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## Lease Tips™

# The Impact on Corporate Real Estate of Lease Accounting Changes under GAAP

September 15, 2010

The commercial real estate industry is abuzz with the proposed changes to lease accounting under generally accepted accounting principles (GAAP). On August 17, 2010, we moved one step closer to these changes with the joint release by the [Financial Accounting Standards Board \(FASB\)](#) and the [International Accounting Standards Board \(IASB\)](#) of an [Exposure Draft](#) of such proposed changes.

Interested parties may [comment](#) on the proposed changes any time prior to December 15, 2010 and KBA intends to do so. The Boards intend to finalize these new standards sometime during 2011, with possible implementation in 2013. Whenever the actual start date, they will provide enough time to prepare for all the changes.

### Why the Changes?

The Boards are trying to eliminate a “form over substance” distinction in GAAP accounting regarding typical, non-financing “operating” leases that has led to confusion and potential under-reporting in financial statements. The Boards consider all leases, including operating leases, to be financially equivalent to purchasing the right to use an asset and financing it.

For example, the Boards see little economic distinction between a company entering into a long-term lease for a piece of equipment versus purchasing and financing it. In both cases, the company is making periodic payments over an agreed time period for the right to use the equipment. This is most obvious in the case of financing or “capital” leases, which are leases with very obvious purchase characteristics (e.g., the aggregate of the lease payments is similar to the purchase price and there is a purchase option at the end for nominal value). Capital leases have long been treated as financed purchases under GAAP.

Real estate leases are no different than equipment leases and face the same form-over-substance issue. There is little economic difference between leasing a building for 30 years versus purchasing and financing it via a 30-year mortgage loan. Like the equipment lease, in both cases, the company is making periodic payments for the right to use the building over 30 years.

Despite these economic similarities, under current GAAP, operating leases and financed purchases are treated very differently in financial statements. Currently, lease payments made under operating leases (i.e., non-financing leases) are recorded as expenses on the income statement as incurred, and nothing is recorded on the balance sheet. In contrast, for actual financed purchases and capital (financing) leases, an asset and corresponding loan is recorded on the balance sheet and depreciation and interest are recorded as expenses on the income statement. The carrying value of the asset is reduced each year as depreciation is expensed, and the loan balance is reduced as lease payments are made.

These differing treatments have led to a lack of comparability and undue complexity. In fact, many users of financial statements (lenders, investors, etc.) find themselves adjusting such statements to reflect the “true” assets and liabilities arising from operating leases. *The Boards believe providing for uniform treatment for nearly all lease transactions will provide reliable information that is useful to present and potential investors and creditors and other financial statement users in making rational investment, credit and other decisions.*

### **What Will Change**

In simple terms, the proposals would treat all operating leases like financed purchases, with the asset being the “right to use” the underlying leased asset for the lease term, and the liability being the loan value to finance that asset. This is similar to the treatment of capital leases under current GAAP.

Thus, a 5-year lease for space in an office building would be treated as the purchase of the right to use the space for 5 years through a single up-front payment financed via a 5-year loan.

### **Life of the “Asset” and Length of the “Loan”**

There is a wrinkle in the proposed changes, however. As proposed, the life used to establish the asset value and the length of the loan would not be the actual length of the lease, but rather the longest “likely” length of the term, taking into account the likelihood of exercising options to extend or terminate it. In other words, if a tenant has a 5-year lease with options to extend the lease for two additional 5-year terms, and the tenant believes it will most likely exercise the first option, then it must treat the asset life and loan period as being 10 years in length.

Furthermore, the proposal requires that the initially established asset values and loan amounts to be adjusted as and when the underlying facts or circumstances change. In other words, if the tenant in the foregoing example changes its opinion and now believes that it will most likely exercise both options, it must recalculate the asset value and loan amount on its balance sheet assuming the 15-years term.

*KBA is concerned that this variability will lead to confusion, complexity and possible manipulation, and might expose corporate officers to criticism if estimates prove to be incorrect. Furthermore, those in corporate real estate negotiate options in their leases for flexibility, and disclosure of a company’s intention to exercise (or not exercise) an option has the potential to undermine its leverage in lease negotiations.*

### **Treatment of Gross vs. Net Leases**

The proposal will also require significant adjustments to the treatment of Gross and Modified Gross leases, which constitute the majority of commercial office leases in the US.

Commercial real estate leases contain two components: the use of the space, which the landlord grants in exchange for rent, and the servicing of the space (the operating, maintenance, real estate tax and insurance expenses), for which either the landlord or tenant is responsible depending on the lease. In pure Net leases, the tenant pays for the use of the space separately from the servicing costs, whereas in pure Gross leases, the rent covers both the use and servicing of the space.

Most commercial office leases are a hybrid of these two, and take the form of Modified Gross Leases. In Modified Gross Leases, the initial rent covers the initial cost of the services, and the tenant reimburses the landlord for increases in services over time. (For a more detailed discussion of Gross and Net leases, see KBA’s Lease Tip, [“Demystifying the Difference between Net and Gross Leases.”](#))

Under the proposed changes to GAAP, it generally appears that the costs of servicing the space will continue to be expensed, whereas the cost of use of the space (i.e., the Net component) will have to be treated as a financed purchase. For Net leases this will be relatively easy, given that these costs are already segregated. However, for Gross and Modified Gross leases, a determination will have to be made to separate the two.

*KBA intends to request clarification and guidance from the Boards regarding how to specifically handle the segregation of building service costs as part of gross and modified gross real estate leases.*

### **Implications of the Changes**

The proposed changes will eliminate off-balance sheet accounting, as they will require that the right-of-use assets associated with current operating leases be brought on to the balance sheet along with a corresponding liability. Therefore, companies

currently with significant operating leases will see a “gross up” of their balance sheets.

A company’s Income Statement will change as well and reported net income could be depressed in the early years of a lease, as recognition will change. Straight-line rent expense will be replaced with interest expense (for carrying the “loan” on the balance sheet) plus the amortization of the right-of-use asset. Because the interest expense will be higher in the earlier years (like a mortgage), the total annual expenses will be front-loaded.

Lease renewal and contingent rents will need to be continually reassessed and the related estimates modified as facts and circumstances change.

The proposed changes will require significant systems and process changes to be in place by their effective date (pre-existing leases are not expected to be grandfathered) and will also require continuous monitoring of all lease transactions.

To avoid some of the negative effects of the new proposals, leases could become significantly more complex as landlords’ and tenants’ objectives diverge. Tenants will be incentivized to sign relatively short-term leases; but this will be problematic for landlords that need to execute longer-term leases to satisfy lenders and investors.

### **KBA’s Thoughts**

Does any of this make sense? From a pure financial reporting perspective, probably so. It puts all companies on an even playing field by establishing a consistent treatment for accounting and reporting their leasing transactions, regardless of what type of asset is being leased. So whether a company produces spare parts for the automobile industry and leases significant amounts of its machinery to do so, or a nationwide insurance company leases significant amounts of office space in major cities around the country to house its employees, parties interested in these companies’ financial position and condition will be able to use reliable comparative data in their decision making process.

For tenants, especially those that lease relatively small portions of large buildings in various scattered locations, all this may seem antithetical to why they chose to lease their space in the first place. If a company needs a limited presence in several locations, purchasing its real estate needs and operating each site is probably too costly. Leasing space which is operated by the owner is much more cost-effective, as the company is only paying for what it uses and only for the time it uses it. The company is not “buying” its space; in fact, the lease contract will specifically say that no ownership right is being transferred. So why will an asset be shown on its balance sheet? Also, the company is not borrowing money to make its monthly rent payments; those funds come from normal operating revenues. So why must it establish an artificial “loan” and calculate annual interest expense?

The answer to those questions, simply put, is that the Boards believe the changes are necessary to properly recognize the fact that lease contracts represent long-term financial commitments that provide lessees with certain use rights and establish legal liabilities for future payments associated with those use rights. If a lessee could, at any time, simply walk away from its rental obligations without legal consequences (i.e., no long-term commitments are established), perhaps the foregoing changes would not be necessary. However, we know that this is not the case, and so it is the accounting profession’s responsibility to make sure that those financial commitments are properly and consistently reflected in companies financial statements.

### **How KBA Can Help**

If enacted (which, as of this date, now appears likely), the new accounting rules will require significant analysis and complex calculations to properly report each lease transaction. This will include:

- Determining the longest possible lease term that is more likely than not to occur
- Estimating rental payments during future option periods likely to be exercised
- Segregating the service portion of lease payments (i.e., the initial cost of operating expenses and taxes included in modified gross lease payments) prior to calculating the balance sheet liability
- Calculating the initial present value of the liability for lease payments, discounted using the lessee’s incremental borrowing rate or, if it can be readily determined, the rate the lessor charges the lessee
- Calculating the annual liability in subsequent years at amortized cost using the interest method
- Calculating the amortization expense for the right-of-use asset on a systematic basis over the expected lease term or the useful life of the underlying asset if shorter
- Performing annual reassessments of the carrying amount of the liability to make lease payments if facts or circumstances indicate that there would be a significant change in the liability since the previous reporting period