

# Marquee

Providing business and financial news for the hospitality and real estate industries Winter 2009

## Proposed standard would eliminate operating lease accounting

By John Hepp, Accounting Principles Partner

The Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) are on the verge of throwing the art and science of lease accounting into turmoil with a new “preliminary views” document, due out within the next month. Although final rules are several steps and likely two-plus years away,



the probable outcome could have a substantive impact on the accounting practices of hoteliers, multiple-store owners, retail chains and other businesses that lease real estate.

In addition to its impact on lease accounting, the new preliminary views document will be closely watched for several reasons.

First, from a regulatory perspective, it responds to the latest push by the U.S. SEC to rein in popular off-balance-sheet accounting techniques. Because such financing arrangements were a major factor in the high-profile scandals earlier this decade, the FASB specifically targeted off-balance-sheet accounting techniques such as leasing, pensions and securitizations.

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Additionally, the leasing preliminary views document represents an important step by the FASB, the source of U.S. GAAP, and the IASB, authors of International Financial Reporting Standards (IFRSs), to address an area of significant divergence between the standards. Another area of importance – revenue recognition – was addressed by a jointly issued preliminary views document in December 2008.

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# Proposed standard would eliminate operating lease accounting (continued)

From an industry perspective, the proposed change to lease accounting far outweighs long-term theoretical considerations: Both the FASB and the IASB plan to remove the requirement to classify leases as capital or operating leases. If and when these rules are finalized, all lease obligations will be on the balance sheet with a corresponding right-to-use asset.

## Lease accounting: Why so controversial?

Leasing is often a cost-effective and tax-efficient way to finance purchases, from personal computers to office complexes.

Under the current system, leasing companies and consultants offer sale and leaseback transactions to provide businesses with access to financing or the ability to extract cash from existing assets, often at a lower cost than other financing alternatives. Similarly, build-to-suit leases often can be used to finance expansion. Experts in the application of the complex lease accounting rules in GAAP generally can provide those benefits without booking a liability on the balance sheet for future payments, even though the leases are noncancelable, thus allowing companies to keep capital available for other business purposes.

Yet, there is a price tag. In order to ensure that a sale and leaseback can be recognized as a sale, the transaction must be designed so that the seller/lessee does not retain continuing involvement. This includes a prohibition on any provisions that would allow the seller/lessee to benefit from future increases in the value of the property.

Similarly, operating lease provisions may not include a transfer of the property at the end of the lease or a bargain purchase option. This usually is not a concern in leases of equipment or other depreciating assets, but could be a significant issue in leases of land or buildings that have the potential to appreciate in value over lease terms generally of 20 to 30 years or more. Instead, the potential for lost appreciation must be incorporated into the total cost of lease financing.

While lease financing and lease accounting may provide advantages to businesses, these techniques can be a challenge for investors and others using the company's financial statements. Currently, users of financial statements must look in the notes of the statements to uncover information regarding the company's future cost obligations under operating leases. These obligations can be substantial. In a 2005 study, the SEC estimated the undiscounted amount of off-balance-sheet lease obligations at \$1.25 trillion.

## Future challenges

If your business makes use of lease financing for long-term assets, especially real estate, including build-to-suit leasing arrangements or sale and leaseback transactions, now is the time to review your financing and negotiating strategies.

While the new standard is not likely to take effect until 2012 or 2013, and could be considerably modified by public response to the preliminary views and subsequent Exposure Draft, businesses negotiating long-term leases that involve assets with the potential for appreciation need to be aware of the implications and begin preparations today.

In a nutshell, moving lease financing transactions to the balance sheet will have some key practical implications:

- Most importantly, assets and liabilities will increase based on the present value of the expected future lease payments as the leases are put on the books.
- Rent expenses will be accounted for in a manner similar to installment loans, separated into interest expense and repayments. As a result, this will change return on assets, debt-to-equity ratios and calculations of leverage, potentially affecting loan covenants or other agreements that reference those items.

Therefore, when negotiating the terms of a lease, you should not forgo any future economic appreciation solely to obtain favorable accounting treatment under the current standards. When designing your financing and negotiating strategies, you should take into account the possibility of new accounting rules that will put the obligation on the balance sheet within the next few years. While leasing still may be the lowest-cost after-tax financing alternative, favorable accounting treatment should not drive the decision to lease.

Obviously, a preliminary views document is not final rulemaking. Yet in Grant Thornton's opinion, anyone whose business model includes financial arrangements structured as operating leases would be well-advised to plan for a future in which the current favorable accounting treatment will not be available. •

# Are you paying too much for your property taxes?

By Joseph J. Calvanico, State and Local Tax Director

Under the current economic conditions, it is likely that the value of many companies' real estate holdings has decreased. However, taxing authorities often are not reducing the assessed value of properties to reflect the real fair value. New guidelines for valuing assets at fair market value provide some perspective on what "fair value" really means.

## What has changed?

The Financial Accounting Standards Board's (FASB) accounting standard on the fair value definition was issued in 2007 but is just now becoming effective for most companies. The FASB released Statement No. 157 to create a single definition of fair value – a definition that would result in increased consistency and comparability in fair value measurements – and establish a more concrete framework for measuring fair value within GAAP. The definition of fair value in the context of FAS 157 is much closer to fair *market* value.

Fair market value is defined as the most probable price paid for a particular asset by a willing buyer to a willing seller, and would include all other conditions requisite to a fair sale. Fair value is what was paid for the property – period.

Prior to the issuance of FAS 157, the fair value measurement for real estate often was based on guidance contained in FAS 141. That definition of fair value was much closer to "value-in-use," or the value to a specific user, which is contrary to the definition of value used for property tax assessments in most states (except Indiana). In fact, most states use fair market value.

## What does this mean to taxpayers?

Value to the average person is generally higher than the fair market value. As an example, most people are very proud of their homes, so when they go to sell, their expectation of what their homes may be worth is higher than what the market will bear. This emotional component to value-in-use usually holds true even in commercial real estate.

When any property is sold, the new owner records the sale with the recorder of deeds. After closing a sale on a commercial property, the declaration showing the actual price goes directly to the assessor's office and often will be used as the property tax assessment. Given the current market and the new definition of fair value, the assessment is likely inequitable to the taxpayer.

## A proper assessment

If we find a client's property is over-assessed, we recommend that the reasons for the over-assessment be brought to the appropriate jurisdiction's attention in order to resolve the issue through administrative negotiations. If such negotiations fail to result in a reasonable agreement, we will recommend a more detailed analysis, provided the estimated cost of such an effort can be justified by the potential tax savings.

As many companies start receiving their annual property assessments, it is prudent to discuss your property tax liability with a tax professional to ensure you are getting an equitable assessment. •

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# Achieving cost reduction and conserving cash in a weak economy

By Jessica Dill, Business Advisory Services Manager and Jim Dee, Business Advisory Services Partner

Faced with frozen credit markets, real estate executives are looking for ways to conserve cash through more efficient management of existing properties and administrative functions. Similarly, in an industry where deep discounting has become a standard practice, hospitality executives are looking for ways to streamline operations to offset declining margins.

Managing costs is the most effective way to soften the financial impact of weak economic conditions. In fact, research indicates that cost reduction can have a significantly greater impact on the bottom line than a sales increase: \$1 saved through cost-reduction initiatives has an equivalent financial impact to a company as a \$5-\$20 increase in sales<sup>1</sup>. Grant Thornton has identified a handful of cost-reduction strategies to help businesses navigate the economic downturn and position themselves for growth once the outlook improves.



Consider the following cost-reduction tactics as your business manages its bottom line.

**1. Conduct an assessment and focus on expenses with the greatest impact.** When it's time to reduce costs and enhance cash flow, take a close look at your supply chain. Labor and operating supplies are generally the two largest categories of operating expenses. Process improvements and innovation can improve efficiency and help reduce labor and administrative costs. Opportunities to reduce operating supplies can be assessed and prioritized. Consider working with an experienced business consultant who possesses an in-depth knowledge of your industry to perform a cost-reduction assessment. Such an exercise will help you identify opportunities to improve your organization's operating results.

**2. Create a cross-functional cost-reduction team to focus on operating expenses.** Evaluate each department and function in terms of costs and profits, comparing existing arrangements with potential strategic alternatives, including outsourcing. Bring together finance and operations professionals who understand technical purchasing requirements to identify cost-reduction opportunities.

Ask the finance department to perform an assessment of expenses in high-dollar categories to better understand the sources of these costs. Team finance with operations and management professionals who thoroughly understand the current market conditions for each category. They will have a sense of which suppliers might be willing to negotiate and offer a better deal, especially if vendors are under pressure to maintain their sales levels.

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<sup>1</sup> META GROUP, E-Sourcing: The Science of Strategic Sourcing, Electronic Business Strategies Delta 1093, 10 July, 2001, Carl Lehmann

# Achieving cost reduction and conserving cash in a weak economy (continued)

Performing this type of analysis can quickly reveal the greatest areas of indirect spending: sales, general and administration (SG&A) expenses. Completing a trial balance spending analysis under different scenarios can help management understand the impact of different cost-reduction measures. For example, companies often are surprised that there is a potential for 5 to 20 percent savings in areas such as transportation, maintenance and repair services, information technology products and services, office supplies, advertising and marketing, legal services, travel, temporary labor, utilities and telecommunications. Furthermore, reducing indirect expenses, even modestly, will significantly boost net income.

### 3. Consolidate purchasing power.

If your business operates in multiple locations, consider opportunities to consolidate its buying power. Combining purchasing into a centralized department may enable your organization to take advantage of volume discounts.

#### Indicators that cost-reduction strategies may be needed:

- Poor understanding of why costs are increasing
- No focus on total cost of ownership
- Informal processes and maverick buying
- Decentralized sourcing and procurement functions
- Lack of contracts with key suppliers
- Informal and/or manual bidding process
- Lack of a purchasing department and/or system
- Poor visibility into spending with suppliers
- Demand patterns and specifications not evaluated
- Commodity products, thin margins and/or global competition
- Mergers & acquisitions

### 4. Stay in communication with your key vendors.

This will ensure you are apprised of potential supply chain risks and that you can address any issues that arise. By maintaining open lines of communication, your organization and its vendors can work more effectively during difficult times. The goal is to discuss creative solutions to minimize supply chain costs while maintaining high-quality service.

Keep in mind that vendors' costs also are increasing. If a vendor has cash flow problems or cannot provide you with timely goods and services, consider finding alternative suppliers. By pursuing "smarter sourcing" of indirect goods and services, you can acquire significant savings that you will enjoy for years to come.

### 5. Measure cost savings and effectiveness.

An effective measurement system gauges the success of your cost-reduction initiative, helping you understand the impact on the bottom line. It is critical that the quality of goods and services and timeliness of delivery are not affected by cost-reduction initiatives.

In an economy where increasing revenue is more of a pipe dream than a realistic goal, hospitality and real estate companies need to examine their cost structure as a means of improving the bottom line. Those that look for ways to trim costs, consolidate purchasing power and streamline processes will be well-positioned for growth when the economy rebounds. •

#### About the newsletter

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