Action Plan to Prepare for the New Lease Accounting Standard

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The Financial Accounting Standards Board ("FASB") and the International Accounting Standards Board ("IASB") are jointly working on a replacement for the current lease accounting standards, FAS 13 and IAS 17, that will be followed by all companies worldwide. The impetus to this new standard was the ENRON accounting scandal of 2001. ENRON's demise was not caused by leases but it was caused by other off-balance sheet transactions. These transactions proved to be accounted for incorrectly and readers of ENRON's financials were not totally aware of the implications. The crisis prompted the US Congress to enact the Sarbanes Oxley Act which, among other things, directed the SEC to identify other off-balance sheet transactions.

Leases, specifically operating leases, were cited as a major class of off balance sheet obligations. In the opinion of the SEC, readers of financial statements would have better information if operating leases were capitalized as an asset and a liability on balance sheet. As a result, the FASB/IASB put a lease accounting project on their agenda in 2006 with the objective of creating a new lease accounting standard requiring lessees to capitalize an asset and liability for all operating leases.

Timing of the Project

The Lease Project is progressing with a target completion date of mid-year 2011 (See Figure 1). The Exposure Draft (ED), published in mid-August, is a draft of the final proposed rules. The accounting boards will review public comments on the ED until mid-December 2010. The accounting boards will review all comments and adjust the draft if warranted. FASB and IASB plan on issuing the final standard in 2011.

The effective date from which companies must comply with the new standard is expected to be January 2013. Although this date may seem distant, the transition requirements and the compliance requirements are complex, so companies should start to plan for the new standard immediately.

New Lease Accounting Standard Timeline

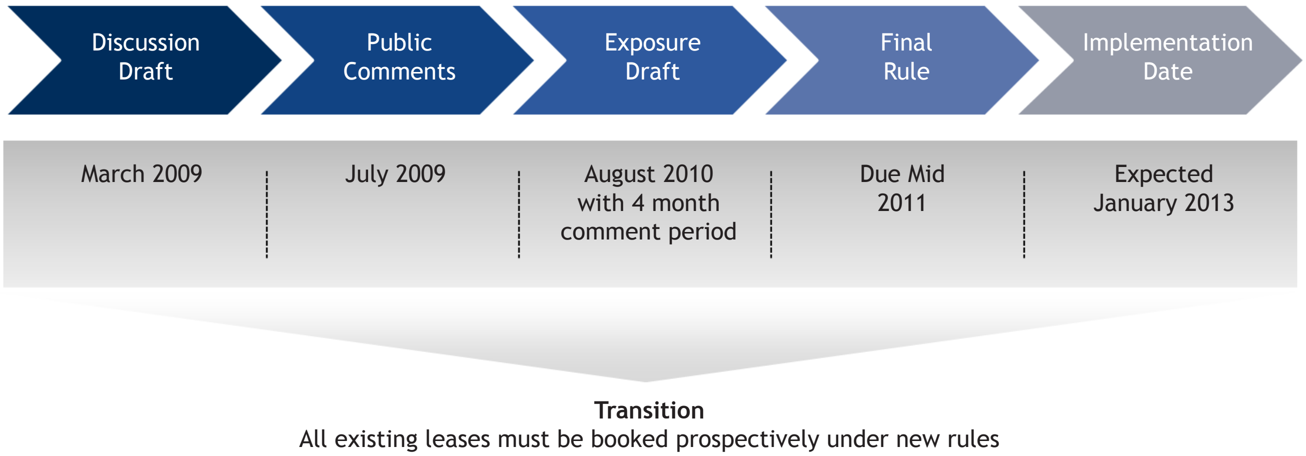

Figure 1: New Lease Accounting Standard Timeline

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What is the Project?

The focus of this whitepaper is lessee accounting, lease administration and operational impacts. For lessees the project means a complete change from FAS 13 where operating leases were off-balance sheet with only the straight line average rent reported as costs in the profit and loss ("P&L") statement. The proposed rule will require a lessee to estimate the lease term and estimate lease payments based on assumptions related to contractual rents, likely renewal rents, likely percentage (contingent) rents and likely residual guarantee payments. The lessee will calculate the present value ("PV") of the estimated payments using the company's incremental borrowing rate (the interest rate charged to borrow under a secured loan with similar terms). This PV is considered to be the value of the right to use the leased asset and the "principal" balance of the obligation to pay rent. This PV amount will be recorded as an asset and a liability. The asset will be amortized (like depreciation) straight line ("SL") to P&L. The lease payment will be broken down into an interest and principal component and the interest will be charged to P&L. The interest and depreciation expense added to the P&L will initially be greater than the traditional SL lease expense causing lease costs to be front-ended. Although lease costs on the financial statements will be greater, the IRS will still only allow rent paid to be deducted as an expense.

The estimates of lease term and lease payments have to be reviewed every time the lessee reports financial results – for large companies this is normally a monthly event. All existing operating leases entered into prior to the ED will have to be booked on a prospective basis capitalizing the remaining estimated lease payments on the transition date. For calendar year reporters this transition date will be the first time earnings are reported in the transition year which is expected to be 2013. Since many companies report comparative financial statements for 2 or 3 preceding years, the new accounting standard will have to be applied to all leases in place during the periods reported – this means most companies will at least have to make the adjustments for 2012 and possibly for 2011.

What is the Impact?

Financial Impact

The impact of the proposed lease accounting standard will be more far reaching than many companies realize. Most leasing experts expected that the new rules would use the methods that the major rating agencies use to capitalize operating lease obligations. The rating agencies' method of calculating present value minimum lease payments, as defined by FAS 13, ignores non-bargain renewal rents and percentage rents until they become obligations. Instead, the proposed lease accounting standard will result in a far greater capitalized lease obligation on the balance sheet. This increase in assets and liabilities may result in debt covenant breaches that will require negotiation and adjustment. Also, many expected that the average rent for a lease term would be used as the P&L expense. This accounting would align well with what the IRS allows as a tax deduction. Instead, the severe front ending of lease cost will reduce profits and force deferred tax assets (another asset added to the balance sheet) to be booked to show costs that are only tax deductible in the future.

The financial impact of the new lease accounting standard has grabbed all the headlines in the business press. The front ending of lease costs is a timing difference. Eventually higher lease costs will "turn around" at the midpoint in the lease term and reported lease costs will be lower for the back end of the lease term. However, the cumulative front end costs will be huge. As an example, Walgreen's, the US company with the largest amount of operating leases, will report reduced earnings of approximately $2.7 billion over the next 10 years as a result of the new lease accounting standard. In the first year under the proposed rules Walgreen's earnings will be reduced by $456 million due to a 23% increase in lease costs versus current GAAP average rent expense (see Figure 3). These estimates, based on Walgreen's footnoted future operating lease payments, are understated because the new definition of lease payments will include likely renewals and contingent rents. New leases will also add to the front ending. The total impact is likely to be 2 to 3 times higher or more!

The Effect of Front Ending Lease Costs

Lease Term	First Year Increase in Lease Cost – proposed rules vs. current GAAP
3 Years	7%
5 Years	11%
7 Years	16%
10 Years	21%
17 Years	26%

Figure 2: The Effect of Front Ending Lease Costs

Impact of Front Ended Lease Cost for Selected Large Companies

Company	Cumulative increase in lease cost up to turn around point	Year of turn around	1st yr increase in lease cost	% increase in lease expense in 1st yr
Walgreen's	$2,664	10	$456	23%
Target	$487	15	$50	21%
CVS	$1,500	9	$330	19%
AEP	$178	7	$55	18%
Wal-Mart	$838	8	$194	17%
JP Morgan	$891	7	$269	16%
Continental Airlines	$777	7	$223	16%
Home Depot	$581	9	$125	16%
Exelon	$98	9	$21	16%
American Airlines	$498	7	$146	15%
Kroger	$323	6	$112	14%
Bank of America	$913	6	$305	13%
FEDEX	$632	7	$211	12%
Best Buy	$275	6	$127	12%
Citigroup	$319	4	$157	11%

Figure 3: Impact of Front Ended Lease Cost for Selected Large Companies

Operational Impact

The impact of the new lease accounting standard that has received insufficient attention is the added administrative burden. The factors that create the administrative burden are:

- New expanded definition of what is included in lease payments
- Data to calculate payments comes from several sources in the organization
- Calculation of lease payments is complex
- Calculation of payments involves judgment and estimates
- Estimates must be reviewed and revised continuously
- Entries to record operating leases are complex
- Financial disclosure requirements are expanded
- Income tax reporting and accounting is more complex
- All existing operating leases will have to be booked on transition date
- The transition date is rapidly approaching
- The scale of the administrative requirements will require systems support for most companies

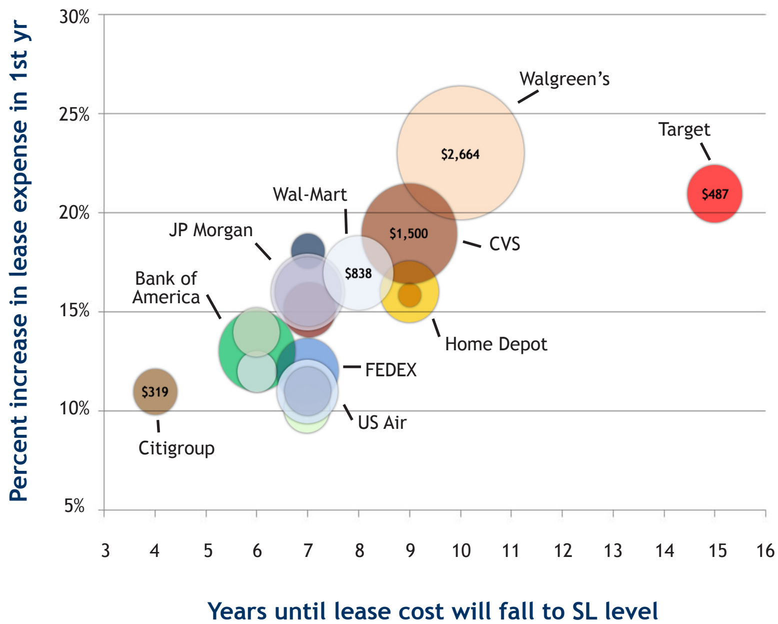

Figure 4: Bubble size represents cumulative increase in lease expense (in $ mm) up to point where annual lease cost declines to SL level.

Recommended Action Plans

Companies need to start preparing immediately for the lease accounting changes and the associated transition requirements. Companies must understand the new rules to determine compliance requirements, start a transition project, start an ongoing process project and review leasing policies based on the new rules.

New Rules Compliance Requirements

Item	Details	Source of Information/Hand off
Lease Payments	Under the new lease accounting standard, the lease obligation includes base term contractual rents and rents from renewal options that are likely to be exercised. Contingent rents (also known as percentage rents) over the estimated lease term must also be estimated and included in lease obligation calculation. Regarding residual guarantees, the difference between the expected value and the guaranteed amount is also included in the lease obligation. For leases that include service elements such as utilities or CAM charges, these services should be bifurcated and accounted for on a "cash basis". Lease payment information should be captured in a lease administration and accounting system to do the calculations, store the data and provide the output reports and journal entries.	▪ Terms are extracted from the lease document. ▪ Business unit management should provide estimated lease term. ▪ Finance should provide CPI estimates for CPI based percentage rents. ▪ Business unit management or accounting/finance can provide sales estimates for sales based percentage rents. ▪ Business unit management can provide residual guarantee possible payments.
Initial Accounting	The estimated lease payments must be discounted using the company's incremental borrowing rate (the rate that the company would incur under a loan with similar terms as the lease). Determining the incremental borrowing rate may be more difficult than expected as most banks do not provide 100% financing or offer fixed interest rates and level payments. A balance sheet entry must be made recording an asset called "the right to use leased assets" and a liability called "capitalized lease obligation". This initial accounting should be performed by a system that has an interface with the general ledger.	Booking information given to the Accounting Department.
Subsequent Accounting	The asset must be amortized straight line over the lease term and be recorded as amortization expense on the P&L. The liability must be accounted for as though it was interest bearing. Interest expense is accrued using the incremental borrowing rate. The lease payment is charged as an accrued interest expense and reduction in "principal". This subsequent accounting is best performed by a system that interfaces with the general ledger.	Booking information given to the Accounting Department.
Adjustments	At the end of each reporting period the estimated lease payments must be reviewed for changes. If the changes are material, adjustments must be made to the book value of the asset and liability. These changes will also affect the lease expense. These adjustments require a system that interfaces with the general ledger.	Booking information given to the Accounting Department.
Tax accounting and reporting	A deferred tax entry reflecting the difference between the tax deduction for rent paid and the book lease cost (amortization of the asset and accrued interest on the liability) must be posted to the balance sheet. At year end the actual rents paid must be given to the tax department to include as a tax deduction. A lease administration system should be used to provide the information necessary to prepare the accounting entries and reports.	Tax accounting information must be given to the Accounting Department. Tax return information must be given to the Tax Department.
Disclosures	Footnote information requirements are expanded to include break downs of estimated payments included in lease payments for future periods (next 5 years and a thereafter). The lease administration system should be able to produce this report.	Disclosure information must be given to the Accounting Department.

Transition Project

Companies must start to prepare now in order to gather the information for comparative financial periods that precede the transition date. For the transition project companies should create a project team with members from all departments involved including: Lease Administration, Information Technology, Accounting, Finance/Treasury, and the Business Units. The first step is to read the proposed rules in detail and list compliance requirements. The next step is to review current systems capabilities. Companies must verify that their software provider meets the new rule's requirements - including the transition requirements. Many companies will need to identify new system(s) prior to the transition date. Next, companies should begin extracting information on existing leases:

- Lease term and rents – timing and amounts
- Renewal option terms and rents
- Contingent rent/percentage rent terms
- Residual guarantee terms
- Purchase options terms, currently not needed for accounting but good to know
- Service elements in lease

Next, companies should identify internal sources for the following information:

- Intentions regarding renewal and purchase options (Business Management)
- Incremental borrowing rate (Finance/Treasury)
- Sales projections for percentage rents (Business Management)
- CPI for percentage rents (Finance)
- Residual guarantee payments (Business Management)

Companies must then implement the systems and input lease data, the incremental borrowing rates, and future estimates of CPI. Borrowing rates will vary by term of lease. For example, a 2 year borrowing rate will be different than a 10 year rate. The system should be able to use data to perform calculations across the entire portfolio. Finally, once this data has been loaded in the system, companies should prepare transition entries to book the leases.

Ongoing Project

Companies that report on a calendar year basis would need to have their ongoing process in place by the new rule's effective date (presumably January 1, 2013). Companies should already have systems in place from the transition project. Companies will need to implement ongoing processes and develop operating procedures. The procedures must include data capture of key lease terms – rents, renewals, percentage rents, residual guarantees and purchase options.

The procedure should also establish contacts in key departments for estimating payments – renewals, percentage rents, residual guarantees and purchase options.

The ongoing processes include:

- Input and maintain information on each lease:
    - Rents
    - Renewal rents
    - Percentage rents formulas
    - Service element amount included in rents
    - Residual guarantees
    - Purchase options
    - Incremental borrowing rate
    - Estimated future sales for the location
- Input CPI estimates for the future
- Provide information for necessary journal entries
    - Initial accounting
    - Monthly entries
        - Amortize asset over lease term
        - Interest amortization on lease liability
        - Deferred tax entry
- Periodic review of estimates
    - Every time company reports earnings
    - Re-run the process contacting internal sources to get new estimates of key information
    - Input changes to system
    - Adjusting journal entries
- Provide lease data
    - Tax department
        - Actual rent paid for tax return
        - Deferred tax accounting entry
    - Finance/Controllers department
        - Footnote information
        - Projected future rents by rents including estimates
        - Breakdown of projected rents – estimates vs. contractual

Review Leasing Business Policies

Companies must understand the proposed new rules and the impact of lease terms on accounting results. From this analysis, companies may decide to negotiate shorter or simpler lease terms with fewer renewal options and contingent rents. Features like percentage rents based on sales or CPI may have been tolerable under existing rules as the cash and expense was in the future when increased sales would cover them. Now that the expense pattern will be front ended there will be no revenue to cover the expense. The expense is a non cash expense but Wall Street will probably not adjust for it. Of course, lease terms also depend on business needs. Companies may want a long term lease and renewal options, regardless of the negative impact to financial statement, if a location is viewed to be especially strategic.

There are new Lease vs. Buy considerations. Formerly this analysis was primarily based on economics as operating leases were off-balance sheet and had no accounting impact. Now that all leases must be capitalized, there are financial metrics that must be considered. Buying will result in a different expense pattern as depreciation will be stretched out over the economic useful life. Whereas, amortization of the leased asset is spread over a shorter lease term. The ROA/ROE results will be decidedly worse for a lease under the new rules, but leasing may still look better than buying from a financial impact perspective. EBITDA and cash flows from operations will strangely look better than under the existing rules as rent is no longer be considered an operating expense on the P&L.

Under the new lease accounting standard, excess leased space will be especially detrimental to Return on Assets (ROA) as the lease asset is on balance sheet and the expense pattern is front ended. This simultaneous reduction in net income and increase in assets will exacerbate the ROA problems. Subleases are also more complex under the new rules. Formerly, both the lease and sublease were off-balance sheet if they were both operating leases. The new rules require that the lease and sublease be accounted for on balance sheet. Therefore, the lessee is not relieved of the obligation.

Sale leasebacks that were completed to remove assets from the balance sheet will no longer provide this relief; although any gains on the sale will not have to be amortized.

Monitor the Project

Read and understand the Exposure Draft. Get into the details. Follow the meetings and progress on the FASB and IASB websites. Companies that disagree with any of the proposed changes should send in a comment letter to the FASB and IASB.

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Real Estate Lease Administration Process Checklist

New Lease Process:

- ☐ Read and analyze every lease
  - Capture the terms of the lease
    - Basic minimum term
    - Amounts of basic term minimum rents
    - Frequency and timing of basic rent payments
    - Contingent rents/percentage rents based on CPI or other index
      - Formula for calculation of percentage rent based on index
      - Timing of payment of percentage rent
    - Contingent rent/percentage rent based on sales
      - Formula for calculation of percentage rent based on index
      - Timing of payment of percentage rent
    - Renewal options that are at the sole option of the lessee
      - Term of each renewal option
      - Amount of renewal rent payments for each renewal option
      - If the renewal option is for fair market value rent note that and any formula for calculation fair market value
    - Purchase options terms, if any
  - Contact the Business Management department and find out if they intend to renew the lease and for how many renewal periods.
  - Contact the Controller's or Finance department to get an estimate of CPI for the periods in the lease term or other index for percentage rents and calculate the estimated percentage rents for the term including expected renewals.
  - Contact the Business Management department to get an estimate of future sales for percentage rents and calculate the estimate percentage rents for the term including expected renewals.
  - Get the company's incremental borrowing rate from the Treasury department

- ☐ Calculate the present value of the total estimated payments over the estimated term and give it to the controller's department or input it into your lease accounting/administration system

- ☐ Calculate the principal and interest run out of the lease obligation either via your lease accounting system, an excel spread sheet or other means and provide that to the controller's department.

Ongoing Process:

- ☐ On each accounting reporting date as defined by your Controller's department review assumptions for CPI and sales with the Controller's department and review your renewal assumptions with the Operations department.

- ☐ If changes are material, revise the present value calculation for future estimated percentage rents and renewal rents and provide the revised present value and new principal and interest run out to the Controller's department or input the new numbers into your lease accounting/administration system.

- ☐ Annually provide actual rents paid to the tax department to be included in the tax return and for them to prepare deferred tax entries as the accounting expense is different than the tax deductions for leases.

- ☐ Prepare disclosure information annually for the Controller's department to be included in the annual report's leasing footnote. Type of disclosure info to be defined but will include table of future rent payments broken down between contractual rents and estimated rents.