

New Lease Accounting Rules:

Considerations for Real Estate Owners and Investors

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(Chicago, IL) - 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 lease accounting changes which affect real estate, tangible property, and equipment leases are significant and, if adopted, should have an enormous impact on corporate financial statements.

Accounting for operating and capital leases has virtually remained unchanged since 1982 when the IASB issued IAS 17 "Leases". 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 of their 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 5 year lease and \$3,928,000 for a 10 year lease. Companies would appear more highly leveraged, which could affect their credit rating among other things.

The lease accounting rule change will also significantly affect the financial statements of real

Derecognition approach:

Under this approach the lessor is seen as having transferred the economic benefits of the underlying asset to the lessee. Therefore, the "right-of-use" granted to the lessee is regarded as a partial disposal of the underlying asset held by the lessor. When the lease begins, the carrying amount of the underlying asset is reduced to reflect this partial disposal, and a new asset equal to the present value of the lease receivable is recognized. The difference between these two amounts could result in a gain for the lessor. In effect, at the inception of the lease, the carrying amount of the leased asset is replaced by a right to receive rental income over the lease term and a residual interest in the underlying asset.

Performance obligation approach:

Under this approach, the underlying asset is viewed as a continuing economic resource of the lessor. Therefore, the existence of the lease does not affect the accounting for the

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 of these methods, 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 (see side bar).

The proposed lease accounting rule changes are a concern to many real estate owners and investors. What is not yet clear is to what extent the new accounting 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 necessary capital for growth and expansion. One of the most discussed likely outcomes is that lessee's may consider shorter term leases or prefer to own their real estate instead of leasing it. A short term lease may not make economic sense for a lessee when market rent is low or significant tenant improvement costs are required. The proposed lease changes will have no effect on the cash flow of the lease arrangement.

Although the proposed changes may add a twist to lease negotiations or the "buy vs. lease" decision, accounting rules are rarely the principal driver of real estate decisions. The proposed lease accounting changes do, however, 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 be holding a public roundtable meeting in January 2011 to discuss the Exposure Draft on Leases. A final standard is expected in 2011 but the effective date of the new lease standards is still under consideration. Most, however, expect it to be sometime in 2013.

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underlying asset on the lessor's balance sheet, which remains at its previous carrying amount with related depreciation being expensed. However, the lease contract results in recognizing a receivable for the right to receive rental income and a corresponding liability representing the obligation to provide the lessee with the right to use the asset over the lease term. Over the lease term, interest income is recognized on the receivable and lease income is recognized as the lease liability is satisfied.

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