



FASB's Changes to Bring About a New "Lease" on Accounting for Leases

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The Financial Accounting Standards Board is committed to make lease accounting more transparent to financial statement users. The board's desire to eliminate off-balance sheet financing, as well as to create more consistent and concise financial reporting, are the driving forces behind the proposed changes. Another strong influence is the impending guidance convergence with the International Accounting Standards Board, which will align global accounting standards. This marriage was agreed upon in 2002 and is necessitated by economic globalization.

In June 2005, the Securities and Exchange Commission recommended that FASB take a fresh look at lease accounting and preferably make changes congruent with IASB. At that time it was estimated that over 70 percent of all operating leases covered real estate, having a balance sheet impact exceeding \$1 trillion. FASB issued its Discussion Paper on the proposed changes in March of this year and comments were due in July. An Exposure Draft encompassing the changes is expected in the first half of next year. The revised standard should be published sometime in 2011, and an implementation deadline will probably follow in another year or two.

FASB released Statement 13 on Accounting for Leases in November 1976. The pronouncement specified conditions under which a lease must be capitalized. More importantly it left boundaries whereby a lease may avoid balance sheet presentation and rental payments are recognized as an operating expense. The new guidelines recognize leasing as a form of financing, eliminating operating leases, and placing all leased assets on the lessees' balance sheets. The asset and corresponding liability will be valued at the present value of the minimum lease payments using the lessee's incremental rate of borrowing. Also, rent payments will be bifurcated into interest expense and a liability reduction, and the asset will be amortized ratably over the life of the lease. Both the asset amortization and the interest will hit the company's income statement below the EBITDA line. These changes could have a major impact on financial ratios, and thus the debt covenants, of many entities.

The "right-of-use" asset is written-off uniformly over the life of the lease. The "obligation to pay rentals" is amortized like any financing transaction, with a heavier interest burden in the early years, thus having a greater impact on income. This trend reverses itself nearer the end of the term. In a lease with escalating rents, the cash outflow (rental payments) and the corresponding expenses (interest and amortization) will travel in opposite directions, creating a financial statement portrayal contrary to the cash outlay.

How to measure renewal options, a common element found in most real estate leases, accentuates the differing philosophies between FASB and IASB, as well as the rocky road to convergence. FASB tends to be very rules-based (e.g. think of the four-pronged test employed to determine whether a lease should be classified as operating or capital) while IASB is more principles-based. The length of time used to calculate the obligation and the corresponding asset is the "most likely term" as determined by the lessee. In other words, it is possible that renewal periods beyond the



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initial term of the lease could, if deemed likely, be capitalized at lease inception. Contractual, non-contractual and business factors should all be considered when making this assessment. Examples of these three factors:

- Contractual – explicitly stated in the lease, such as renewal rates, a residual value guarantee, or the specification of asset condition upon surrender.
- Non-contractual – other factors which may influence a lessee's tie to an asset. Leasehold improvements, relocation costs and tax consequences are non-contractual factors.
- Business – non-financial business factors that could affect a lease term. For instance whether the asset is critical to the lessee's operations or the asset's proximity to lessee's other facilities or its competition.

Any reassessment of the lease term will require an adjustment in both the obligation to pay rentals and the right-of-use asset.

The new guidance will require recognition of contingent rental payments (e.g. a percentage of sales over a threshold in a retail lease) in both the asset and liability. Current FASB guidance recommends that the lessee measure the liability on the most likely outcome, while IASB favors a probability-weighted estimate of the obligation. When contingent rent is based on an index or rate (e.g. prime interest rate or consumer price index), the lessee will employ the index or rate at the inception of the lease. A change in the estimate of contingent rent will result in a change in the obligation and a gain or loss if FASB's methodology is chosen. However, if IASB prevails, the change in the liability will be mirrored in the asset. Residual value clauses are handled in virtually the same manner.

Another popular real estate transaction today is a sale and leaseback, wherein a corporate owner and occupier sells its property to a entity who becomes the lessor, and then leases the property back to the original owner, now the lessee. FASB did not address this issue in the Discussion Paper, but in its June board meeting voted unanimously to endorse the position that the seller/lessee derecognizes the asset, and treats the impending lease like any other under the new guidance. The board has yet to determine the handling of leaseback rental rates which do not reflect market rates.

Additional critical aspects in the real estate arena which were not addressed in the Discussion Paper but will be covered in the Exposure Draft are subleases, where the original lessee becomes the sublessor, and the service component included in many leases. Also, in preparing the Discussion Paper, the board noted that the vast majority of issues in lease accounting were on the lessee's side; therefore, FASB didn't tackle lessor accounting in that document. In their July board meeting, however, FASB began to wrestle with this issue and tentatively decided that the lessor's right to receive rental payments did constitute an asset that will be discounted at the interest rate implicit in the lease and recorded on the lessor's balance sheet.

The breadth and depth of the new guidance may prove overwhelming to many, but the best way to handle the changes is to be proactive. In other words, understand the effect the new rules will have on present or future leases before the changes take place. Contact your real estate services provider to set up pro-forma models for current leases. Armed with this knowledge, companies will be able to quantifiably determine how these changes will affect



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conformity with any of their debt instruments and how best to enter into future transactions. Grubb & Ellis' Corporate Finance group is well-versed in the complexities companies will face when encountering these impending changes, and is ready to lend a hand.

This paper is a summary of the changes in lease accounting looming on the horizon. It is the first in a series exploring the new guidance and the effects it will have on real estate transactions. The next topic in this series will be an in-depth look at the capitalization of leases, the accounting treatment and their consequences.

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