PREPARING FOR THE LEASE ACCOUNTING RULE CHANGES

PRESENTATION FOR THE DALLAS BAR ASSOCIATION
REAL PROPERTY SECTION

April 8, 2013

E. David Coligado – Munsch Hardt Kopf & Harr, PC
Tom W. Watson – BKD, LLP

PREPARING FOR THE LEASE ACCOUNTING RULE CHANGES

1. <u>Overview.</u>

   A. Leasing Accounting Rules? But, I'm a Lawyer! Who is affected?

      1. Rules affect all parties that follow "General Accepted Accounting Principles" (**"GAAP"**).

      2. In the U.S., GAAP rules are established by the Financial Account Standards Board ("**FASB**") for establishing rules for public and private companies as well as non-profit organizations, the Governmental Accounting Standards Boards ("**GASB**") for determining the principles for local and state governments and the Federal Accounting Standards Advisory Board ("**FASAB**") for determining the principles for the federal government. FASB was created in 1973 to establish and improve the standards of financial accounting and reporting for nongovernmental entities in the U.S. The FASB issues pronouncements on accounting and reporting codified in the Accounting Standards Codification, which are officially recognized by the SEC and the American Institute of Public Accountants

      3. Internationally, many countries are moving to the International Financial Reporting Standards ("**IFRS**"), which are established by the International Accounting Standards Board ("**IASB**"). IASB was founded in 2001 as the successor to the International Accounting Standards Committee

   B. Why GAAP?

      1. The basic objective of GAAP is to provide a set the rules for financial reporting that is useful to investors and creditors to make rational decisions with respect to investments, credit and other financial decisions.

      2. The objective of GAAP is not to affect the underlying economics of the transaction.

      3. Since 2001, FASB AND IASB have been trying to create joint standards for showing obligations in financial reporting. The SEC has a stated goal of moving from US GAAP to the IFRS.

2. <u>When Will the Lease Accounting Rule Changes Be In Effect?</u>

   A. The FASB/IASB Joint Project to establish unified rules for lease accounting has been in process for several years. The original exposure draft (the "**Exposure Draft**") of the FASB/IASB Joint Project was released August 17, 2010, and was met with extensive public comment. Both the credit world and real estate world reacted to the proposed changes.

   B. July 21, 2011 – the Boards agreed to re-expose their revised proposals for a common leasing standard

C. As of March 26, 2013, the revised Exposure Draft is scheduled for 2nd Quarter, 2013 (goal of 1st Quarter from last fall has come and gone); followed by a 120 day comment period.

D. The target is a final standard by late 2013, with an effective date no earlier than annual reporting periods beginning January 1, 2016.

3. <u>Why the Rule Changes?</u>

A. Today, U.S. companies following FASB rules are only required to show leases meeting certain criteria on their balance sheets. The obligation to make payments under most non-cancelable leases is not shown as a liability under current FASB rules.

B. The official project objective:

"Leasing is an important activity for many entities. Therefore, it is important that lease accounting provides users of financial statements with a complete and understandable picture of an entity's leasing activities. The existing accounting models for leases require lessees to classify their leases as either capital leases or operating leases. However, those models have been criticized for failing to meet the needs of users of financial statements because they do not provide a faithful representation of leasing transactions. In particular, they omit relevant information about rights and obligations that meet the definitions of assets and liabilities in the Boards' conceptual framework. The models also lead to a lack of comparability and undue complexity because of the sharp bright-line distinction between capital leases and operating leases. As a result, many users of financial statements adjust the amounts presented in the statement of financial position to reflect the assets and liabilities arising from operating leases."

C. The breakdown of the stated objective:

1. Today's lease rules allow agreements to be manipulated to garner an accounting treatment that does not present the economic realities of the agreement

2. The need for transparency?

(a) Reducing "off balance sheet" transactions.

(b) If financial analysts are including leases in their valuations of companies, shouldn't GAAP reflect this?

3. Leases fall somewhere between a purchase and a service

4. Globalization - consistency of accounting standards

D. More from the Joint Project:

1. The core principle is that lease contracts give rise to assets and liabilities that should be reflected in the balance sheets of lessees and lessors. As

such, calculated financial ratios (leverage ratios, for example) would be more complete and comparable.

2. All lessees would use a single method of accounting for all leases. Balance sheets of lessees would include both assets representing the right to use the leased asset and liabilities arising from lease contracts at the present value of the expected lease payments.

3. Users of financial statements would have more timely information about variable features such as renewal options and contingent rentals.

4. A simplified approach would apply to short-term leases.

5. The proposal does not change the current definition of a lease contract.

E. The rules apply to both personal property leases and real estate leases – today, we are addressing the rules as they apply to real estate leases.

4. <u>Impact of the Rule Changes</u>

A. Total U.S. balance sheet effect estimated at over $1.25 trillion.

B. Increase in corporate balance sheets

C. Improved EBITDA but lower profits

D. Potential breach of financial covenants

E. Increased financial reporting burdens

F. Possible change in lease terms and lease structure

G. Effect on decisions to lease v. own

5. <u>Lease Accounting Rules – Generally – Existing Rules v. Revised Model</u>

A. Today's rules

1. Lease is either an "Operating Lease" or a "Capital Lease'

2. Operating lease treatment:

(a) No asset or liability on the financial statements

(b) Rent is treated as an expense on a straight line basis over the term of the agreement

(c) Only reference in the financial statements to an operating lease in financial reports is by footnote and reflection of the rental expense.

3. Capital lease treatment:

(a) Capital lease is reported as an asset and a liability

(b) Depreciation and interest

4. What is a capital lease: Any lease that contains one of the following is a capital lease:

   (a) The lease includes the transfer of ownership of the leased asset at the end of the term;

   (b) The lease includes a bargain purchase option for tenant;

   (c) The lease term is equal to 75% or more of estimated economic life of leased property; or

   (d) The present value of lease payments is at least 90% of the fair value of the leased asset.

   If none of the above, then it is an operating lease.

   Classification of the lease is determined at the outset and determined independently by landlord and tenant.

5. Leases that are less than 12 months (including all possible renewal) are treated similar to operating leases

B. The Proposed Rule Changes: “Right to use” model.

1. For lessees, all leases become “Capital Leases” – Tenant is “buying” the use of space.

   (a) A lease includes:

      (i) Right-of-use assets in a sublease

      (ii) Leases of noncore assets

      (iii) Long-term leases of land.

      (iv) The Boards tentatively decided not to provide a scope exclusion from the leases standard for assets often treated as inventory, such as non-depreciating spare parts, operating materials, and supplies, and that are associated with the leasing of another underlying asset.

   (b) A lease does not include:

      (i) Leases for the right to explore for or use minerals, oil, natural gas and similar non-regenerative resources

      (ii) Leases of biological assets, including (U.S. generally accepted accounting principles [GAAP] only) timber

(iii) (IFRSs only) Leases of service concession arrangements within the scope of IFRIC 12, Service Concession Arrangements

(iv) Short term leases.

6. Issues Created by the Proposed Rules.

A. Valuation of the Asset and Lease Term

1. How to treat renewal options or termination options?

2. "Significant economic incentive to renew": This term is not currently defined and will be highly subjective. Issues like penalties for not renewing, lessee investments in leasehold improvements, etc. will drive what renewal periods should be included in the lease term.

B. Valuation of the Asset and Lease Payments

1. How to deal with contingent rent (e.g., percentage rent) and uncertain rent (e.g., rent adjusted by CPI).

2. How to value purchase options

3. Adding termination option penalties to lease payments

4. Adding initial directs costs to the lease (e.g., adding legal expenses).

C. Valuation of the Asset: Lessor Accounting v. Lessee Accounting

1. Present value calculation

(a) Tenant = Tenant's incremental borrowing rate, unless the rate being charged by the lessor is not known.

(b) Landlord = PV implicit in lease rate

2. Residual values and amortizing the value of the Lease

(a) For Tenants, recognize in lease payments the amount of RV expected to be paid based on RV guarantee less the projected fair value of the asset at the end of the lease term

(b) Landlords do not recognize RV in their computation of lease payments

3. Landlord's valuation: receivable and residual model or operating lease model.

D. Factors requiring reassessment. Leases will need to be reassessed with each reporting period, so Landlords and Tenants will need to re-evaluate how leases are reported on a regular basis.

1. A significant change in factors relevant to determining whether a significant economic incentive to renew exists

2. A change in lease payments due to a change in the lease term

3. A change in the amount of the residual value guarantee expected to be paid

4. Changes in an index used to determine lease payments

E. Separating Components of a Lease

Identifying and separating the lease and non-lease components of a lease (e.g., separation of service costs in net v. gross leases).

(a) Goal of rules is to capture the net costs of leases without regard to operating expenses, taxes, CAM, etc. – such "executory costs" will now be required to be isolated.

(b) Some landlords who profit from operating expenses may not like this additional clarity.

F. EBITDA Effect

1. Front-end loading impact on the reporting of profit and loss for accelerated leases.

(a) For Tenants: early years would have reduced net income due to the added expense of the leased asset but increased EBITDA and later years would have increased net income but decreased EBITDA

(b) For Landlord: greater net income in the early years as compared to later years if lease qualifies as an accelerated lease.

(c) Issue: The reporting does not reflect the economic reality.

2. Employee compensation if tied to EBITDA.

G. Financial covenants under existing loan documents.

1. Incurrence of and ratios related to assets and liabilities will change.

(a) Some covenants restrict capital asset purchases or incurrence of new debt.

(b) The number of transactions that will result in new assets and debt will

2. Any covenants related to leverage ratios will be impacted by both the straight-line and accelerated lease models.

3. Debt service coverage ratios will be impacted by accelerated leases.

4. Consider revising the definition of GAAP in loan documents (i.e., tie the definition to GAAP at the date of the agreement.)

5. Consider a "contract" based audit requirement that would dictate the manner in which leases are measured

H. Increased lease accounting burdens for landlords and tenants.

1. Additional annual and quarterly reporting – the lease term and lease payment estimates have to be reassessed at each reporting date.

2. Judgment calls necessary for probability of use and length of leases

I. Preference for shorter terms? Effects of shorter terms include:

1. A shorter term will decrease the tenant's reported liabilities.

2. A shorter term will increase the cost of lease incentives due to the decreased amortization period and thus may decrease lease incentives.

3. Short terms may increase the difficulty of landlord financing.

J. Will companies consider purchasing assets rather than leasing to simplify accounting?

1. Leasing will remain a financing tool even with lease accounting rules - the Lease Accounting Rules are not changing the essential economics.

2. Globe St. article in Spring 2012 indicated that a Deloitte study showed that 42% of real estate executives leaning toward short-term leases and 28% are deciding to purchase rather than lease.

K. No Grandfathering of Existing Leases – the new Rules are not expected to be grandfathered.

7. <u>Preparation for the Lease Accounting Rule Changes?</u>

A. Tenant actions:

1. Review existing leases to verify impact on their financial statements

2. Review existing credit agreements to verify changes in financial covenants and renegotiate if possible

3. Review existing leases for problematic lease provision and contact landlord to revise, if possible.

4. Review future real estate needs (lease v. own)

5. Review software needs

6. Review compensation packages

B. Landlord actions:

1. Review existing leases to verify impact on their financial statements

2. Review existing credit agreements to verify changes in financial covenants and renegotiate if possible

3. Review existing leases for problematic lease provision and contact landlord to revise, if possible.

4. Review future real estate needs

5. Review software needs

6. Review compensation packages

REFERENCES

The following sources provided the guidance for this presentation.

www.fasb.org

Roger D. Aksamit, The Proposed FASB/IASF Rules on Leases-Status, Rules & Overview, Presentation to HBA Real Estate Section, January 18, 2012.

Marc Betesch, Lou Ferro, FASB Lease Accounting Changes, Commercial Real Estate Leases: Selected Issues in Drafting and Negotiating in Distressed and Troubled Market, June 11-12, 2012, ST054 ALI-ABA 1327.

Kathleen (Kitty) O'Connell Henry, The "New" Rule 13 – An Overview, September 2010.

Scott Hunsaker, Proposed Major Changes in Lease Accounting, The Real Estate Finance Journal, Vol. 26, Spring 2011.

Leases Suffer Identity Crisis, CFO Journal, May 22, 2011.

Heads Up, Deloitte & Touche LLP, September 27, 2012, Vol. 19, Issue 24

Mark A. Maiona, The Impact of Changing Accounting Rules on Lease Structures & Audit Rights, Negotiating Commercial Leases: How Owners and Corporate Occupants Can Avoid Costly Errors 2011, Practising Law Institute Real Estate Law and Practice Course Handbook Series, November 17-18, 2011, 594 PLI/Real 797.

Mark A. Maiona, Lease Accounting: A Day At the Track: Combining New Lease Accounting Standards and a Base Year Lease Audit Make a Winning Ticket Better, Negotiating Commercial Leases: How Owners and Corporate Occupants Can Avoid Costly Errors 2011, Practising Law Institute Real Estate Law and Practice Course Handbook Series, November 17-18, 2011, 594 PLI/Real 797.

Marc A. Maiona, New Lease Accounting Standards Are Evolving, Negotiating Commercial Leases: How Owners and Corporate Occupants Can Avoid Costly Errors 2011, Practising Law Institute Real Estate Law and Practice Course Handbook Series, November 17-18, 2011, 594 PLI/Real 769.

Stephen F. Olsen, Peter R. McElwain, Thomas F. Kaufman, Accounting Changes for Leases: How It Will Change Lease Reporting and Leasing, Commercial Real Estate Leases: Selected Issues in Drafting and Negotiating in Distressed and Troubled Market, June 11-12, 2012, ST054 ALI-ABA 1313.

Martin D. Polevoy, The Proposed Financial Accounting Standards Board Leasing Accounting Guidelines, Negotiating Real Estate Deals 2012, Practising Law Institute Real Estate Law and Practice Course Handbook Series, June 5, 2012, 600 PLI/Real 65.

John C. Ramirez , The Property Tax Implications of Lease Accounting GAAP Changes, Journal of Multistate Taxation and Incentives, February 2012.

214.855.7583 Direct
214.978.4328 Fax
dcoligado@munsch.com

3800 Lincoln Plaza
500 N. Akard Street
Dallas, Texas 75201-6659

Download vCard

RELATED PRACTICES

- Acquisitions & Dispositions
- Development & Construction
- Land
- Leasing
- Multifamily Projects
- Office Buildings
- Partnerships, Joint Ventures & Funds
- Real Estate
- Real Estate Lending
- Retail Centers
- Seniors' Housing Projects

EDUCATION

The University of Texas School of Law, Juris Doctor

Trinity University, Bachelor of Arts
Graduated *cum laude*

WEB 2.0

E. DAVID COLIGADO

Shareholder

OVERVIEW

David is a real estate/business transaction attorney with a focus on commercial real estate development, investment and financing. His practice consists of the acquisition, development, financing and disposition of office, industrial, retail and multifamily projects. His practice also includes the acquisition and disposition of hospitality/resort property, build-to-suit transactions, leasing and real estate finance transactions including Commercial Mortgage-Backed Security (CMBS) transactions. David was formerly in-house counsel with Archon Financial, L.P., now known as Goldman Sachs Commercial Mortgage Capital, L.P.

MEMBERSHIPS & AFFILIATIONS

- Dallas Asian American Bar Association
- Dallas Bar Association, Construction Law, Corporate Counsel and Real Property Law Sections
- NAIOP, North Texas Chapter
- State Bar of Texas, Business Law, Corporate Counsel, and Real Estate, Probate and Trust Law Sections

ADMISSIONS

- Texas

ARTICLES & SPEECHES

- May 5, 2011 — David Coligado: Will FAS 13 Put an End to Leasing?
- April 2009 — What's Your Exit Strategy: Property Owners with Mortgage Loans Scheduled to Mature in 2009

experience expertise

Tom W. Watson, CPA, FHFMA

Managing Partner

Dallas
713.499.4600
twatson@bkd.com

bkd.com

Tom is the managing partner of BKD's Dallas-Waco practice. Prior to assuming the managing partner role, Tom was BKD's South Region health care industry leader. He has 19 years of experience providing services to health systems, hospitals and other health care entities. Tom works with a variety of health care providers, ranging from large urban hospital systems to rural community providers. He also has assisted clients with Medicare and Medicaid reimbursement matters, litigation support, cost report preparation and analysis, strategic planning and feasibility studies. Since moving to Texas in 2004, Tom has been instrumental in building BKD's Texas health care practice. BKD now provides services to nearly 25 percent of Texas hospitals.

Tom has served as president of the Arkansas Chapter of Healthcare Financial Management Association (HFMA) and is a frequent speaker for HFMA, the Texas Association for Healthcare Financial Administration, Texas Healthcare Trustees and other state societies and organizations. He often presents industry updates and educational programs to client boards, staff and the community.

He earned one of the highest scores ever achieved on the CPA exam in Arkansas and received the Elijah Watt Sells Award for outstanding performance on the exam. He is a Fellow in the HFMA (FHFMA) and a member of the President's Council at Harding University.

Tom is a 1992 graduate of Harding University, Searcy, Arkansas, with a B.B.A. degree.

BKD is the top-tier U.S. CPA and advisory firm that delivers its experience and service with a deep understanding of your business, your needs and what it takes to improve your business performance.

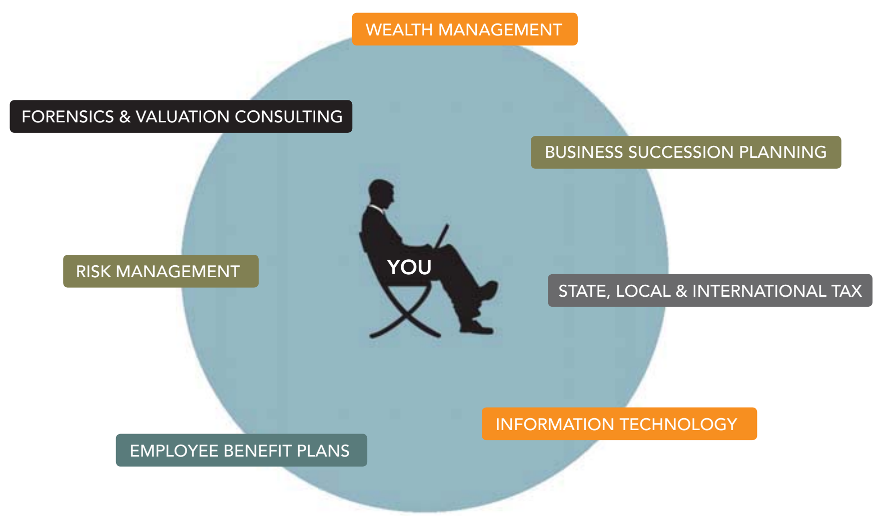
experience BKD LLP
CPAs & Advisors

Firm Profile

BKD, LLP is the top-tier U.S. CPA and advisory firm that delivers its experience and service with a deep understanding of your business, your needs and what it takes to improve your business performance.

With approximately $402 million in revenues, BKD's unmatched client service is provided by approximately 2,100 CPAs, advisors and dedicated staff serving clients in all 50 states and internationally. Beyond our knowledgeable solutions, BKD **clients experience expertise, insight, ideas and attention** to help them achieve their financial goals.

BKD's expertise has benefited thousands of individuals and privately and publicly traded businesses in the health care, manufacturing, distribution, financial services, construction and real estate industries, as well as not-for-profit organizations and governmental entities. The firm also invites clients to experience results in:



BKD, LLP is one of the largest members of Praxity, AISBL, a global alliance of independent firms serving clients in more than 80 countries. We offer multinational clients a gateway to the global marketplace with services delivered by alliance firms committed to the highest standards required in international business.

BKD is registered with the Public Company Accounting Oversight Board (PCAOB), which is required to serve as an independent auditor of public companies. BKD audits approximately 80 U.S. Securities and Exchange Commission registrants, including more than 30 benefit plans. BKD is a member of the American Institute of Certified Public Accountants (AICPA) and its three quality centers: Center for Audit Quality, Employee Benefit Plan Audit Quality Center and Governmental Audit Quality Center.

1:5 top

With a partner-to-staff ratio much lower than the 1-to-9 average found in other top firms, you'll have access to partners and **experience personal communication.**

BKD, LLP

BKD Corporate Finance, LLC

BKD Wealth Advisors, LLC

BKD Foundation

About BKD

BKD, LLP, a national CPA and advisory firm, provides expertise in consulting, tax, assurance and accounting outsourcing solutions to businesses, governmental entities, not-for-profit organizations and individuals. Our clients experience practical advice, ethical solutions and results with integrity.

BKD Corporate Finance, LLC provides merger and acquisition, sales, management buyout, ESOP, recapitalization and financing services. Member FINRA and SIPC.

BKD Wealth Advisors, LLC is an investment advisory firm registered with the U.S. Securities and Exchange Commission and provides personal wealth planning, investment management and estate planning solutions.

BKD Foundation is our 501(c)(3) not-for-profit foundation that enriches BKD's local communities with financial support and our commitment of time.

bkd.com

experience BKD LLP CPAs & Advisors

BKD at a Glance

BKD, LLP
BKD Corporate Finance, LLC
BKD Wealth Advisors, LLC
BKD Foundation

About BKD

BKD, LLP, a national CPA and advisory firm, provides expertise in consulting, tax, assurance and accounting outsourcing solutions to businesses, governmental entities, not-for-profit organizations and individuals. Our clients experience practical advice, ethical solutions and results with integrity.

BKD Corporate Finance, LLC provides merger and acquisition, sales, management buyout, ESOP, recapitalization and financing services. Member FINRA and SIPC.

BKD Wealth Advisors, LLC is an investment advisory firm registered with the U.S. Securities and Exchange Commission and provides personal wealth planning, investment management and estate planning solutions.

BKD Foundation is our 501(c)(3) not-for-profit foundation that enriches BKD's local communities with financial support and our commitment of time.

bkd.com

Clients – Private and publicly traded companies, governmental entities, not-for-profit organizations and individuals

Total Personnel – Approximately 2,100

Partners & Principals – Approximately 250

Net Revenues – Approximately $402 million

Fiscal Year-End – May 31

Founded – 1923

Locations – 29 offices serving clients in all 50 states and internationally

Client Service – **The BKD Experience** is a promise of unmatched client service brought to you by approximately 2,100 CPAs, advisors and dedicated staff who take your business personally.

International Solutions – The firm is one of the largest members of Praxity, AISBL, a global alliance of independent firms serving clients in more than 80 countries. We offer multinational clients a gateway to the global marketplace with services delivered by alliance firms committed to the highest standards required in international business.

Professional Affiliations – BKD is a member of the American Institute of Certified Public Accountants (AICPA) and its three quality centers: Center for Audit Quality, Employee Benefit Plan Audit Quality Center and Governmental Audit Quality Center.

BKD is registered with the Public Company Accounting Oversight Board (PCAOB), which is required to serve as an independent auditor of public companies. BKD audits approximately 80 U.S. Securities and Exchange Commission registrants, including more than 30 benefit plans.

Mission Statement – The mission of BKD is to always strive for excellence in providing services to clients, create rewarding career opportunities and maintain sound professional, business and financial standards.

2100

The **BKD Experience** *is a promise of unmatched client service brought to you by approximately 2,100 CPAs, advisors and dedicated staff who take your business personally.*