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Proposed lease accounting changes: what they will mean

Leasing is an instrumental source of financing for companies. Currently, there are changes being discussed in lease accounting standards that will have a significant impact on the way leasing companies do business and ultimately affect their balance sheet. Operating leases likely will be replaced by capital leases and many companies will suffer the consequences in the form of dramatically increased debt on their balance sheets.

It is likely you have heard about the potential sweeping changes in the lease accounting standards as a result of convergence and now you know why these changes should have your attention. So, how did these new proposed standards come about? Convergence came about due to the global need for transparency in financial reporting and a unified set of accounting standards. It is the coming together of the traditionally rules-based U.S. accounting principles of the Financial Accounting Standards Board and the principles-based international accounting standards of the International Accounting Standards Board. The FASB and IASB identified leasing as an area where uniformity and transparency in financial reporting is needed.

Under current U.S. accounting rules, leases are recorded as either an operating or capital (finance) lease. There are bright-line tests to determine the appropriate accounting and, generally, nonowner tenants have recorded real estate leases as operating leases. Under



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these existing operating lease rules, lease expense is recorded in the income statement straight-line over the lease term with little or no effect on the lessee's balance sheet.

Alternatively, capital leases reflect the assets and liabilities related to the benefits and obligations of the transactions on the lessees' balance sheets as capital assets and liabilities and an expense is recorded in the income statement as depreciation and interest components.

The new conceptual lease accounting standards identified by the FASB and IASB in their joint discussion paper issued in March 2009 are based on the "right-to-use" concept. This concept will require operating leases to essentially be treated as capital leases and recorded on the balance sheet of the lessee. Lessees would record an asset representing its right to use the leased item for the lease term and a liability for its obligation to pay rentals. The liability is measured initially at the present value of the lease payments discounted using the lessee's incremental borrowing rate and then reassessed at each reporting date.

Sound complicated? Well, it will be. The measurement of these assets and, more importantly, the liabilities will

require complex calculations and assumptions that would include not only base rent but also contingent rentals, obligatory lease options and residual guarantees. Even the FASB and the IASB are not yet on the same page with respect to some finer points in the discussion paper. One thing is for certain, regardless of the final assumptions and calculations used, the proposed concepts will significantly increase the amount of debt all lessees will record on their balance sheets at a time when many entities are struggling to survive. And compounding the effect on lessees' financial statements, the lessees' income statements will likely reflect accelerated occupancy expense since expenses related to leased assets will no longer be recorded on a straight-line basis as currently required for operating leases.

The effect on tenants will be far-reaching and likely considerable. Almost every company leases assets in some form, including real estate, office equipment, vehicles and the like. The increased debt and interest expense from the right-to-use concept could have a major impact on existing loan covenants for companies. In addition, speculation has begun regarding the unintended consequences as lessees begin assessing the impact this additional debt has on their financial statements and potentially shortening lease terms in order to mitigate the amount of debt that will need to be recorded on their financial statements.

So now that the impact on

lessees has been discussed, what is the potential impact on the lessors? Should similar changes be anticipated? In the original discussion paper, the IASB and FASB tentatively decided to defer consideration of lessor accounting and concentrate on developing an improved lessee accounting model. Consequently, the boards have not discussed accounting for lessors or owners in detail. Although it is noteworthy that some of the comments received by the board in response to the discussion paper include the request to have lessor accounting rules clarified simultaneously with lessee rules.

There still are a lot of details to be worked out as the new concepts are discussed. The IASB and FASB received 290 letters of comment on the proposed new accounting model for lessees, and they are currently evaluating those comments and insights. No one can know for certain, but the FASB and IASB tentatively expect to issue an Exposure Draft in 2010 with a Final Accounting Standards Update issued in 2011. Clearly this new lease accounting being discussed will have significant changes for the commercial real estate community from both an owner and tenant perspective. Although only time will tell how the final standards are written, both owners and tenants alike should begin assessing the impact of the right-of-use concept on their own financial statements.▲