

THE NEW LEASE ACCOUNTING STANDARDS ARE ISSUED: WHAT REAL ESTATE STRATEGIES SHOULD LESSEES CONSIDER?

The wait is finally over...or is it?

Sweeping changes to lease accounting have been finalized. To varying degrees, these changes affect all global companies, across all industries. The Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB), collectively the "Boards," have now separately issued new standards that will move virtually all leases onto the balance sheet. While the issuance of the new standards seems to symbolize that we have finally crossed the finish line of this epic journey, looking at the situation from an implementation perspective, the starter's gun has sounded and we are just now leaving the blocks.

The new standards require lessees to essentially capitalize all leases, including real estate, equipment, automobiles, etc. Companies that report under International Financial Reporting Standards (IFRS) will treat all leases as Finance Leases with a front-end-loaded expense pattern, while those following U.S. Generally Accepted Accounting Principles (GAAP) will determine if the transaction more closely resembles a rental or a financing and classify the lease as either an Operating Lease or a Finance Lease, respectively. The effective date for the FASB standard (Accounting Standards Codification (ASC) 842) is 2019 for public companies and 2020 for private companies, while the IASB has an effective date of 2019 for all companies that will follow IFRS 16. Both Boards allow for early adoption of the new standards.

At first glance, the thought of capitalizing all leases—whether for a company's

headquarters or for a copy machine on the fifth floor—seems like it will necessitate a change in corporate strategy. However, once the initial shock of capitalization wears off, CBRE does not believe it will have a significant impact on real estate transactions. At the margins, it is possible that deals may be structured differently, especially in the United Kingdom where it is not uncommon to have unusually long lease terms ranging from 25 to 100 years. In this case, a greater number of companies may consider reducing the length of their leases or the types of renewal clauses within. However, in general, the vast majority of real estate leasing should emerge unscathed.

LEASE VERSUS OWN DECISION

The changes to lease accounting may alter the "lease versus own" strategy for a company. While accounting treatment has always been a consideration in real estate transactions, it has rarely been the driver. The main objective is, and will continue to be, the efficient use of capital. For core single-tenant assets, there may be a higher likelihood of ownership once the new standards become effective. This is especially true for entities with stellar credit, as a company's cost of capital may be considerably lower than the landlord's projected yield on the lease. Additionally, under today's ASC 840 (previously FAS 13) and IAS 17 rules, a trade-off in the "lease versus own" dilemma means giving up the benefit of an asset's residual value for off-balance sheet treatment. The new standards eliminate this dilemma.



Note: In January 2016, CBRE's Global Task Force on Lease Accounting issued a lease accounting update reviewing the technical details of the new lease standards by the IASB and FASB.

To access this document, please [click here](#)

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Today, most corporate real estate needs are being met by leasing, not owning. The new standards present the simple and logical question: "Occupied space will be on the balance sheet, so why not own?" While some companies may find ownership more compelling for core assets they fully occupy, for those occupying space in a multi-tenant building, the possibility of "owning" the asset is usually not an option—even if it makes sense on paper. Condominiumizing (as it is known in the U.S.) multi-tenant buildings is not expected to widely occur as a result of the new standards because it is burdensome and costly to landlords. Additionally, the benefits to an occupier of taking an ownership position in a multi-tenant building will most likely be outweighed by the risks and limitations. There are geographic exceptions to this perspective where owning space within a larger building is already common practice. This is true in parts of Asia where it is not uncommon for developers to sell their buildings "strata title" (i.e., floor by floor). In such cases, developers may see a greater level of interest by multi-national corporations.

OCCUPIER STRATEGIES

The new standards create additional scenarios for tenants to consider when evaluating leases. Because the new standards eliminate the need to navigate the capital/finance lease pylons in ASC 840 and IAS 17 for off balance sheet treatment, tenants may consider revisiting forgone strategies, such as bargain renewals and purchase options.

However, employing a bargain renewal or purchase option will likely result in a lease being classified as a Finance Lease with the front-end-loaded expense pattern. In the case of a bargain purchase option, the purchase price must also be included in the amount to be capitalized and the Right-of-Use (RoU) asset must be amortized over the useful life of the underlying asset.

Additionally, a bargain purchase option could make it "reasonably certain" that a tenant will exercise a renewal option and therefore, result in a greater amount recorded on the balance sheet. These impacts must be weighed against the potential benefits.

Many lessees enter into what are called "gross" or "full-service" leases where the payment includes rent for the space as well as operating expenses and taxes associated with the property. In these situations, the gross rent payments should be segregated with only the net rent portion being capitalized. Any expense-related component included in the gross payment will be accounted for as a current operating expense. As such, during lease negotiations, tenants should require this information be provided by the landlord. CBRE research teams around the world compile this data on a regular basis and can provide estimates if landlords do not.

The new lease accounting standards will motivate companies to establish processes and controls to ensure real estate facilities acquired, whether purchased or leased, are consistent with overall corporate objectives. CBRE expects the balance sheet impact of leases will now be under the watchful eye of corporate finance departments, potentially adding an additional voice, and likely more levels of approval, to real estate transactions. The resulting unintended consequence may be a longer time frame to negotiate and execute a lease. Leasing will have a more visible role within corporations and transactions will more closely resemble capital expenditures. No company wants to miss its return-on-assets metric because of an ill-timed early renewal and extension.

CBRE also believes the new standards may encourage more companies to fund tenant improvements (TIs) in order to capture the spread between their cost of funds and the interest rate embedded in the lease. Self-funded TIs, and those incorporated into a lease, will be accounted for differently on a company's books.

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Under the new standards, companies will likely request more alternatives from a landlord when contemplating a lease. Pricing for multiple terms, like 5, 10, and 15 years, with varying TI packages and several renewal options will provide a tenant with a matrix of scenarios from which to choose.

These differing amounts will be a factor in selecting the best term and TI combination, but probably not the sole determining factor. The need for firms, like CBRE, to assist clients in analyzing their options and finding the sweet spot—where the lease economics and the company's cost of and best use of capital intersect—will increase.

MONETIZATION STRATEGIES

Sale/leasebacks have always been an effective vehicle to liberate capital locked in an illiquid asset.

The new standards will not change this. The determination of whether a sale has occurred will be in accordance with the new Accounting Standard on Revenue Recognition. This is a broader definition than previous U.S. GAAP, but is a tightening of scope for those following IFRS.

Generally speaking, under current U.S. GAAP, any gain on the sale of an asset is recognized ratably over the term of the leaseback; the same is true under IFRS if the leaseback is a Finance Lease. However, in the new standards, a sale/leaseback is viewed as two distinct transactions, requiring any gain or loss to be recognized immediately. This may spur some companies to undertake a sale/leaseback when the immediate recognition of a gain or loss is to their benefit. Some companies prefer today's requirement that the gain be spread over the term of the leaseback because it becomes a consistent source of income and is used by analysts in computing important financial metrics.

Another monetization alternative that may gain momentum as a result of the changes in lease accounting is on-balance sheet lease financing. This intra-company structure allows for an asset to be monetized, while still maintaining ownership and control. If an entity enjoys investment-grade credit, the economics can be compelling.

Utilizing a credit-based financing instrument such as a Credit Tenant Loan (CTL), the high-credit entity becomes the lessee, a related entity takes on the role of lessor, and a lease is created between the two parties. Unlike a traditional mortgage which uses "bricks and mortar" as the basis for financing, a CTL monetizes the cash flow from the lease, which can be greater than the value of the building. The result is the company extracts money from a non-income producing asset while maintaining control and ownership.

Another structure seeing an uptick in activity in the U.S. is the Synthetic Lease. A Synthetic Lease is a hybrid structure that is an Operating Lease for accounting purposes, but ownership for tax purposes. Synthetic leases are credit-based instruments and can be used to acquire a property that will then be leased to an investment-grade tenant or to fund a build-to-suit. The tenant never owns the asset; instead they sign a lease with a Synthetic Lessor, usually a division of a bank, which becomes the owner and lessor. The rent is comprised of interest payments on the acquisition price, and the rate is a credit spread over LIBOR. Synthetic Lease terms are usually five years, resulting in a modest balance sheet impact.

(For more information on synthetic leases please [click here](#))

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OTHER CONSIDERATIONS

A question many firms will have is whether the capitalization of leases will alter access to, or the pricing of, debt.

If the addition of leases to a balance sheet deteriorates the financial metrics a bank uses to compute debt capacity or pricing (i.e., return on assets, debt to equity and debt coverage ratio), the implementation of the new standards may cause issues. On the other hand, a company's credit rating should withstand the changes, as rating agencies today apply a multiplier to a company's current year rent expense to determine an estimated lease liability to be added to the balance sheet. As long as this long-standing approach has not been significantly understating a company's actual lease liability there should not be a major impact to a company's rating.

Companies will need to become familiar with the transition rules of their applicable standard and prepare financial models and sensitivity analyses on existing leases to assess the impact of the proposed changes. The potential impact of the new standards on a company's balance sheet should then be communicated to its lenders, credit analysts, and Wall Street prior to implementation. It has been recently estimated that listed companies reporting under IFRS and U.S. GAAP have U.S.\$3.3 trillion in lease obligations, of which 85% are not currently recorded on their balance sheets.

While the effective date of 2019 may seem a long way off, it is important to note that the comparative financial statements will need to be restated to comply with the new standards. This effectively brings the initial date of impact for most public companies back to 2017 for the income statement and 2018 for the balance sheet.

Companies' needs for real estate are not going to vanish with capitalization requirements, but the requirement to capitalize leases will add scrutiny to current

leases, as well as future transactions. One method to lessen the impact of implementing the new leasing standards is to "right-size" a company's real estate portfolio. Are there blocks of space acquired in a merger that are no longer needed? Can some personnel situated downtown perform just as well in less expensive suburban space? Could workplace strategy techniques be employed at the next renewal to reduce square footage? These and many other questions will be asked as real estate departments find themselves in a more integral role within corporations.

CONCLUSION

In conclusion, changes to lease accounting will impact the balance sheets of lessees and a brighter spotlight and greater level of scrutiny will be placed on corporate real estate executives and real estate transactions. However, when the dust settles, the landscape is expected to look much the same. Leases will still be negotiated with the best interest of the business in mind; capitalization will be a factor, but not the driver.

For suggestions on what companies can do as they begin to work through the implementation phase of the new standards, **please see the recommendations previously put forth by the Task Force.**

Additional information on this topic can be found on the websites of the [FASB](#), [IASB](#) and the [CBRE Task Force](#).

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