A New Age Of Reporting:

Preparing to Comply with New FASB/IASB Lease Accounting Standards

by JOHN SALUSTRI

WHO ARE WE ?

When the relationship comes first, the business follows

The Industrial Asset Management Council is the leading trade association serving corporate real estate executives focused on optimizing their industrial portfolios. We represent the full range of industrial assets: manufacturing, warehouse and distribution facilities around the globe.

Founded in 2002, IAMC has built a membership of more than 600 industry practitioners, more than a third of whom are senior corporate real estate professionals. They represent some of the most recognizable corporate names in business today, including 70 Fortune 500 companies. In fact, in the past three years, IAMC member firms have invested nearly $67 billion in building their real estate portfolios, participated in more than 1,185 projects worldwide and creating 176,032 jobs.

Since its inception, IAMC has remained true to its core mission: to provide world-class education, leadership development and relationship building for industrial real estate professionals.

WHY IAMC?

Out in front on a major industry issue

It is in the interest of our membership that we undertake the work of providing a guideline for addressing recent FASB and IASB updates to lease accounting methodologies.

It is our belief that such a guideline better prepares all impacted real estate professionals for the changes to come and to make the most of their time before implementation to ensure compliance. We anticipate that for many members, the ensuing months will be a time of reviewing leases to capture data previously considered unnecessary, coordinating with other departments to clarify internal policy and documenting predictions concerning such issues as leasing options.

As *Cry the Beloved Country* author Alan Paton wrote: "About a storm a man can do nothing, but he can rebuild a house."

The updates to the FASB/IASB accounting standards define anew what our houses should look like. This guideline is designed to help members rebuild.

METHODOLOGY

The contribution of multiple sources

Many people have, directly or indirectly, contributed to this White Paper. Prime among these were the members of the IAMC Lease Data Standards Task Force. In particular, the author wishes to thank Russell Burton, Jennifer Roth, Matt Denio, Brant Bryan and Joel Parker for their time and generosity. We also wish to thank Sean Torr of Deloitte for his input and guidance. This Paper is also the result of research into various articles on the intent and requirements of the new standards as well as the readings of the standards themselves.

EXECUTIVE SUMMARY

Preparedness is the key

Early in 2016, after years of study, research and internal discussion, in addition to much outside speculation, the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) issued new lease reporting standards. The intent of the new standards — or upgrades, as FASB refers to them — was to improve financial reporting about leasing transactions and in so doing gain greater transparency for investors and other stakeholders.

The FASB updates (ASU 2016-02) will take effect in two stages: for public companies the updates will take effect for fiscal years, and related interim periods, beginning after December 15, 2018. For all other organizations, the updates will take effect for fiscal years beginning after December 15, 2019. IASB changes (IFRS 16 Leases) will be implemented for periods after January 1, 2019. (It should be noted that early adoption is allowed and may be exercised for certain industries.)

There are other points of differentiation between the new FASB and IASB standards, primarily the use by the former of a dual lessee accounting model and the latter's use of a single-lessee approach. Nevertheless, both will require assets and liabilities to be recognized when the deadlines arrive, and much information not a part of previous accounting standards will now be required.

This makes it clear, then, that in the months prior to the above dates, there is work to be done. According to IAMC Task Force members, a major part of this process will be a review and categorization of all leases, as well as their terms and options. While this might seem obvious, it may not be to all, even among very large, global members.

The new standards also require a coordinated effort of internal departments to ensure that corporate policy concerning the standards is sound and all appropriate information is captured, centralized and archived. Depending on the infrastructure of the organization, that will include ongoing communication among accounting, finance, purchasing, operations and, of course, real estate.

Obviously, different members will find themselves in different places in the countdown to compliance. No matter how complex the readiness stage of compliance might be, there remains enough time for members to respond, to gather required information and establish those inter-departmental connections. This will not always be true, and procrastination might lead to dire complications.

The time to act is now.

FASB/IASB Changes the Lease Accounting Landscape

New rules of the road

Your world is about to change. That might sound overly dramatic, but in a very real sense it is true. On January 13, 2016, the International Accounting Standards Board (IASB) issued new accounting standards to help "investors and others get an accurate picture of a company's lease assets and liabilities."

This was followed, on February 25, by an Accounting Standard Update (ASU) from the Financial Accounting Standards Board (FASB) intended to "improve financial reporting about leasing transactions."

The new standards (FASB's ASU 2016-02 and IASB's IFRS 16 Leases) were the result of a decade of joint work by the two boards. As FASB related in its February statement, the two boards "embarked on a joint project in 2006 to improve the financial reporting of leasing activities. Since that time, the FASB and IASB have issued three documents for public comment that generated more than 1,700 comment letters.

"Throughout the project, the FASB and IASB also conducted extensive outreach with diverse groups of stakeholders," the statement continued. "That outreach included more than 200 meetings with preparers and users of financial statements; 15 public roundtables, with more than 180 representatives and organizations; 15 preparer workshops attended by representatives of more than 90 organizations; and 14 meetings with preparers. The FASB and IASB also met with more than 500 users of financial statements covering a broad range of industries."

According to FASB chair Russell G. Golden, the new guidance "ends what the US Securities and Exchange commission and other stakeholders have identified as one of the largest forms of off-balance sheet accounting, while requiring more disclosures related to leasing transactions."

In reality, what is characterized as a joint initiative had its points of disagreement and debate. Just one example was the treatment of leases as debt.

There may be obscure exceptions, but "most places in the world, except for the US, have historically counted all lease obligations as debt," says Russell Burton, 2017 chair of IAMC. "In the US, we've been allowed to show FASB-defined operating leases on the P&L as a payment, like the light bill, with only financial footnotes clarifying the underlying longer-term obligations."

It was a point of major differentiation between the two boards, the IASB arguing that it is not a light bill, Burton says. "It's a financial obligation and IASB has been arguing that it should show up on the balance sheet just as if you went to the bank and borrowed the money. US business interests — including real estate brokers and practitioners, everyone — are going to be impacted in a major way by this change."

To put it plainly, this is a very big deal. In fact, a March 1, 2016 Bloomberg BNA article stated that "In the US, public companies' operating leases carried off-balance sheet amount to more than $1 trillion in leasing obligations."

And a Wall Street Journal article at the time estimated the total impact as high as $2 trillion.

For FASB, the ASU will kick into effect in two stages: for public companies, the updates will take effect for fiscal years, and related interim periods, beginning after December 15, 2018. For all other organizations, the updates will take effect for fiscal years beginning after December 15, 2019. IASB changes will be implemented for periods after January 1, 2019.

As the Bloomberg article reports, "FASB will require enhanced disclosures. Those feature qualitative and quantitative reporting in footnotes to financial statements."

The implications of that statement are massive. "The vast majority of the data that is going to be required to comply with these new regulations for real estate leases is going to come out of real estate departments," says Burton, who is also director of global real estate for PepsiCo.

Ironically, while the vast majority of data will generate from real estate, it is not necessarily the real estate department that drives compliance. Depending on the infrastructure of the organization, that could be finance or accounting. But it is incumbent upon the real estate department to start asking questions or risk getting caught short.

"We don't know what we don't know," says Jennifer Roth, director of real estate for Bimbo Bakeries USA. "If you aren't in front of the issue, if you're not proactive and getting in front of the CFO and controllers group to ask for direction, guidelines and policy on this, it could be disastrous because it can totally turn a company's financial reporting upside down."

From discussions with IAMC Active members, we know the new rules of the road for lease accounting are going to have significant repercussions inside their companies. Now, let's look at how a major accounting company views these changes.

The New Requirements

12 key provisions

According to financial consulting firm Deloitte, there are basically 12 key provisions of both the FASB ASU and IFRS 16 (For more information, visit *www2.deloitte.com/content/dam/Deloitte/us/Documents/audit/ASC/HU/2016/us-aers-headsup-fasb-new-standard-brings-most-leases-onto-the-balance-sheet.pdf*). Following is a breakdown of those provisions, offered as a guideline to the changes. These are not intended for use without further input from in-house stakeholders.

1. The Scope of the FASB standards encompasses leases of all property, plant and equipment — with exceptions that include biological assets, inventory and assets under construction. IFRS 16 encompasses leases of all assets not limited to PP&E.

2. Both Boards indicate that lessees can recognize payments on a Short-Term Lease on a straight-line basis over the lease term — much like an operating lease currently. The leases would not appear on the balance sheet. Both also define a short-term lease as 12 months or less with no purchase option. Only FASB includes the phrase, "purchase option that the lessee is reasonably certain to exercise."

3. Both boards share the same essential Definition of a Lease, which is a contract, or part of a contract, that conveys the right to control the use of identified property, plant or equipment for a period of time in exchange for consideration. That asset is referred to as the "identified asset" in the FASB terminology; while it is the "underlying asset" for IASB. There are other nuances within that overarching definition, including that a leased asset must be "specifically identifiable, either explicitly or implicitly"; that substantive substitution rights will need to be considered; that a distinct portion of a larger asset could serve as a specified asset (such as a single floor in a building); but that a capacity portion of a larger asset — such as part of a storage tank — will not so serve; and that the contract conveys control of that asset over the specified time. This, however, requires that the customer have both the right to obtain all of the economic benefit and the right to direct its use.

4. While generally accepted accounting principles in the US (GAAP) do not provide a specific exemption for Leases of Low-Value Assets, FASB does embrace a reasonable capitalization policy under which the entity will not recognize assets and liabilities below a certain threshold. IASB uses much the same language but adds that it will recognize low-value leases on a straight-line basis. IASB doesn't define low-value, although in deliberation, "the Board referred to assets of $5,000 or less."

5. For the purposes of Lessee Accounting, the lessee recognizes a liability for its lease obligation and "an asset for its right to use the underlying asset (i.e., the right-of-use or ROU asset) equal to the lease liability, adjusted for lease payments made at or before lease commencement, lease incentives and any initial direct costs. The effective interest rate method will be used to account for the liability. FASB employs two methods for amortizing ROU assets: Under the finance lease approach, the asset is amortized on a straight-line basis, with separate lines for interest and amortization on the income statement. The operating lease

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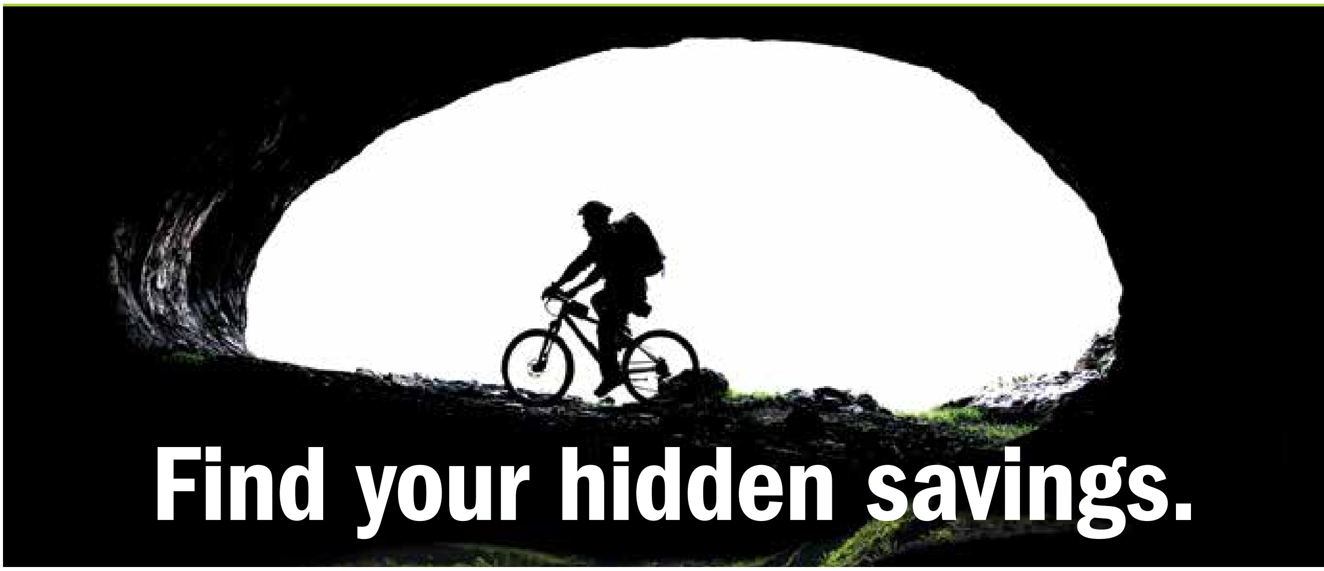

Find your hidden savings.

Strategies for turning your lease portfolio into a winning profit driver.

by **JEAN CHICK**
Principal, Deloitte Consulting LLP
Deloitte.

Real estate is typically the 2nd largest expense on the books.

Yet surprisingly it's often put aside … that is, until someone casts a light on it. Real estate is a critical piece of an organization's business, and thinking of it strategically can add significant value to the bottom line. Market conditions are ripe to take a deeper look now and whether you're looking to reduce expenses or have reason to invest, we're introducing a new six-part series on finding the hidden savings in your lease portfolio. Each step in the leasing lifecycle can be improved to make leasing a profit driver, not a cost center. It's a year-round affair and with new regulations putting a spotlight on lease portfolios via company balance sheets, executives everywhere are taking a closer look.

Move leasing to the head of the pack

The reality is that the leasing function has been significantly downsized over the last decade. Instead of a staff of 75, a company may have a staff of 10 managing sometimes hundreds or thousands of real estate and leasing contracts. Thus, 80 percent of their time is spent on management of those leases, while only 20 percent of the time is spent on portfolio strategy. However, the time ratio should be quite the reverse. Behind staff, lease management is typically the second or third largest expenditure on the books. It's time to take a fresh look at your portfolio strategy. There are four key reasons why.

1) **New Financial Accounting Standards Board (FASB) rules.** Nothing like a new regulation to shake things up. Many leases are moving onto the balance sheet for the first time, creating more transparency and therefore prompting companies to get leases right the first time or possibly face regulatory scrutiny later. Make sure your team is ahead of the curve.

2) **Staff productivity and the draw on talent.** As Boomers continue to retire, talent shortages in certain job functions and industries will likely force companies to get smarter about attracting and locating talent. Having grown up in a technologically connected world, the Millennials' work style preference is much different than their predecessors.

3) **Greater leasing options.** Developers and owners are changing their leasing models to provide greater flexibility—not just in the space design but in dynamic, multi-use scenarios that can prove more economical for companies.

4) **New technology developments.** New technologies like IBM's TRIRIGA® recent upgrade and Deloitte's lease management product, LeasePoint™, are offering c-suite executives tools

to help their leasing function make smarter, strategic leasing decisions and act more efficiently. Look towards blockchain, artificial intelligence, and behavioral analytics to offer even more potential. Companies managing their lease portfolio via spreadsheets will likely have difficulty trying to survive in today's competitive, evolving environments—and could fall to the back of the pack.

The race is on!
Rethink your portfolio strategy

Forecasting long-term needs in fast-moving markets has always been challenging. And the new regulations are prompting questions about whether to buy or lease. Where are the quick wins when it comes to lease portfolio optimization? How does your organization look at site selection and negotiate the best deals for your leases? Are you missing opportunities because your leasing function doesn't have the technology and analytics you need? And most importantly, is your organization ready to execute the new lease regulations?

By utilizing all the parts of a winning peloton strategy, c-suite, real estate and leasing executives are able to push forward an interconnecting race plan. They all operate harmoniously, but take on their own significant role in achieving ultimate victory.

A six chapter perspective for an effective real estate peloton strategy

1 **Portfolio strategy**
What does your finish line look like?

2 **Lease portfolio optimization**
Where are the quick wins?

3 **Site or equipment selection**
Did you look beyond the obvious?

4 **Lease negotiation**
Are you getting the best deal for your buck?

5 **Lease portfolio management**
Are you missing opportunities?

6 **Lease accounting & reporting**
Are you ready to deliver without question?

What does the start line look like?

The lifecycle of a lease is full of opportunities to improve margins, increase revenue, and lower costs, improving the overall ROI of real estate and lease portfolios. As you think of your portfolio strategy, consider the following insights.

An unbiased mindset is key. If it's impossible, consider seeking out a third party without conflicts of interest. Biases can exist internally and externally among brokers.

Seek the buy-in of the entire C-suite. The expenditure is too great not to take it to the entire leadership team and has implications that are far-reaching.

Think of the ideal state and work backwards. Dream big. Determine what you want your business footprint to look like and how people will collaborate 10 or 20 years out and devise a plan that gets you from where you are today, to that future vision.

Want more? Visit *www.deloitte.com/us/lease-portfolio-profit-driver* and sign up to get all six chapters to support a winning portfolio strategy.
Find your hidden savings and turn your lease portfolio into a profit driver. It's time for a new play on real estate.

TWO STRATEGIC CASES. ONE TO SAVE, THE OTHER TO GROW.

There are typically two end objectives that bring real estate and leasing into the boardroom: cost savings and increased revenue. Designing your portfolio strategy then centers around a mix of steps to support the win for your organization.

Optimizing space, saving on costs

Deloitte's internal real estate team set out to optimize its United States portfolio due to steadily declining usage patterns over the last decade. Like similar organizations, Deloitte personnel access the office 30% of the time on average, and our growing millennial population prefers a more collaborative work style. By adding collaborative space, assigning offices based on frequency of access, and hoteling space used by more mobile populations, Deloitte has reduced occupancy costs significantly through reduced footprints for new buildouts and an office portfolio optimization effort which will deliver $60M in savings over the remaining lease terms. Deloitte's practitioners are drawn to the collaborative spaces in the new offices and feedback is favorable.

More locations, growing for service

A large technology company just announced it's ready to break ground on its new headquarters and has opened offices to accommodate new division operations in several markets across the United States. With more than 70 locations in more than 35 countries, nearing a billion-dollar annual rent expense, Deloitte recently helped the company install an upgrade of IBM's TRIRIGA® to manage it all efficiently. The technology is a key component of their portfolio strategy. Without it, they wouldn't be able to optimize their leases or manage them efficiently and are saving money as a result.

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approach results in a straight-line expense profile presented as a single line item in the expense statement. IASB embraces an approach similar to FASB's finance lease methodology.

6. The new standards largely retain current Lessor Accounting approaches for operating and capital leases, but FASB warns that a dealer's profit may be recognized either upfront or on a deferred basis, depending on that classification. IASB will recognize dealer profit upfront.

7. Lease Term is defined as "the non-cancelable period in which the lessee has the right to use an underlying asset together with optional periods for which it is reasonably certain that the lessee will exercise the renewal option or not exercise the termination option or in which the exercise of those options is controlled by the lessor." Lessees will be required to reassess the lease term after lease inception if (1) there is a significant event or change in circumstances that is directly attributable to the actions of the lessee, (2) a contract term obliges the lessee to exercise (or not exercise) an option to extend or terminate the lease, or (3) the lessee elects to exercise (or not exercise) an option to renew or terminate the contract that it had previously determined was not reasonably certain to be exercised. Finally, "A lessor is not required to reassess the lease term unless the lease is modified and the modified lease is not a separate contract."

8. Lease Payments include fixed and variable payments that are based on a rate or index (e.g., CPI index); amounts owed under residual guarantees (for lessees) and amounts at which residual assets are guaranteed by a lessee or by a third party (for lessors); and payments related to renewal or termination options. Note: Lease payments do not include variable payments based on usage or performance of underlying assets. For FASB, variable payments will be reassessed when the lease obligation is reassessed. IASB will reassess "whenever there is a change in contractual cash flow."

9. Lessees use the Discount Rate "charged by the lessor if the rate is readily determinable," and if not, an incremental borrowing rate as of the commencement date is used.

10. Lease Modifications refer to any change to terms and conditions. The lessee accounts for modifications as a separate contract when the change "grants the lessee an additional ROU asset" and the price of that asset is commensurate with its standalone price. Lessees would account for a lease modification that is not a separate contract by using the discount rate as of the modification effective date to adjust the lease liability and ROU asset for the change in the lease payments.

11. The Boards differ slightly in their classifications of a Sublease, FASB recommending classification based on the underlying asset of the head lease and IASB using the ROU asset.

12. A Sale/Leaseback Arrangement is not considered a sale by FASB if it does not qualify as a sale under ASC 606 or the leaseback is a finance lease. If it does qualify as a sale, the entire gain would be recognized. For IASB, a sale/leaseback will not qualify as a sale if it does not qualify under IFRS 15. Gains of qualifying sales will be limited to "the amount related to the residual portion of the asset sold." FASB sets down specific conditions determining when a repurchase option results in a failed sale, while IASB always treats a repurchase option as a failed sale.

(To read Deloitte's analysis of the new standards, please visit *www2.deloitte.com/content/dam/Deloitte/us/Documents/audit/ASC/HU/2016/us-aers-headsup-fasb-new-standard-brings-most-leases-onto-the-balance-sheet.pdf*).

Prep Step-by-Step

Now is the time to gather information

As we have discussed, the real estate department will most likely not take the lead in complying with the new FASB/IASB standards. However, much of the needed information for real estate leases will generate from that department and, as the prior section implies, much of that information may not be readily at your disposal.

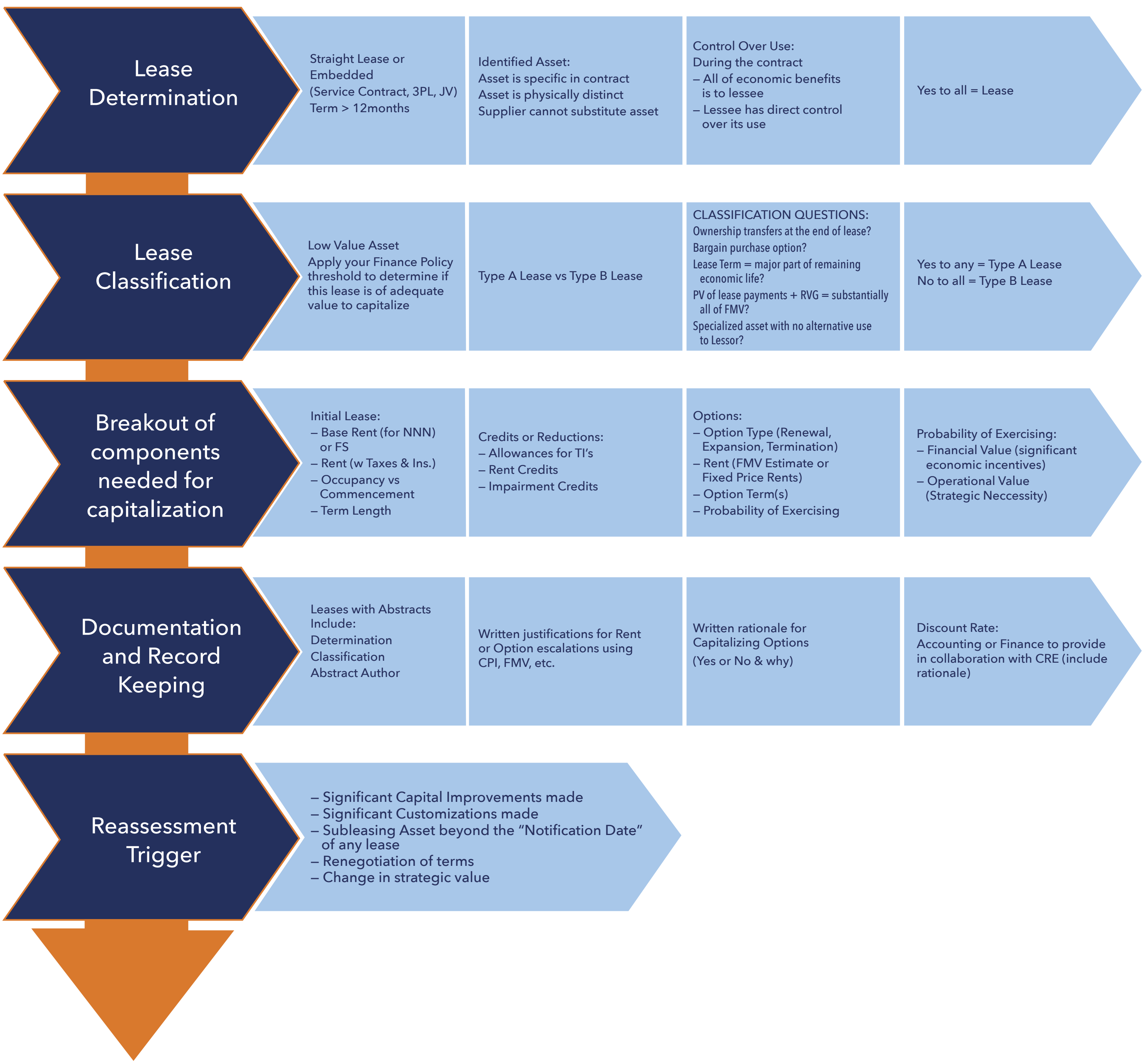
Playing on Jennifer Roth's warning, here are the steps IAMC members need to take to know what they need to know and set up protocols to capture and archive that data for future reference and justification.

"There are quite a few large public companies that don't have abstracts written on each of their leases or justifications and rationales behind their options," says Task Force member Matt Denio. "Especially as it relates to options, people need to be aware, you need more detail behind your options and whether or not you will be exercising those."

Brant Bryan agrees. "This is a very different beast than most accounting changes," says the managing principal of Cresa Capital Markets.

LOGIC DIAGRAM

This flow chart enables users to assess their leases in light of the new lease accounting standards in an organized, stepwise manner so they can make the necessary evaluations and decisions in a logical order.



"The reason this is different is that there's a lot of operational information that has never been gathered before, and IAMC members have to make operational assessments in order to input the data. It could change some decisions for some companies."

Recognizing that each member company will be in a different place along the preparedness timeline, here are the basic steps leading to compliance (Please See Exhibit A, Task Force Logic Diagram — co-authored by Denio and Bryan — for more detail on each of the following):

1) **Making Connections:** "Compliance is a matter of getting smart and getting smart quickly," says Roth, who urges members to start now, "knocking on the doors of their controller and CFO offices to make sure they're aware of this ruling and pursuing what corporate policy will be, because it's not real estate that sets the guidelines on how this is reported."

2) **Lease Determination:** According to Denio, who is also director of real estate and facilities for Sierra Nevada Corp., the next step is to determine what will be considered a straight lease or one embedded in another contract, such as a 3PL or service contract. If it is a specific, physically distinct asset that cannot be substituted by the supplier, and the lessee has control over the asset for the term of the contract and gains all of the economic benefits, it is a lease in the eyes of the new standards.

3) **Lease Classification:** There are two determinations here, says Denio. First is whether or not the lease is low-value. "Everyone in finance and accounting has different rules as to what is an immaterial lease," he says. "So you need to make the determination if your company has a policy on this, and if it's immaterial you don't need to capitalize it."

   Next is determining if it's a finance (Type A in the exhibit) or operating lease (Type B). Does ownership transfer at the end of the lease? Are bargain purchase options reasonably certain to be exercised? Is it a specialized asset with no alternative use to the lessor? These are just some of the questions members need to ask in order to classify the lease properly.

4) **Capitalization components:** For net leases, only the base rent is needed in the capitalization calculation. For full service or modified gross leases in addition to the rent, the real estate taxes and insurance should be included within the capitalization calculation. A key component of the new rules is that capitalization begins at occupancy or when the lessee has beneficial control of the asset and not necessarily at the commencement date of the lease.

5) **Considering option policies:** The next question concerns capitalization on option policies, such as termination, renewal and expansion options. Answers to these questions obviously will depend on the lease's classification as a finance or operational lease.

6) **Documentation & Record Keeping:** Each of the above protocols demands recordkeeping. This includes abstracts, preferably with identified authors, on all lease documents; written justifications for rent and option escalations.

7) **Reassessment triggers:** Ongoing controls will be a part of the compliance process, obviously, as the Logic Diagram indicates. Have you made significant capital investments since the last assessment? Have you made significant customizations since then? Have you renegotiated any terms? And of course, documentation throughout is key.

CONCLUSION

Intentions and Expectations

How each individual corporation addresses the coming changes at the hands of FASB and IASB is dependent on many factors: The corporation's internal infrastructure; the proactive stance of the heads of finance and even the C-Suite; and IAMC members' own proactive stance on the issues at hand.

What is very clear, as Jennifer Roth indicated, is that we don't know what we don't know, and there are but two options for IAMC members: Start defining — now — what you need to know, or get caught short at the 11th hour.

As 2017 IAMC chair Russell Burton indicates, "This is an overhaul of lease accounting rules that are going to ripple through your entire organization. It is important for real estate departments and IAMC to get out in front of this. And the sooner a corporate real estate executive can start working on the issues of compliance, the better."

It is hoped that this White Paper helps define the task that lies ahead. The time to act is now.

About the Author

John Salustri, a frequent contributor to IAMC publications, is editor-in-chief of Salustri Content Solutions, a national editorial advisory firm. A four-time winner of the Excellence in Journalism Award from the National Association of Real Estate Editors, Salustri was founding editor of GlobeSt.com.