



CB RICHARD ELLIS
GLOBAL RESEARCH AND CONSULTING

SPECIAL REPORT

FAS-talking
**Unpacking Real Estate's Impact
on Financial Statements**

Corporations hardly need another setback in reporting their financial position. However, as a result of efforts to create better financial transparency and institute other compliance safeguards, accounting boards and government regulators may generate another round of balance sheet blows and earning impacts in the process.

This white paper will address the new perspective on mark-to-market valuations of real estate assets in a distressed environment. We will also address the proposed change to eliminate the off-balance-sheet treatment of operating leases. Both of these changes may significantly impact the reporting of assets on the balance sheet and the recognition of earnings on the income statement. The capitalization of operating leases also affects the recordation of liabilities and shareholder equity.

While the regulatory intent, standards enforcement and media focus are currently on financial instruments, real estate reporting is equally impacted. And for many companies, the adjustments may have an even greater effect. Unfortunately, few corporate real estate departments are currently prepared for these changes.

FASB/IASB THROWS THE FINANCIAL GAUNTLET

The diminution of real estate values on a corporation's financial statements, coupled with proposed changes to eliminate the off-balance-sheet treatment of operating leases, will result in paper losses and imputed contingent liabilities. Further, these impacts will not only adversely affect earnings but also capital requirements, debt covenant ratios and credit ratings.

In response to the current market decline and the treatment of real estate valuations, the U.S. Financial Accounting Standards Board (FASB) issued its Statement of Financial Accounting Standards ("SFAS") 157 "Fair Value Measurements" standard, also known as "mark-to-market," effective for financial assets as of November

15, 2007, and non-financial assets including real estate as of November 15, 2008. The International Accounting Standards Board ("IASB") adopted similar reporting based on IFRS 7, effective January 1, 2009. SFAS 157/IFRS 7 provides further guidance and clarification of the methodology required to recognize capitalized assets whose values may be impaired relative to net book value (as stipulated in SFAS 144/IAS 36 "Accounting for the Impairment or Disposal of Long-Lived Assets").

Furthermore, concern is spreading throughout corporate finance and real estate departments as a result of the FASB and IASB's March 19, 2009, Discussion Paper, "Leases: Preliminary Views," which addressed recording operating leases on the balance sheet. As of the writing, *the projected*

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balance sheet impact of this proposed standard is estimated to be well over a trillion dollars to U.S. corporations alone. And while capitalizing operating leases on the balance sheet could go into effect as early as 2011, corporations must be vigilant and continue to evaluate the long-term effect of lease durations and related terms, and acquisition strategies on portfolio values. Continued analysis and planning, and an awareness of "what's to come," are essential to avoiding detrimental financial effects on earnings.

MARK-TO-MARKET

Today's real estate values are declining at an unparalleled rate. When an impairment, or write-down of real estate, is recognized and recorded, it not only reduces the asset value on the balance sheet, but also generates a pre-tax loss on the income statement. (Please refer to "Mark-to-Market Impairment Impact" sidebar for an illustration of this impact). In the face of a weakening balance sheet, the reduction in profits represents a financial "double-whammy" that few businesses are capable of absorbing at any time, let alone amid the throes of our current financial crisis.

MARK-TO-MARKET IMPAIRMENT IMPACT

The comparison below shows the impact to financial statements relative to the recognition of a decline in market value of a real estate asset.

Ramifications of a Mark-to-Market Impairment

1. Company A bought a building for \$39 million 15 years ago. The current market value is 30% less than the acquisition cost.
2. Company B bought a building for \$39 million 2 years ago. The current market value is 30% less than the acquisition cost.

	Financial Statement Impact				
	Balance Sheet		Income Statement		Expense Impact to Profits
	Asset	Market Value	Expense		
Company A					
Acquisition Cost 1994 (Historical Value)	\$39,000,000				
Accumulated Depreciation (39 year schedule)	\$15,000,000				
Net Book Value	\$24,000,000	\$27,300,000			
Mark-to-Market Impairment		\$0	Write-down	\$0	\$0
	Asset	Market Value	Expense		
Company B					
Acquisition Cost 2007 (Historical Value)	\$39,000,000				
Accumulated Depreciation (39 year schedule)	\$2,000,000				
Net Book Value	\$37,000,000	\$27,300,000			
Mark-to-Market Impairment		(\$9,700,000)	Write-down	\$9,700,000	(\$9,700,000)

SFAS 144 "Accounting for the Impairment or Disposal of Long-Lived Assets," and the guidance offered within SFAS 157 "Fair Value Measurements," re-evaluate the applicability of "mark-to-market" valuation in a time when markets are collapsing. With many global commercial real estate markets' value down in excess of 30% since their peak, corporations may have real estate "held for sale" or otherwise impaired relative to net book value, requiring a write-down on the balance sheet with a corresponding impairment expense on the income statement.

In accordance with SFAS 144, an "impairment exists whenever a long-lived asset's carrying amount exceeds the fair value, with the difference being recognized as a loss only if the carrying amount of the subject asset is not recoverable (e.g. net book value is greater than

the sum of nominal cash flow expected to result from the use and eventual sale of subject property), and net book value exceeds its fair value." The accounting statement goes on to explicitly document examples of non-recoverability, including:

1. a significant decline in market price
2. an adverse change in manner of asset use
3. an adverse change in legal factors or business climate (regulatory)
4. an accumulation of cost originally contemplated for acquisition or construction of subject asset
5. a current period operating loss, or
6. an expectation that the asset will be sold prior to previously estimated useful life.

SFAS 157 was developed to increase consistency and comparability in fair-value measurements and for expanded disclosure. This Statement clarifies that the exchange price is the value achieved in an "orderly" market. It "establishes a fair-value hierarchy that distinguishes between (1) market participant assumptions developed based on market data obtained from sources independent of the reporting entity (observable inputs), and (2) the reporting entity's own assumptions about market participant assumptions developed based on the best information available given the circumstances (unobservable inputs).

There are three levels of inputs to consider when valuing an asset:

- Level 1—identical
- Level 2—observable, either directly or indirectly
- Level 3—unobservable, "but developed based on best information available given the circumstances, including the reporting entity's own data."¹

By most measures, commercial real estate would typically fall into the most challenging category, Level 3. It is worth noting, however, that the "level" of input categorization is not indicative of the input's relevance or validity when presented to support an asset's value. It merely represents a method set forth to characterize the type of evidential matter, nothing more. Further, the hierarchy is intended to apply to orderly transactions and markets. A disorderly market, or one that is inactive, could lead to a distressed, improper valuation wherein there is insufficient time to market the asset, or an absence of bidders.

In today's market, corporate real estate departments are challenged to evaluate owned assets for impairment, and to assess their current market value. One consideration is timing of disposition. The other issue is the lack of relevant observable inputs (i.e. comparables that would not be considered distressed sales). However, if a corporation has the financial wherewithal to carry the property until normalized market conditions return, the argument exists that the company should be able to avoid a distressed sale scenario in which the asset would be valued at a "fire sale" price.

CAPITALIZATION OF OPERATING LEASES

The proposed reclassification of "operating" leases as "capital" leases mandates that real estate professionals comprehend the financial statement impact, and brace for the possible strategic and operational changes as public companies work to understand this new doctrine and its implications. The sidebar, "Operating Lease vs. Capital Lease," illustrates the ramifications of this proposed reclassification.

Off-balance-sheet transactions have driven global calls for more stringent corporate financial transparency for most of this decade. The valuation of balance-sheet assets in the face of volatile and distressed markets further increases pressure for more accurate reporting. Financial statement "surprises" and subsequent significant restatements have led not only to the demise of Fortune 100 companies, but also to the decline of global economies. Concern for the stability of worldwide capital markets and the lack of credit to fund business operations have alarmed governmental regulatory bodies in all countries, and have stoked the fires of conservative accounting and financial regulation.

¹ Source: SFAS 157, paragraphs 24, 28 and 30

OPERATING LEASE VS CAPITALIZED LEASE

The comparison below shows the financial statement impacts of recognition of an operating lease vs that of a capitalized lease from the perspective of 2 companies.

- Company A enters into a transaction to lease a building for one 20-year period
- Company B enters into a transaction to lease a building for four 5-year periods

Ramifications of a Capitalized Leasehold

1. Capitalization of a lease requires an entry for an asset and a corresponding liability on the entity's balance sheet based on the NPV of the rental payments.
2. The asset recordation results in a straight-lined depreciation expense, matching the remaining benefit (lease term) of the asset.
3. The liability generates an interest expense and principal reduction, which both of which will be amortized over the remaining lease-term.

		Financial Statement Impact						
		Balance Sheet		Income Statement		Expense Impact to Profits		
		Asset	Liability	Expense				
Operating Leasehold Example	Company A							
	Lease term: 20 years	Year 1	\$0	\$0	Rent	\$1,000.00	(\$1,000.00)	Year 1
	Annual rental: \$1,000.00							
	Number of terms/renewals: 1	Year 2	\$0	\$0	Rent	\$1,000.00	(\$1,000.00)	Year 2
			Asset	Liability	Expense			
	Company B							
Lease term: 5 years	Year 1	\$0	\$0	Rent	\$1,000.00	(\$1,000.00)	Year 1	
Annual rental: \$1,000.00								
Number of terms/renewals: 4	Year 2	\$0	\$0	Rent	\$1,000.00	(\$1,000.00)	Year 2	

		Financial Statement Impact						
		Balance Sheet		Income Statement		Expense Impact to Profits		
		Asset	Liability	Expense				
Capitalized Leasehold Example	Company A							
	Lease term: 20 years	Year 1	\$10,344.00	\$10,344.00	Depreciation	\$517.20		
	Annual rental: \$1,000.00				Interest	\$767.93	(\$1,285.12)	Year 1
	Number of terms/renewals: 1				Depreciation	\$517.20		
	7.5% incremental borrowing rate	Year 2	\$9,827.00	\$10,112.00	Interest	\$749.91	(\$1,267.11)	Year 2
			Asset	Liability	Expense			
Company B								
Lease term: 5 years	Year 1	\$4,159.00	\$4,159.00	Depreciation	\$831.76			
Annual rental: \$1,000.00				Interest	\$287.76	(\$1,119.51)	Year 1	
Number of terms/renewals: 4				Depreciation	\$831.76			
7.5% incremental borrowing rate	Year 2	\$3,327.00	\$3,447.00	Interest	\$232.46	(\$1,064.22)	Year 2	

ACCOUNTING FOR LEASEHOLD OBLIGATIONS

By definition, every operating lease represents an off-balance-sheet transaction—a financing in essence. This treatment has been debated by the FASB since the inception of SFAS 13 “Accounting for Leases” in 1976. Operating leases represent more off-balance-sheet transactions than virtually any other form of financing in a typical business.

In conjunction with the IASB, the FASB issued a March 2009 Discussion Paper titled, *Leases: Preliminary Views*, and solicited comments from its members and other industry professionals related to the capitalization of all operating leases. Additionally, the Securities and Exchange Commission (SEC) has opined on Section 401(c) of Sarbanes-Oxley, calling for further clarification of reporting for off-balance-sheet transactions.

The proposed treatment equates to the recognition of previously non-depreciable and leasehold interest costs over the term of the given leasehold. Such a recordation will increase expenses on a corporation’s income statement in the first years of the term, potentially affecting profitability, debt covenants, performance measures and other competitive positions.

The March FASB Discussion Paper required that comments be submitted by July 17, 2009. If the change continues to move forward, the FASB could release an exposure draft in 2010, and a formalized standard could be in place before 2012.

LEASEHOLD TREATMENT BY TENANTS

Currently, SFAS 13 and its international equivalent, IAS 17, introduce the concept of classifying leasehold obligations as either “capital” or “operating.” Such classification dictates that the lessor and lessee analyze subject leases and administer four key tests:

1. Is there an automatic title transfer at the end of lease?
2. Does the lease contain a bargain purchase option?

3. Is the term of the lease at least 75% of the economic useful life of the leased asset?
4. Is the present value of the minimum lease payments at least 90% of the fair market value of the leased asset?²

If the answer to any of these four criteria is “yes,” then the lease is required to be capitalized, as well as recorded on the balance sheet. If the answer to all four questions is “no,” then the lease is considered an “operating” lease and is maintained off balance sheet.

The current SFAS 13 pronouncement also mandates that the lessee/tenant’s rental payments are to be accounted for on the income statement under a “straight-line” methodology.³ Any tenant improvements (TIs) received as part of the leasehold contract are amortized over the shorter of the TIs’ economic useful life, or the lease term.⁴ From an accounting perspective, the landlord/lessor issuance of any balance for the completion of TIs is not applied toward the cost of space fit-out, which would impact the amortization calculation. Instead, it is treated as a liability and amortized on a straight-line basis over the lease term as a reduction of rental expense.⁵

When attempting to run the minimum lease payment test, note that the lease term can commence prior to the rent commencement date, as in the case where the period of TI/fit-out of space occurs after the lease is executed. In such an instance, the straight-line calculation can also commence at execution.⁶ In the case where the renewal is reasonably assured, the straight-line calculation would include the renewal period as part of the original lease term.⁷ Rent holidays (rent abatements) are also included in the straight-line calculation.⁸

Again, the current off-balance-sheet treatment of operating leases means that substantial financial obligations

2 Source: SFAS13, paragraph 7a-d

3 Source: SFAS 13, paragraph 15 and 19b

4 Source: EITF05-6, TPA 5600.14

5 Source: TPA 5600.16, FTB 88-1

6 Source: TPA 5600.09

7 Source: TPA 5600.08, FTB 88-1

8 Source: FTB 85-3

are currently not represented as a liability on the balance sheet. The SEC requires public entities to report up to five years of operating lease obligations as a future obligation in the footnotes of their 10-Qs and 10-Ks. However, such future contingencies are sometimes overlooked due to existing lease expirations and the “appearance” of a waterfall of declining obligations on occupancy costs as existing lease terms expire.

WHAT THIS MEANS FOR CORPORATE REAL ESTATE

Balance Sheet Impact

Should capitalization of leasehold obligations become a reality, current operating leases would be recorded on the balance sheet. (Again, please refer to the “Operating Lease vs. Capital Lease” sidebar for an illustration of this.) Under the existing methodology, the capitalization of the leasehold (by the lessee/tenant) represents the recordation of an asset and a contingent liability obligation equal to the present value of the minimum lease payments, discounted at the entity’s incremental cost of capital over a similar period⁹ and commencing at the effective lease commencement date.¹⁰ Minimum lease payments exclude taxes, maintenance and insurance.¹¹

Over any given reporting period, the operation, use, and benefit of the leasehold asset are recognized with an entry to depreciation against the remaining net book value (NBV) of the leasehold. Concurrently, an entry for the actual lease payment is made with the lease payment taken to “Accounts Payable—Cash,” with corresponding entries for interest expense at the tenant’s incremental cost of capital, and a lease liability to offset the difference. In other words, the liability is

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reduced each year by the principal reduction from the amortization of the contingent liability.

Income Statement Impact

While SFAS 13 stipulates that operating lease treatment must include a straight-lining of rent expense, capitalized leases do not record a rent expense. Instead, capitalized leases are treated similarly to a building purchase with 100% financing. Rather than incurring a rent expense on the income statement, capital leases include a straight-line depreciation expense and amortizing interest expense. The result is a considerably higher initial expense of depreciation and interest, which decrease over the term of the lease until they are reduced to \$0 at lease expiration. (Again, see sidebar Exhibit B for impact.)

PORTFOLIO STRATEGIES

While the capitalization of operating lease change could be a few years away, many corporations are evaluating their real estate portfolio strategies today in light of the potential impacts. Some of the diverse options available to corporate real estate come with fundamental pros and cons, as illustrated below:

Own Versus Lease

Rigorous analysis of decisions to buy or lease properties will become more critical. A company that owns a majority of its real estate will experience little of this change, if any. Conversely, a competitor who primarily leases now will arguably have negative financial-statement impacts to liabilities and earnings.

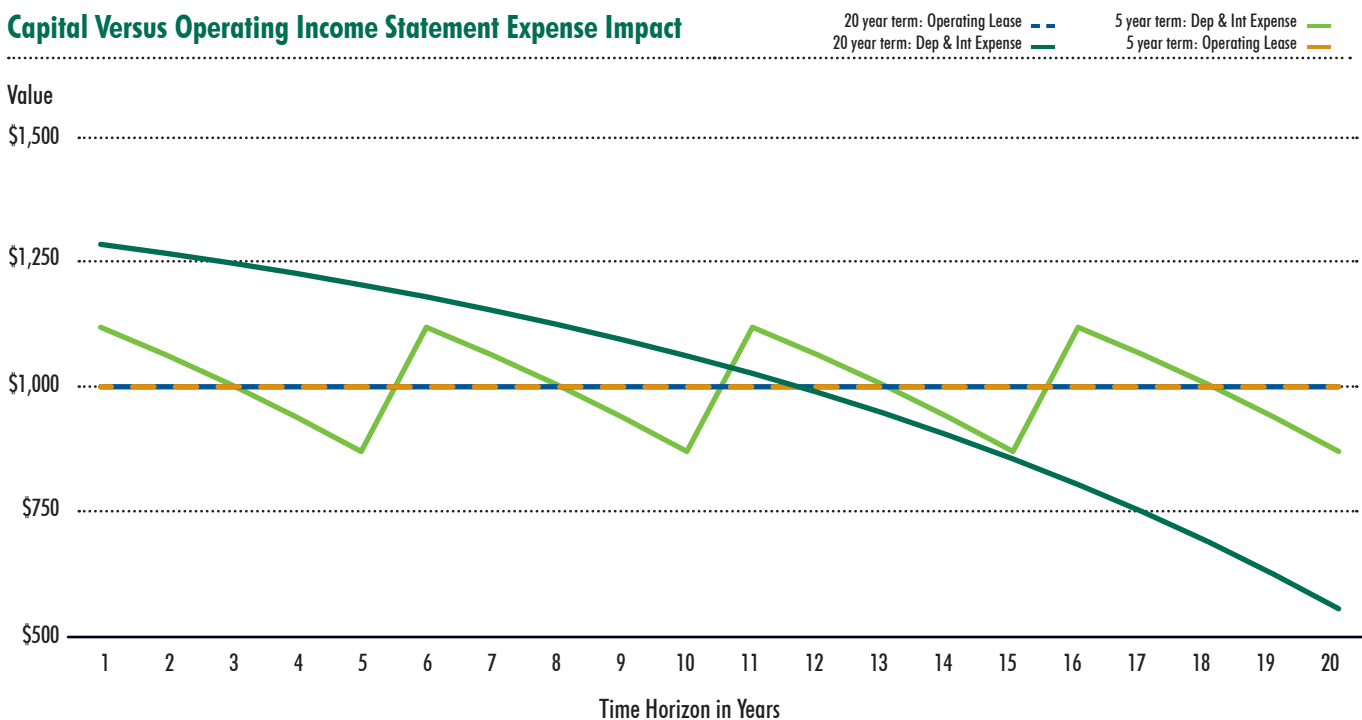
The financial-statement impact of a capital lease is that the depreciation schedule and liability obligation last only as long as the lease term. The acquisition of real property, on the other hand, allows depreciation over a longer period of time in accordance with Generally Accepted Accounting Principals (GAAP) and an income

⁹ Source: SFAS 13, paragraph 5I

¹⁰ Source: SFAS 13, paragraph 10

¹¹ Source: SFAS 13 paragraph 5j(i)

Capital Versus Operating Income Statement Expense Impact



tax shield for 39 years (as stipulated by the Internal Revenue Code of U.S. Internal Revenue Service) depending upon the age of a subject asset. Correspondingly, the flexibility of the liability and interest expense for owned properties align with the actual financing, if any.

Short Versus Long Lease Terms

Shorter lease terms will reduce the impact to the financial statements if duration matching presents itself as an option. However, many leases will continue to be longer term due to market conditions, required control of the premises, landlord inducements and, most importantly, the accretive value to any given real estate portfolio (such as reduced uncertainty, inflation hedge, leased investment opportunity and other indicators). The longer the lease term, the greater the NPV impact will be on balance-sheet assets and liabilities.

A company will need to optimize the need for flexibility, cash flow impact, financial statement impacts and the strategic purpose of the facility in making these and other transaction-strategy decisions.

PROACTIVE STRATEGIC PLANNING

The convergence of international accounting standards, transparency requirements brought on by Sarbanes-Oxley (404), and a dynamic regulatory landscape are challenging corporate real estate and finance departments to recognize, comprehend and comply with new governance, process, procedure and reporting for financial disclosure.

With an understanding of evolving reporting standards and their corresponding financial statement implications, a real estate department can proactively strategize how to best position itself to comply with existing and prospective financial accounting requirements, and in a manner and time period that minimizes detrimental financial impacts. Ideally, a corporate real estate executive should aspire to continually add value through embracing real estate transaction structures that enhance competitive positioning while avoiding the future detrimental accounting impacts on earnings and contingent liabilities.

All too often, real estate departments and corporate finance departments work in isolation, resulting in work statements that reflect a linear, sequential order. A transaction is completed and then the finance team records the results. This disconnect has resulted in negative and unintended income statement consequences as a result of failing to recognize and comprehend the following:

- Straight-lining of rent, per SFAS 13
- Recognition of contingent liabilities upon exit or disposal activities, and the impairment gap between existing rental obligations and the sublease rentals, per SFAS 146
- Year-end balance-sheet adjustments for capital leases, per SFAS 13
- Asset impairment write-offs, per SFAS 144

The re-emergence of capitalizing operating leases (bringing them onto the balance sheet) and the continued evolution of mark-to-market valuation guidance make the impact of corporate real estate portfolios ever

more present in the minds and on the desks of chief financial officers and the entire C-suite.

Corporations conducting “business as usual” without embracing the importance of financial accounting and reporting transparency for their real estate may be at the mercy of their own ignorance—suffering potential year-end audit consequences, detrimental financial adjustments that may have been otherwise avoided, or, in a worst-case scenario, years of competitive disadvantage due to the duration of the real estate transactions negotiated. Conversely, those companies that adopt a proactive analysis and programming mentality, reflecting thoughtful financial planning, emerging industry best practices and active engagement of corporate finance departments will stand to gain financially and competitively while carefully navigating the minefield of unanticipated financial accounting impacts.

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