ProLease
REAL ESTATE & FACILITIES SOFTWARE

LEASING 101

The Lease Accounting Project
Real Estate Leases
Impact & Action Plans

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Acronyms

FASB = US Financial Accounting Standards Board

IASB = International Accounting Standards Board

GAAP = generally accepted accounting procedures

Off Balance Sheet = current GAAP for operating leases

Operating lease = a lease that does not transfer ownership/executory contract (most real estate leases)

Capital lease/finance lease = a lease that does transfer ownership = currently on balance sheet

Capitalize a lease = put a lease asset & liability on balance sheet for an operating lease

Key: red = bad, green = good, amber = caution

What is the project?

To put operating leases on the lessee's balance sheet = capitalize them = record an asset that represents the value of the right to use the leased asset + record a liability representing the obligation to pay future rent

The Boards changed their minds on lessee accounting - now thinking that a lease creates a liability that cannot remain off balance sheet – the lessee has control of the leased asset and has an obligation to make payments over the lease term

Why the project?

The Boards said lease accounting had financial reporting deficiencies – primarily that the operating lease obligation was not on balance sheet as a liability

Lenders, debt & equity analysts adjust financials for operating leases when analyzing companies' financials - to estimate a "debt-like" equivalent for the obligation & an estimate of interest equivalent for ratios and measures

The change will give them all an accurate number for the lease liability = makes all their lives easier

How do you Capitalize a Lease?

- Determine the lease rents to be capitalized
  - Bifurcate CAM & other services
  - Review renewal/purchase options to see if they are bargains/compelling
  - Include variable rents based on an index (CPI), a rate (floating rate) and expected residual guarantee payments
- PV the rents using your incremental borrowing rate (fixed loan/bond rate for the lease term)
- Book the PV as a (right of use" (ROU) asset & "non-debt" lease liability
- Create a straight line rent expense pattern = imputed interest + "plugged" asset amortization **(you need a system to do this)**
- Book any landlord allowances and initial direct costs as part of the ROU asset and straight line amortize them to rent expense
- Track changes in variable rents for possible adjustments

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What is the impact and action plan?

WORK, complexity & lots of it!

- Start a project to transition to the new rules – we know the basic accounting framework from the FASB outline of decisions made to date

- Select a lease accounting & administration system

- Start using it

What is the impact and action plan?

- For existing leases on the books on the transition date
  - capture financial information
  - do the calculations to capitalize the lease
  -
- For new leases - set up a process with internal controls to capture information on leases
  - estimate lease terms, variable rents
  - do the calculations to capitalize the lease

- For all leases
  - track the leases for changes
  - calculate & account for any changes in the leases

What is the Financial Impact?

Some ratios and measures will change for the worse due to capitalizing operating leases– BUT all companies will be impacted – some more than others depending on their comparative level of operating leases:

- EBITDA – no change
- Gross Margin – no change
- Operating Expense Ratio – no change
- Current Ratio – no change
- Quick Ratio – worse due to added liability
- Debt to Equity Ratio – no change
- Return on Assets (ROA) – worse due to added asset
- Return on Equity (ROE) – no change

Structuring to Improve Financials

- Shorter lease terms = less capitalized – helps to improve ROA, Quick Ratio

- Structure rent payments to minimize them/minimize capitalized amount – net of property taxes, separate services (use of gym, common cafeteria, etc.), CAM charges = less capitalized - helps to improve ROA, Quick Ratio

- CPI vs step up = defer costs (temporary benefit), less capitalized – helps to improve EBITDA, Gross Margin, Operating Expense Ratio, ROA

Who is impacted?

- All companies who must produce audited financial statements must follow GAAP

- US companies fare better than IASB companies as their rules differ – IASB rules front end lease costs and label the liability debt – as a result most ratios are worse

- 15 of the top 30 in terms of operating lease rents are retailers
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  6 are transportation companies

Who is impacted?

Amounts added to the balance sheet:

	Total assets	Leases Capitalized Value
Walgreen's	$37bn	$21 bn/57%
CVS	$74bn	$17 bn/23%
United AL	$36bn	$13 bn/36%
McDonald's	$34 bn	$9 bn/26%

Check out the ProLease website for a model to estimate the impact on your company's balance sheet & P&L
http://proleasesoftware.com/

When will the new rules hit?

- For companies with a calendar year end – 2018 is the transition date when financials must reflect the rules

- Comparative numbers needed
  - Balance Sheet for 2017 & 2018
  - P&L for 2016, 2017, 2018

- Large companies will need a lease accounting system to make all the transition calculations and prior year adjustments

- Every lease on the books as of the transition date must be booked as of the earliest period presented (2016!)

Frequently Asked Questions

- Will my Debt covenants broken?
  - No – the lease liability is not classified as debt
- Will my credit rating be impacted?
  - No, as rating agencies and lenders all factored your operating leases into their analysis
- Will the changes impact equity analysis view of my company?
  - Yes and No - They factored in leases but some ratios & measures will be negatively impacted but the market will adjust to the new environment – everybody's ratios will move in the same direction
  - An accounting change does not affect the financial strength of your company

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