified as a finance lease if the building's fair market value was less than \$57,434,068. Since \$57m on a 100,000sqf building implies a value of \$570 per sqf, it is easy to imagine a lot of scenarios whereby Company 1 would easily conclude its lease was properly classified as a finance lease.

Meanwhile, Company 2, which did not conclude it was reasonably certain to exercise its renewal option, would conclude it had an operating lease, as the present value of its ten years of lease payments would only equate to \$36,032,433, or roughly \$360 per sqf. Hence even if Company 2 similarly concluded that leases where the present value of the minimum rent payments equalled or exceeded 90 per cent of the fair market value of the building constituted a finance lease, in this instance Company 2 would conclude its 10-year lease was properly classified as an operating lease as long as the fair market value of the building was in excess of roughly \$40m.

Put another way, even if both Company 1 and Company 2 had the exact same accounting policies with respect to determining whether a lease was to be classified as a finance or an operating lease, the exact same lease could be accounted for in very different ways by these two firms. This, in large part, is due to the subjective nature of the way in which renewal and termination options are accounted for under the new standards. It can also be influenced, however, by the subjective nature of the way firms are allowed to determine what constitutes 'substantially all' of the fair market value of a building or what, with respect to the term of the lease, represents 'the major portion' of the 'remaining economic life' of the building. (These subjective concepts are incorporated in the FASB's new accounting standards only because the FASB utilises the 'dual model' approach.)

Continuing this example, because Company 1 concluded it was reasonably

certain to exercise its renewal option, and because, for the sake of illustration, the fair market value of the building was established as \$55m, Company 1 will account for its lease as a finance lease since the present value of its 20-year rent stream actually exceeds the building's value. Meanwhile, Company 2 will account for its lease as an operating lease, as the present value of its 10-year lease term did not equal or exceed 90 per cent of the fair market value of the building. These differences seem fairly innocuous, but when it comes to EBITDA results they are significant.

Figures 10 and 11 below illustrate the way in which the identical lease affects EBITDA when the lease is classified as an operating lease under FASB's new standards, as compared against the same lease classified as a finance lease. The subjective aspect of the new standards results in Company 1 reporting no — repeat, no — impact on its EBITDA results each year, while Company 2, which classified this lease as an operating lease, reports EBITDA impacts from the identical lease of \$4,700,000 per year.

Considering the Boards' original desire was to end up with consistent lease accounting standards with transparent results, it is clear to see those objectives were not really achieved.

That one firm accounting for a lease would have EBITDA or shareholder equity impacts that were millions worse — or better — than another company which was accounting for the very same lease seems very odd indeed. Once again, the Gershwin brothers seemed to strike the right chord:

'For you like this and the other
While I go for this and that.
Goodness knows what the end will be;
Oh, I don't know where I'm at.'

Now that we know far different accounting outcomes are possible when two different companies account for identical lease obligations, perhaps the better question to ask is: 'How can a firm achieve a particular accounting outcome by understanding and applying the new accounting standards in the course of negotiating lease agreements?' Since the new standards are quite subjective, a firm taking a strategic — but reasonable — approach to implementing the new standards is very likely to find a change in lease structure and negotiation can result in a material improvement in the firm's financial results.

In the next instalment of this paper we will explore how to achieve particular outcomes

Calendar Year	Profit & Loss Reporting						
	2019	2020	2021	2022	2023	2024	2025
Right of Use Amortization	3,190,782	3,190,782	3,190,782	3,190,782	3,190,782	3,190,782	3,190,782
Interest	3,235,559	3,212,636	3,156,621	3,087,507	3,004,624	2,907,269	2,794,000
Total	6,426,340	6,403,418	6,347,402	6,278,288	6,195,406	6,098,051	5,985,000
*EBITDA Expenses →	-	-	-	-	-	-	-

Figure 10 Snapshot of annual EBITDA impacts for Company 1's lease classified as a finance lease, showing interest and amortisation expense flowing through the P&L.

Calendar Year	Profit & Loss Reporting						
	2019	2020	2021	2022	2023	2024	2025
FAS13 / IAS17 / SLE Rent Expense	4,700,000	4,700,000	4,700,000	4,700,000	4,700,000	4,700,000	4,700,000
Total	4,700,000	4,700,000	4,700,000	4,700,000	4,700,000	4,700,000	4,700,000
*EBITDA Expenses →	4,700,000	4,700,000	4,700,000	4,700,000	4,700,000	4,700,000	4,700,000

Figure 11 Snapshot of Company 2's version of the same lease as modelled in Figure 10, but classified as an operating lease.

on the balance sheet, P&L or EBITDA results. But make no mistake, when it comes to the new lease accounting standards, the Rolling Stones had it right back in 1969:

‘You can’t always get what you want
But if you try sometimes well you might
find
You get what you need.’

Companies — and their advisers — who take the time to understand the mechanics of the new accounting standards will undoubtedly find there are myriad risks and benefits alike that can result from the implementation of the new accounting standards. In the meantime, keep singing, because as the finalised standards prove, the Boards certainly concluded: ‘We better call the calling off off.’

REFERENCES AND NOTES

- (1) Financial Accounting Standards Board, Accounting Standards Update 2016–02, Leases (Topic 842), February 2016.
- (2) International Accounting Standards Board, International Financial Reporting Standard 16 Leases (IFRS 16), January 2016.
- (3) The IASB’s original exposure draft, entitled ‘Exposure Draft Leases’, was published on 17th August, 2010, available at <http://www.ifrs.org/Current-Projects/IASB-Projects/Leases/ed10/Documents/EDLeasesStandard0810.pdf> (accessed 14th April, 2017). The FASB’s original exposure draft, entitled ‘Proposed Accounting Standards Update, Leases (Topic 840)’, was similarly published on 17th August, 2010, available at http://fasb.org/cs/ContentServer?c=Document_C&pagename=FASB%2FDocument_C%2FDocumentPage&cid=1176157191432 (accessed 14th April, 2017).
- (4) On 16th May, 2013 the FASB issued its ‘Proposed Accounting Standards Update (Revised)’ and the IASB issued its ‘Exposure Draft ED/2013/6 — Leases’, which collectively and individually are widely referred to as the ‘Revised Exposure Draft’ (RED).
- (5) Both Boards have excluded ‘short-term’ leases, defined as those leases with a maximum possible term of less than twelve months, from the new standards. The IASB has also explicitly allowed firms reporting under IFRS to exclude what they refer to as ‘small ticket’ leases from the reporting requirements of the new IFRS standards. The FASB has not made an explicit allowance for ‘small ticket’ leases, although it is expected companies and their auditors may apply some level of materiality threshold in adopting the new rules so as to avoid having to capitalise a lease of low-value assets, such as water coolers or postage meters.
- (6) See ASC 842, Section 842–10–55–26 of the FASB’s new standards and IFRS 16, Appendix B, Section B37 for a detailed description of the economic factors to be considered.
- (7) For a more detailed discussion of these four types of incentive, and evaluating when they exist and their relative significance, as well as some of the other subjective issues contained in the finalised standards, see Maiona, M. A. (2013), ‘The Revised Lease Accounting Proposals: Aesop’s Fables Revisited’, *Corporate Real Estate Journal*, Vol. 3, No. 1, pp. 53–74. See also <https://www.leasecalcs.com/resources> (accessed 14th April, 2017).

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