



Accounting Rules and the Effect on Real Estate Decisions

The Inevitable Changes to ASC 840 / FAS 13

By David Nebiker and Marty Koenig



Who We Are

David Nebiker

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and

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Denver Business Journal's
2011 CFO of the Year
Nominee



A Member of



Atlanta, Austin, Boston, Chicago, Cincinnati, Dallas, Denver, Houston, Los Altos, Los Angeles, Orange County
Miami, NYC, Philadelphia, Phoenix, San Antonio, San Diego, San Francisco, Tampa, Washington DC

Agenda



- Who's leading this
- Who's nervous?
- Current problem
- Proposed solution
- Impacts: Lessees, lessors, brokers
- Problems
- Timing and engagement
- Q&A

Who – Joint Project

FASB Chairman **Leslie Seidman**

Oct 2010



IASB - Professor Sir **David Tweedie**



IASB - June 2011 - Hans Hoogervorst



Who's Nervous

- CFOs, Controllers
- Audit Committees
- Lessees and Lessors
- Brokers
- FASB Goal: End up with a standard that's perceived around the world as an improvement, operational and comprehensive.



Current Problem

- Capital or operating leases – GAAP
- Off Bal. Sheet – small lease terms differences
- Ambiguity reduces comparability
- Financial statement est. effect of operating leases on leverage and financial metrics
- Variable features – outcome basis – hard to assess effects on future cash flows
- \$1.25 trillion off B/S now

ASC 840 CAP vs Operating

Capital Lease Criteria:

If the answer to any of the following questions is "Yes", then the lease is a capital lease.

- 1 Does the lease transfer ownership of the property to ABC Company by the end of the lease term?
 No <---will be stated in lease
- 2 Does the lease contain a bargain purchase option?
 No <---will be stated in lease
- 3 Is the lease term equal to 75% or more of the estimated economic life of the leased property?
 No <---an assumption about the life of the property must be made (do some research)
- 4) Does the present value at the beginning of the lease term of the minimum lease payments equal or exceed 90% of the excess of the fair value of the leased property?
 No <---see 'NPV Calc'

Conclusion:

This lease agreement fails to meet any of the capital lease criteria. Therefore, this lease is considered an operating lease.

Disclosure Requirements (for operating leases):

- 1 Future minimum rental payments (at balance sheet date) for the next 5 years;
- 2 Total of minimum rentals to be received in the future under noncancelable subleases (at balance sheet date);
- 3 Rental expense for each period an income statement is presented – break out minimum rentals, contingent rentals, and sublease rentals;
- 4 General description of leasing arrangements.

NPV Analysis of Lease

Incremental Borrowing Rate
 NPV of Minimum Lease Payments

	6.000%	<---input (either rate stated in lease, or the implicit rate of the lease)
	\$ 211,842	<---calculation
	\$ 2,000,000	<---input (either stated in lease, or might have to make an assumption of the value - or do some research on what it would cost to buy)
	10.59%	<---calculation

FMV of Asset
 Percentage



Proposed Solutions

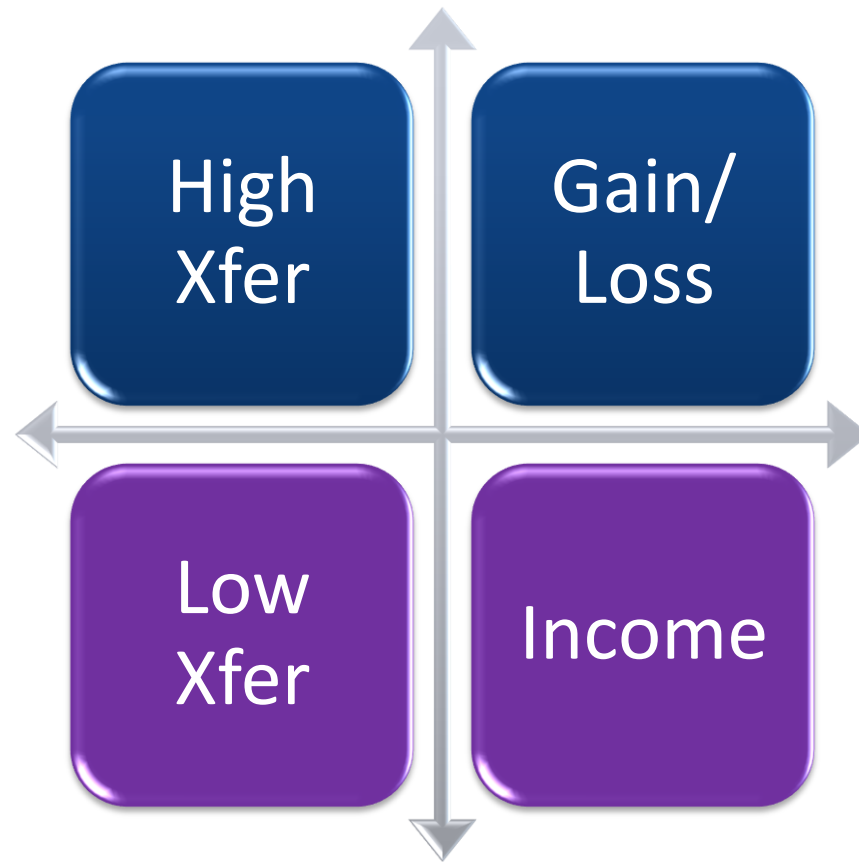
- Transactions structured for desirable accounting outcomes
- On-balance sheet treatment -> accurate liabilities and future cash flows.
- Expected lease payments to include variable payments -> better assess future cash flows
- Lease contracts give rise to assets and liabilities on B/S of lessees and lessors

Proposed Solutions Cntd...

- Financial ratios more complete and comparable
- Lessees - single acctg. method
 - Asset represents right-to-use
 - Liabilities from lease contracts @ PV
- Lessors – reflect risks or benefits to the asset
 - Risk xfer or benefits: Gain or loss on commencement
 - Xfer significance



What



Balance Sheet Reflection



- The lease must be reflected on the company balance sheet.
- Leases must be recorded as a liability and right-to-use the space as an asset.
- Lease must be at least 12 months long for reporting purposes



Ruling Completion

- The FASB Accounting changes will be finalized in 2011.
- These rules will be enacted in late 2012 or early 2013.
 - Could be as late as 2015
 - Allow ample time to understand the requirements and to plan for an effective transition
 - Many companies are preparing pro forma statements to analyze impact.

Impacts - Lessee

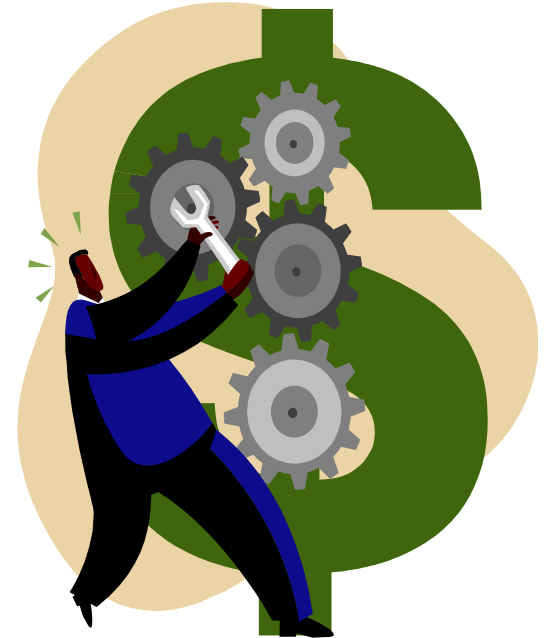
- Shorter term leases
- Increased building ownership
- Reduced tenant improvement dollars
- Upset debt ratios
- Loan covenant non-compliance/default
- Negotiating new covenants
- Financial ratios for credit approval
- Restatement of financial statements
- Deferred tax component
- Leasing as a less beneficial option
- Increased administrative burden
- Nearly all operating leases- material changes

Impacts – Lessor/ Investor

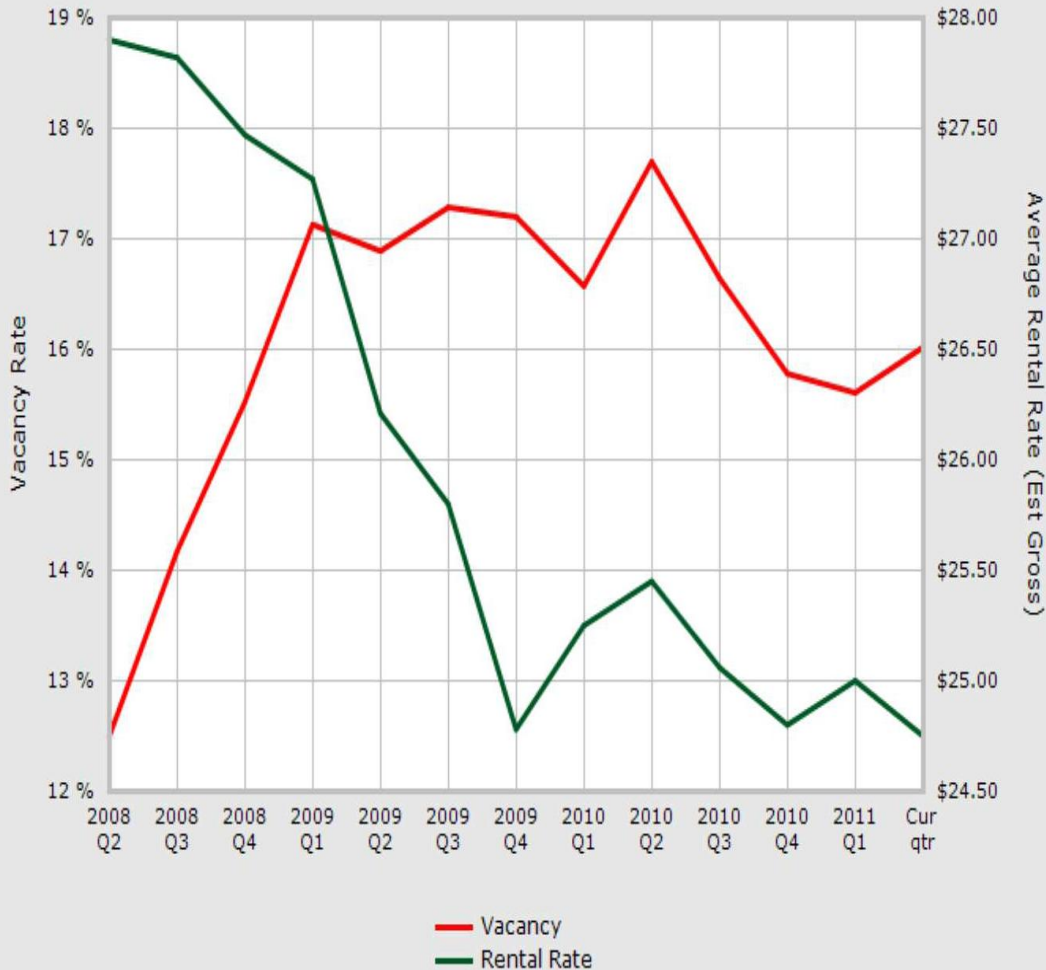
- Short-term leases less secure
- Single tenant bldgs – leasing premium gone
- Why not just buy the building?
- Publicly traded/debt with audited financials
 - Analysis of each tenant, occupancy terms, contingent lease rates
- More detailed financial statement disclosure
- Learn more desirable transactions to lessees
- Advice: Secure purchase/refinancing pre-change

Impacts - Brokers

- Lease agreements - increased complexity
- Drives more short-term leases
- Creates financing issues and new difficulties
- Advice: Secure purchase/refinancing pre-change



Current Market Conditions



- Lower Downtown / Central Business District
 - Class A + B Buildings = 26,849,336 square feet
 - 86% leased
 - Average time on market of 21 months
 - Net absorption at 2%

Current Market Conditions



- **Denver Tech Center**
 - Class A + B Buildings = 21,226,086 square feet
 - 78% leased
 - Average time on market of 23 months
 - Net absorption at 4%

How to Engage

www.fasb.org



Leases

- Exposure Drafts, Comment Letters
- Podcasts of meetings, Contacts
- Discuss w/CFO, outside accountant, broker and tax folks
- Avoid surprises

Tenant Recommendations

- Perform thorough lease review and/ or ownership position
- Identify possible savings opportunities
- Leverage current market conditions
- Transfer risk to landlord



Questions & Answers



Thank You!



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