

New Lease Accounting Rules:

Considerations for Real Estate Owners and Investors

by Yvonne A. Jones, CPM, CCIM, President, Principal, Zifkin Realty Group, LLC
and Mary K. Fuller, CPA, Partner, Shepard, Schwartz & Harris, LLP



Fuller



Jones

The Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) are currently overhauling the rules for lease accounting to create a uniform global standard and greater transparency for lease accounting procedures. The proposed changes, which affect real estate, tangible property, and equipment leases, should have an enormous impact on corporate financial statements.

For some time it has been a goal of both the FASB and IASB to merge US Generally Accepted Accounting Principles (GAAP) and International Accounting Standards (IAS). The major criticism has been that under the current lease accounting standards lessees do not recognize all lease obligations on the balance sheet, based on what some considered being subjective distinctions between operating and capital leases. The Exposure Draft (ED) issued jointly by FASB and IASB on August 17, 2010, proposes new standards to address these concerns.

Under the proposed standards, lessees would no longer be permitted to treat leases as “off-balance sheet” financings with only the straight line average rent reported as costs in the profit and loss statement. Instead, the proposed rule would require lessees to reflect the leased asset (“right-of-use”) and a lease obligation on the balance sheet. The liability shown on the balance sheet would reflect the lessee’s lease value or rent commitment (minimum and contingent rents) over the entire term, including all probable renewal options at present value discounted at the lessee’s incremental borrowing rate.

A lessee that pays \$500,000 per year in rent for one of its locations would see its balance sheet liability multiply depending on whether it has a five-year or ten-year lease. For example, using a 5% discount rate, the lessee would initially reflect a present value liability for the lease obligation of \$2,208,000 for a five-year lease and \$3,928,000 for a ten-year lease. Companies would appear

more highly leveraged, which could affect their credit rating among other things.

The rule change will also affect the financial statements of real estate owners and lessors. Lessors recording their investment property at cost need to assess their exposure to risk or benefit of the underlying asset. The proposed standard has outlined two alternative methods for accounting, the “Derecognition” approach (recognize gain or loss), and the “Performance Obligations” approach (recognize income over the lease term). With both, the lessor recognizes a receivable for the right to receive lease payments from the lessee, which may or may not correspond with the obligation (liability) recognized by the lessee. Lessors and lessees may make different assumptions of renewal terms and contingent rent estimates. The two methods deal differently with the remainder of the lessor’s interest in the underlying asset.

These changes are a concern to many owners and investors. What is not yet clear is to what extent the new guideline will affect a lessee’s decision-making process. The new ruling is expected to cause a lessee’s financial statements to show lower working capital, a higher debt-to-equity ratio, and possibly lower profits in the initial years of the lease, all of which may significantly decrease the lessee’s ability to borrow capital for growth and expansion. One likely outcome is that lessees may consider shorter term leases or prefer to own instead of leasing. A short-term lease may not make sense for a lessee when market rent is low or significant tenant improvement costs are required. The proposed changes will have no effect on the cash flow of the lease arrangement.

Accounting rules are rarely the principal driver of real estate decisions, however, the proposed lease accounting changes illustrate that now, more than ever, real estate executives and professionals will require a team of professionals who can help to prioritize objectives and make tactical decisions that align with the business strategy.

The FASB and IASB will hold a public meeting in January 2011 to discuss the Exposure Draft on Leases. A final standard is expected in 2011 but the effective is still under consideration. Most, however, expect it to be sometime in 2013.