Grant Thornton

Preparing for global lease accounting standards

Implications for the real estate industry

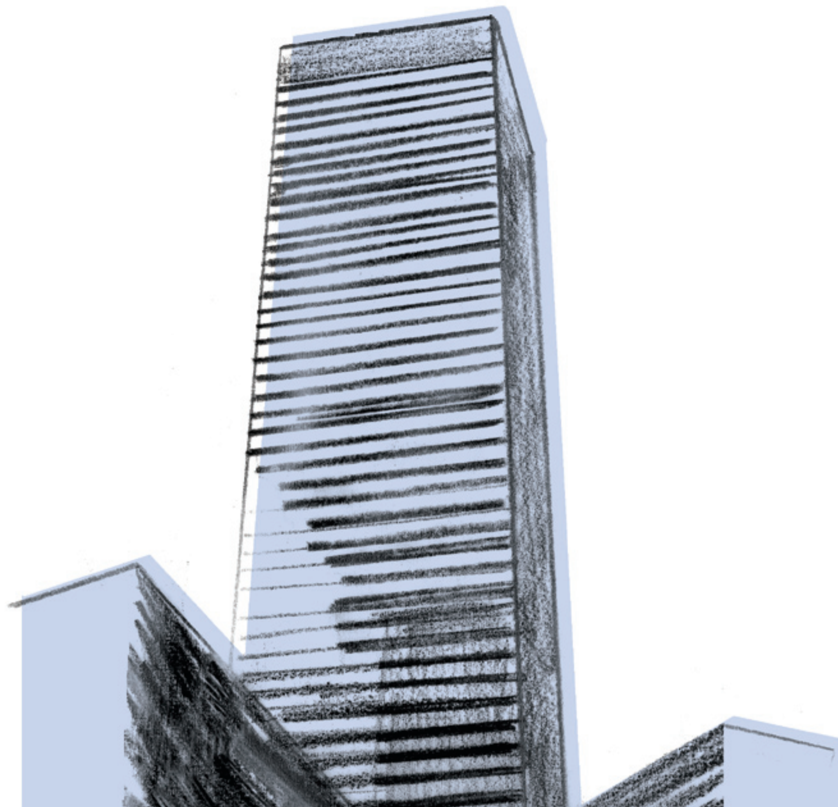
Preparing for global lease accounting standards examines the status of the proposed lease accounting standards and offers real estate executives' perceptions—from Australia, Canada, India, the UK, and the United States—of the standards' potential impact.

Introduction

Real estate companies and other lessor organisations around the world—and especially their lessees—face the prospect of fundamental changes in how they account for leases. New lease accounting standards proposed by the International Accounting Standards Board (IASB) and the US Financial Accounting Standards Board (FASB) are expected to become International Financial Reporting Standards by the end of 2011. They could create costly process changes for some real estate firms and reshape the accounting models of others—and they have all firms looking for potential real estate market side effects. Reaction within the real estate sector to the proposed standards and initial deliberations has ranged from annoyance to concern.

Contents

3 Introduction
4 Why the change?
6 Awareness and impact
9 Lease lengths and incentives
11 Real estate prices and demand
12 Buy rather than lease
13 Working with lenders
14 Concerns and recent board discussions
16 Preparedness
18 Global contacts



Why the change in lease accounting standards?

The IASB and FASB first published a discussion paper in March 2009 on lease accounting in response to concerns about the treatment of lease contracts under International Financial Reporting Standards (IFRS) and US Generally Accepted Accounting Principles (GAAP). IASB and FASB noted that many lease contracts at that time (total contracts worth about US$760 billion in 2007)[1] did not appear on a statement of financial position/balance sheet because IFRS and US GAAP split leases into two categories: finance leases (capital leases under US GAAP) recognised in the balance sheet and operating leases (a lessee simply recognises lease payments as an expense over the lease term).

In August 2010, after an initial comment period in 2009, the boards published, for public comment, the Leases Exposure Draft (ED). That document described the concerns of IASB and FASB over current accounting approaches.

The existing accounting models for leases require lessees to classify their leases as either finance leases or operating leases. However, those models have been criticised 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 finance 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.[2]

The ED proposed an approach to lease accounting based on the principle that all leases give rise to liabilities for future rental payments and assets (the right to use the leased asset) that should be recognised in an entity's statement of financial position, ie, requiring companies to recognise lease contracts as liabilities and assets on their balance sheets. The proposed approach seeks to ensure that leases are accounted for consistently across countries, sectors, and industries. Specifically, the ED stated:

The exposure draft proposes that lessees and lessors should apply a right-of-use model in accounting for all leases (including leases of right-of-use assets in a sublease) other than leases of biological and intangible assets, leases to explore for or use natural resources, and leases of some investment properties. For leases within the scope of the draft IFRS, this means that:

(a) a lessee would recognise an asset representing its right to use the leased ('underlying') asset for the lease term (the 'right-of-use' asset) and a liability to make lease payments.

The proposed approach seeks to ensure that leases are accounted for consistently across countries, sectors and industries.

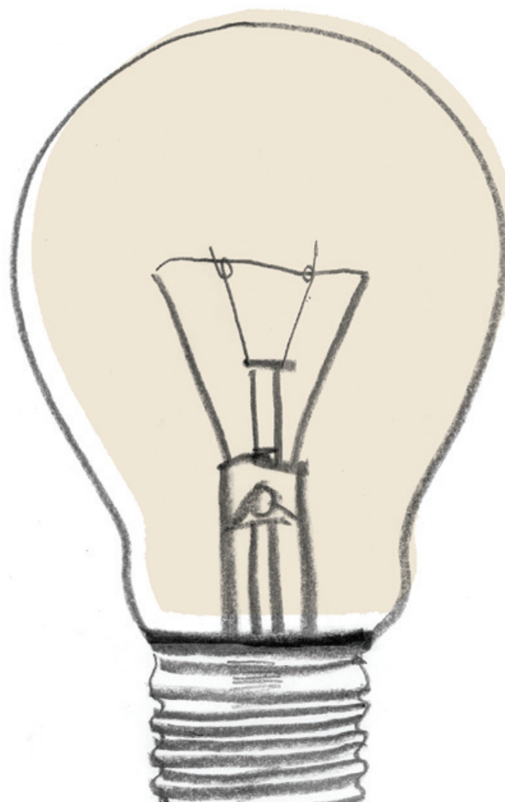
(b) a lessor would recognise an asset representing its right to receive lease payments and, depending on its exposure to risks or benefits associated with the underlying asset, would either:

(i) recognise a lease liability while continuing to recognise the underlying asset (a performance obligation approach); or

(ii) derecognise the rights in the underlying asset that it transfers to the lessee and continue to recognise a residual asset representing its rights to the underlying asset at the end of the lease term (a derecognition approach).[3]

The comment period for the 66-page ED ended on December 15, 2010. The two boards held public roundtable meetings in December 2010 and January 2011 to discuss the ED; in addition, the boards reviewed more than 700 comments on the standards and analysed a range of issues, while continuing an outreach programme seeking input from lessors, lessees, investors, accounting firms and other interested parties. Discussion by the boards have focused on areas of concern (see *Concerns and recent board discussions*). The boards initially intended to publish final standards by June 2011, but in April reported an extension of the timetable of a few additional months.

Accounting and/or business changes are likely for many real estate companies, but the extent of changes and their timing are difficult to pinpoint given boards' extended timetable and ongoing redeliberations—ie, the proposed standards remain a moving target. (Note that executives quoted in this report based their comments on the ED and public reports on the proposed lease accounting standards as known prior to April 2011.)



[1] World Leasing Yearbook, 2009.
[2] Leases, Exposure Draft, IFRS Foundation, August 2010.
[3] Ibid.

Awareness and impact to individual businesses

One thing is clear in speaking with lessors from around the world and reviewing formal comments offered to the boards: most lessors are following the issue closely, with an understanding of the proposed lease accounting standards. Opinions regarding the standards' impact vary considerably as many lessors do not see a direct impact on their businesses but rather see impact for their markets. In addition, many real estate firms will not see significant accounting revisions due to exclusions expected in the final standards:

- **investment property:** The IASB has proposed to exclude investment properties measured at fair value (in accordance with IAS 40) from the lease accounting requirements
- **national GAAP:** in much of the world, unquoted (privately owned) real estate and other companies apply national accounting rules rather than IFRS or GAAP. Those companies' financial statements will only be directly affected if national standard-setters decide in due course to converge with the new IASB and FASB lease accounting model. Similarly, the impact on lessees will in many countries depend on whether they are quoted (public) or private entities
- **short-term leases:** leases of less than 12 months, such as for multifamily housing, would be excluded.

"We have studied them in detail since the initial exposure draft and we have been involved with sector-wide discussions and held meetings with relevant IASB members," noted an executive of a large UK-based real estate company with holdings primarily in the UK. The executive also points out that "thoughts are well advanced for real estate investors that carry their assets at market value (such as us) to be exempt from the provisions."

Another UK real estate executive said he is familiar with the standards "because the various professional bodies are putting out circulars saying what it's about and what they think the impacts will be. But, of course, for us, it's still a couple years away. And there have been threats about an update to lease accounting for 20 years that have not followed through." His company generally reports under UK GAAP and is unlikely to see a short-term impact, he said, but he expects the standards to become relevant if the UK Accounting Standards Board aligns UK GAAP with IFRS, which is probable.

Terry Bradshaw is executive VP and chief financial officer of American Asset Corp. (AAC), a diversified real estate company based in Charlotte, N.C., that owns suburban class A office, large-footprint retail, and industrial flex space—about 6 million square feet in the Raleigh and Charlotte metropolitan statistical areas (MSAs). Bradshaw said he's well versed in the

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Brian Bickell,
Finance Director, Shaftesbury PLC

standard, although he did not submit a comment letter.

“Given that a significant part of our business is investment in commercial property, the proposed changes to the leasing standard have the potential to see significant changes to our sector,” said an Australian real estate executive. “However, from a reporting perspective, the adoption of the fair value model means that as a lessor the measurements and disclosure requirements of the proposed changes do not apply to our investment portfolio.” The executive also noted that, despite its fair-value approach, his business is likely to feel some impact as it incurs costs in updating processes to capture and monitor the additional information requirements associated with the new standard, particularly for contracts in which the company enters leases as the lessee (a small part of its business).

“Obviously, as a real estate investor, we’ve been carved out of having to apply the standard ourselves,” said Brian Bickell, finance director, Shaftesbury PLC, a real estate investment trust focused exclusively on London’s West End. Shaftesbury’s portfolio consists of shops and restaurants (about 70 percent), offices (20 percent), and residential (10 percent).

“I suppose the point at which we became carved out, I probably [lost] interest in it as it doesn’t affect us directly but obviously could have an impact on our tenants,” continued Bickell. “I think our philosophy has always been you do the right thing commercially and actually not let the accounting tail wag the dog because, you know, you just look at what’s in the best long-term commercial interest of the company.”

Howard Garfield is CFO of Behringer Harvard Multifamily REIT I Inc., a real estate investment trust based in Addison, Texas that acquires a portfolio primarily of high-quality multifamily communities, including conventional multifamily assets, age-restricted residences, and student housing. Garfield wrote a comment to the IASB and FASB, and has been in favour of changes for lessees, but “when the scope of it was expanded to include lessors, I was quite opposed to it.” He called the lessor standards as proposed in the ED a “theoretical model” that characterises real estate as financing. “To call what real estate owners do as financing is just absurd. And to think that, now, people are going to start recognising interest income and changing their approach to real estate just shows how far a theoretical model is from the real world. This will truly trivialise GAAP, and we’ll all spend money.”

Even among firms that do have to address the new standards, concern is primarily focused on costs to comply and the effects on markets and tenants rather than on business model changes. Philip Payne, CEO of Charlotte, N.C.-based Ginkgo Residential, a real estate operating company that provides management for 28,500 apartment homes across the United States, said he does not expect major impact “other than significant increase in accounting effort and cost with

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no benefit. [The] proposal will not result in more accurate or informative financials. [It] in fact may be misleading."

"I think, long term, just the pure cost of having to implement something as complex as this standard in the type of economic environment we're in is unfortunate timing," said Bradshaw from AAC.

Sandro D'Ercole, VP accounting, Redcliff Realty Management Inc., a Toronto-based real estate company providing asset management, property management, and development services to private investors and pension funds, reiterated that comment: "This will lead to more subjective interpretations of the financial statements and questions by our stakeholders."

Angus Harvey Ross is senior director at CB Richard Ellis, Brisbane, Australia, which is a service provider in the corporate real estate area, providing advice and services to major corporations that occupy space rather than those who invest in the development of space: "I think it'll have a substantial impact in both my business and in the business of my clients. We're already seeing the commencement of it now. I think we're probably a little bit too late in the process, but we're starting to see much more emphasis being brought on to the changes that will take place and how that will affect the portfolios and the balance sheet."

Executives believe there will be little room to manipulate or develop accounting structures to improve competitive position or gain advantage via the standards, such as providing the appearance of enhanced cash flow. Most believe that the rigorously detailed standards (as they currently exist) will at least achieve a goal of transparency and make trying to tilt the playing field difficult or of limited value.

"There may be opportunity to structure leases in such a way to give favourable accounting positions through varying incentives, lease structures, or lease review profiles, however we have not fully investigated these at this time as all outcomes associated with the new standard are still not known," said an Australian executive. "We expect these opportunities to be limited as we assume the final standard will focus on the substance of the transaction."

"From what I've read of the standard, it's fairly well written," said Bradshaw. "When I say well written, [I mean] it doesn't lend itself to manipulation very well from what I can tell. Unlike most of the standards we've had heretofore in the US, it's a principle-based standard and not a rules-based standard. When you have a principle-based standard, it's very difficult to manipulate the process to your benefit. So I don't think there's a lot of room, at least in the way the standard's written now, for landlords to develop a programme where tenants get a favourable treatment on their balance sheet by some structuring mechanism. Maybe there will be, but I haven't seen it yet."

Sumit Chatterjee, GCFO, Pioneer Urban, a real estate development firm headquartered in Gurgaon, India, near New Delhi, remarked, "The objective of this standard is to have a more transparent accounting structure. We believe that the companies in the leasing business will surely develop a leasing structure that complies with IAS along with maintaining cash flows and financial positions of both lessor and the lessee."

Lease lengths and incentives

Executives in the real estate sector are concerned about the effect of pending standards on markets just now emerging from recession. One concern is that if leases are accounted for by lessees as liabilities for the length of the leases (and possibly including options for additional years), will lessees seek shorter-term leases? And if that occurs, how might it impact valuation of lessor properties?

A UK executive argues that companies are already seeking short leases and earlier breaks, and that the new standards will put even more pressure on them to negotiate shorter terms. "We've got existing, very long leases. I don't know what's going to happen next time we do a major deal. I guess there'll be pressure about whether it affects valuation and how it will affect the amount of debt that can be raised at one time on the deal."

An Australian real estate executive also anticipated shorter lease lengths. "We believe that in the short term that covenants will be altered to accommodate the change, and this impact on businesses will be highlighted as a detailed note in the accounts. The medium- to long-term [time frame] could lead to shorter lease terms or alternate methods of contracting to minimise balance-sheet impact. This would potentially impact our non-residential business model."

Others argue that most tenants need to be able to project their occupancy costs and want to minimise lease cash costs, which would mean lessees won't necessarily seek shorter lease terms. Garfield said, "If they're retail, they certainly don't want to be exposed to market rifts. In major shopping centres, those are typically 10-year leases, and they're not going to want to go to two- or three-year leases and then be exposed to market conditions just for accounting issues; same thing with office tenants."

"Inevitably the likely reaction will be different for different types of tenants," said a UK executive. "Our portfolio is prime, and we find that the retail occupiers often want long leases to be assured of having a unit on a key trading area. There will be other tenants with a different view. If leases were to be shorter, the impact on valuation will be a function of the market: in a strong market it may have little impact; in a market craving certainty, then depending on the level of the rents, it may be seen as a disadvantage. However, this standard has been on the agenda for the last decade and has not significantly altered tenant behaviour so far."

"I think sophisticated tenants or sophisticated lessees will analyse it correctly and remember why they wanted a long-term lease to start with," said Bradshaw. "It's an inflation hedge, and so that you can budget and control your cost. I think that if [desire for short-term leases] is a phenomenon, I think it'll be short-lived, because I don't believe most lessees want significant volatility in their occupancy costs."

Harvey Ross of Australia added: "We're not seeing people changing to short-term leases, primarily because the markets here work on long-term leases and the benefits and incentives are for long-term leases. So, it's unlikely that we'll see too much short-term work. The major issue for these companies is that the initial impact, in other words the data changeover, means that every lease becomes a capital lease irrespective of its [term]. What the auditor is assigned to look at now is the spread of the expiry dates over a 10-year period so that if it's better now to renegotiate the leases to get a better spread of expiries, then we're renegotiating the leases prior to the impact of the new accounting standards."

A prevalent thought among real estate executives is that savvy businesses—lessees or lessors—will continue to do what is right for their businesses and not let accounting dictate their moves. Nonetheless, there is the potential that shorter leases will affect the incentive packages (eg, inducements, flexibility of terms, tenant improvement allowances, contingency clauses) and/or space configurations.

"We are in a marketplace here where only long-term leases attract any form of incentive," said Harvey Ross. "So anything that happens in the next two to three years will certainly have an impact on the likely incentives. I expect that what will happen is that the companies will now look at leases, which are relatively short term—in other words, leases with expiry dates in two, three, four, five years' time—and try and renegotiate now for a longer period so that they get the benefit of the incentives now and that can go against any future costs on the balance sheet."

"I think there'll be a lot more thinking about all that," said a UK executive. "I think there will be changes. I don't know what the changes will be. There could be some irrational behaviours from a commercial perspective, purely in terms of leases, because there'll be some other commercial imperatives driven from the numbers, from the accounting, a kind of knock-on effect. So you actually almost do something that's potentially not commercial in order to avoid an accounting impact, because that accounting impact leads to other knock-on effects. And I think that's a bizarre kind of event but a possibility."

"Being a developer, we have to plan the projects as per the market requirement," pointed out Chatterjee. "Every lease has its own requirement and will be framed/negotiated separately. Changing space configuration may not be the right solution. This has to be mutually decided between the lessor and the lessee."

At AAC, Bradshaw ruled out the company changing space configurations due to the new standards. "No, I don't think it would change our configuration. We are very much a long-term property owner. This sounds bad, but we're going to build what we think is a long-term viable asset, and the tenants will come or they won't. But I don't think we'll change our footprint or our programme to fit because of this standard. We do have assets in our portfolio that lend themselves well to smaller footprint spaces, which I think is a good thing to have, but I don't see any change in our programme to accommodate this."

"I don't think this will affect our tenants' decision on how long their lease will be," said D'Ercole. "This decision should be based on business needs, not accounting treatments."

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Real estate prices and demand

Most real estate executives don't expect prices to be significantly influenced—short or long term—by the proposed lease accounting standards. Nor do they expect space availability to be affected. But opinions were mixed on both issues, and it is difficult to know how lessees might react amid the current uncertain economic climate.

"It may have some impact on the prices in the short term," said Chatterjee, "but will not impact the prices largely in the open market as we go forward."

Bickell does not see much of anything impacting high-end pricing in Shaftesbury's portfolio: "I think the West End of London is a fairly unique area of real estate. So the fundamental tension between supply and demand will create the market. I think outside of the core of the centre of London, then, yes, I think it may well have an impact because I'm sure a lot of people will be looking at the term of their leasing commitments and what that's doing to their financial reporting and the way people just generally view their balance sheet position."

"We expect the underlying dynamics of the real estate market should not change due to these financial reporting requirements," says an Australian executive. "There may, however, be changes in how leases are structured to ensure that any adverse impacts are mitigated from both a landlord and tenant perspective. Demand for space should continue to be driven by economic conditions and market fundamentals, unless we see changes to property offerings from lease to individual ownership structures."

"I think that the major impact that we see is in the first two to three years following the implementation of the standards," said Harvey Ross. "Long term, we believe that the market will actually just get back to a normal process and everybody will accept the terms."

"If lessees come to the rational decision that I think they will—'We can't allow this accounting standard to dictate our business'—and they continue to sign leases of normal term, I think it has very little impact on value," said Bradshaw. "If there is a precipitous move to short term—true short-term leases of less than five years—in all estimations, it'll destroy the real estate industry altogether. Anything less than a five-year lease is almost not underwriteable from a long-term debt standpoint, so it would have an incredible impact. I just don't believe that will be the outcome."

"[And] we're signing leases right now under the same lease terms we've always signed them, normal five-, even seven-year," Bradshaw added. "And that's the interesting thing. Even with this looming standard out there, I'm still seeing very sophisticated tenants wanting to sign longer leases than normal. If five years is the normal, they're wanting seven- to 10-year leases, because they're afraid of overall inflation in the marketplace."

Buy rather than lease

Real estate executives do not believe the new standards will significantly force lessees to consider buying space rather than leasing, saying they will remember the reasons they are choosing to be tenants in the first place. "Generally, lessees will lease space because they will rather put their cash into their business rather than tying it up in real estate," said Redcliff Realty's D'Ercole. "They understand their business, they don't generally understand real estate."

"In the property space, buying would generally not be an option available to most tenants due to the current ownership structure of how assets are held and traded, which does not lend itself to the smaller space requirements of the majority of our tenants," said an Australian executive. "We expect that tenants' current criteria will continue to drive decision-making, such as cash flow, taxation impact and length of tenure, availability of suitable space, and flexibility on expiry of term."

"Although the impact on tenants' gearing [ratio of long-term debt compared to its equity capital] is broadly the same whether leased or bought, we see liquidity issues and operational focus as likely to dictate tenant behaviour: ie, so leasing is still attractive," said a UK executive. "However, the balance sheet disclosure benefits of sale and lease-back transactions will disappear, making them less attractive to potential tenants going forward."

From the lessee side, Australia's Harvey Ross believes there could be a trend toward buying. "One of the big issues that we have here, as I suspect you have everywhere else, is the lack of available funds for development coming through the normal banking industry. One of the opportunities that this offers the occupiers is the ability to use any available cash flow or the bank balance as the funding for new developments. Again, this has a couple of derivatives. Not only does it mean that the ratio of lease-to-own may well change, it also means that corporations—major occupiers—may take short-term profit out of funding a new development, and then doing a sale lease-back at some stage beyond the changeover in the accounting standards."

Working with lenders

Lenders are gradually becoming aware of the proposed lease accounting standards, given that the balance sheets of their clients may change as more leases become liabilities and assets. Some lessors have discussed the change with lenders—including potential revisions to loan covenants and capital structures—but there was no consensus on how lenders would react.

An Australian real estate executive said that his firm is comparing the issue to the adoption of IFRS in Australia, with an emphasis on ongoing dialogue with financiers, customers, and investors. “Whilst many existing covenants either already seek to include impacts from contracted lease arrangements and/or provide for adjustments relating to changes in accounting standards, there will be continued discussions with financiers as the adoption date gets closer and we have clearer guidance on the final form of the new standard.”

Behringer Harvard’s Garfield said he sees, based on the ED, potential for significant change with lenders and the perspective of the industry by lenders: “Real estate has a conventional view of how it’s analysed. Revenue and net operating income are fundamental characteristics of real estate. If the exposure draft is incorporated into literature, that will be dramatically changed and, in essence, will change our business model, at least as it’s reported, from what has traditionally been a rental perspective to a financial model, and interest income will be a dramatic part of that. And as a consequence of that, the timing of revenues will be dramatically changed since now, from a lessor perspective, it’s now weighted more to the front end. There’ll be more interest income in the early years of a lease vs. the end. The incorporation of what we kind of call the ‘service aspect’—and, again, per the exposure draft—to have to try to incorporate that over the life of the lease will dramatically change and, in my view, distort the true economics of real estate.”

One UK executive imagines that lenders might “read something into” changes on the balance sheet, with potential negative impact, and also is curious about the effect on financial institutions themselves. “The banks are now holding on to lots of property. And a lot of them have got a little bit of property, and they lease out their own use properties if they’re a retail bank. One wonders how that might be accounted for, because banks, more than anyone, are worried about their balance sheet.”

“We found the lenders didn’t really know about the potential standard or what impact it would have,” said Bradshaw in the United States. “So explaining to them the changes it would make to the balance sheet was somewhat surprising to them. But they didn’t have any immediate concern—at least the lenders we were dealing with. Of course, we’re a real estate company, so they have concerns more now over value of the assets and things like that than they do true balance-sheet covenants.”

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Executive VP and Chief Financial Officer of American Asset Corp.

Concerns and recent board discussions

Much of the initial lease accounting discussions by the IASB and FASB have dealt with challenges inherent in trying to enact principle-based rather than rule-based standards. Among the difficulties in developing principle-based standards is the movement away from legal definitions of leases, which exist within country-specific legal contexts and vary significantly around the globe. Instead, the IASB and FASB seek to account for the underlying economic effects of leases and related transactions and contracts. For a majority of transactions this is relatively clear, but other transactions require judgement and therefore generate more discussion—and controversy.

Major areas of discussion—concerns expressed by lessors and lessees—as well as the considerations of the boards, included:

Concern	IASB and FASB Considerations
Definition of a lease: the boards seek to find a definition that doesn't rely on national laws—ie, whether the legal document is described as a lease—in trying to offer a set of requirements that applies only to leases. Concerns have been expressed that the ED definition is too broad and would capture too many service contracts.	The boards are considering whether they should exempt leases in which the provision of an asset is incidental to providing a service: eg, limited use of rental equipment as part of a broader construction contract, rental of set-top boxes to receive cable TV service, a season ticket or personal seat licence to a sporting or entertainment venue.
Lessor accounting: the lessor accounting proposals are not as well developed as the lessee accounting model; concerns have been expressed that they need more work and field-testing.	This has been identified as a topic requiring more attention. Although there has been speculation that lessor accounting could be removed from the 2011 version of a new standard, that is an unlikely scenario. It may be impossible to build a coherent standard that addresses only one of the two counterparties to a lease.
Accounting for optional renewal periods: many comments addressed how the ED defines the lease term when the contract has a basic term and a lessee option to prolong the lease: the length of the lease term affects the amount of the asset and the liability, both recognised on the lessee's balance sheet. The lessee is then required to identify the longest lease term "more likely than not to occur." That means that lessees have to predict the outcome of future extension decisions and possibly include assets and liabilities for unexercised future lease renewals.	The boards are considering removal of the concept of having the lease term based on "the longest term more likely than not to occur," replacing it with a requirement to include option periods only when the lessee has a clear economic incentive to extend the lease. That would be, for example, if the rental during the extension period was set at a bargain level. In practice, for many commercial leases, the lease term (and therefore the asset and liability) would only include the contractual minimum period and would account for extensions as they occur—with no prediction of unexercised extension options.
Contingent rents or variable lease payments: the ED proposed that contingent rentals would require a best estimate of future payments, such as contracts in which rental is not a fixed amount but depends on the particular lessee's revenue from a particular location. Concerns have been expressed that lessee and lessor would need to make a best estimate of the outcome of uncertain future rentals. The amount of that estimate would affect the asset and liability recognised on the lessee's balance sheet. That, in turn, raised concerns about excessive subjectivity and loss of comparability, given the difficulty of making accurate estimates.	The boards appear to be backing away from a best estimate of the future payments, instead opting to require an estimate of variable payments only if based on an external index. This condition would be uncommon, as contingent rents are typically linked to lessees' revenue from the spaces or usage of the assets (ie, rent increases the more the asset is actually used). The boards are also seeking to address so-called "phony" contingent rent clauses, structured so that all or much of the rental is contractually described as variable but, in practice, require the lessee to have to pay at least a base level of rent. The boards are likely to propose that most contingencies to increase rent are accounted for only when the contingent event actually occurs.
Front-loaded lease expense: under IFRS and GAAP operating lease requirements, the lessee normally recognises the same lease expense every year for each lease—"straight-lining." Under the ED, however, a lease with a fixed annual rental would lead to a higher expense for the lessee in earlier years and a lower expense in latter years. This effect follows the normal accounting treatment for non-financial assets and financial liabilities—amortising the asset straight-line and recognising interest expense based on a constant yield on the outstanding amount of the liability each year.	The boards had considered developing a model under which lessees would classify leases as "finance" or "other-than-finance" leases. A finance lease is a contract in which the lessee's intention is to finance long-term use of an asset—in essence, a purchase by alternate means. Finance leases would be distinguished from other-than-finance leases using criteria similar to current criteria, which distinguish on-balance-sheet leases from off-balance-sheet leases. Both types of lease would be "on balance sheet" but the front-loaded expense effect would arise only for the finance category. However, the latest indications are that the boards will confirm the single model approach in the ED, along with the consequential front-loading effect.

Preparedness

The new lease accounting standards will require lessors and lessees to adapt their current business systems and processes to capture and account for lease assets and liabilities. The ease of this transition will be based on the type of company, number and type of leases, and the accounting expertise and mechanisms (internal tracking and information technologies) currently in place. At a minimum, most executives said the transition to the new lease accounting standards will add costs, training, staff time—and aggravation.

"As a real estate company, we already have to do a lot of analysis around the overall lease term," said AAC's Bradshaw. "The same spreadsheets we use to straight-line rental income, which is an existing requirement under GAAP, those spreadsheets would lend themselves to also help with this standard." Accounting software already used in calculating straight-line rents should lend itself to the proposed lease accounting standard, he added, but will require additional effort. "It's going to be a change, and it's going to take a lot of work just because of the sheer number of leases that we and the industry have to deal with. But we're probably more able to at least understand that concept and deal with it because it's not completely foreign to us than would a non-real estate company. I think they've got major fundamental changes, something they've never looked at before."

Bradshaw wondered how large corporate lessors outside of the real estate business will deal with the standard. "I think a lot of those companies are very worried about that."

For example, a comment letter on the ED by Hewlett-Packard states, "We have 250,000 leases that would need to be re-evaluated at each reporting period to determine if there have been any significant changes that would require measurement of lease-related assets and liabilities." A General Electric respondent wrote a comment letter, stating, "Given the number of leases, lessors and lessees [we] have—and we have well in excess of 1.8 million lease contracts as a lessor—we believe several years will be required to make a new lease accounting standard operational."

Garfield of Behringer Harvard said cost and effort will increase: "I've got the expertise, and I've got a staff of CPAs, so I know we can figure it out. And … there's nobody else that's expert, so it's not like I can find people that have been doing this before. So I think my staff can handle it, but [I deal with multifamily leases], so I'm going to be affected the least." But he did not believe that most existing software applications for the industry are currently able to handle the necessary calculations, and says an Excel-based approach may become impractical due to the number of leases involved. He anticipated a boon for software providers. "I think my IT costs will

At a minimum, most executives said the transition to the new lease accounting standards will add costs, training, staff time—and aggravation.

go up, my staffing costs will go up, my audit costs will go up—and, again, with no benefit."

A UK executive said his company has large systems for managing the flow of information about every one of its properties, "but we will have to apply a lot more sophistication and make it fit the purpose to help it support our accounting needs as well. It will be a pain, [but] it's achievable for us. I don't know if it will be as easy to do for other organisations… It'll be costly, and we'll have to probably take on a couple of extra heads to deal with it."

"To capture, measure, and report necessary disclosures, our accounting systems and procedures will need to be updated and followed by training of the finance teams and general education of the overall business and tenants," says an Australian real estate executive. "However, we do not expect any wholesale changes will be required to our accounting systems and much of the focus will be procedures to identify transactions and manage contracts to ensure they are correctly treated."

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General Electric statement from comment letter on exposure draft

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