Changes in Lease Accounting: What Should the Real Estate Industry Know About It?

What is the Project?

The FASB & IASB will jointly develop a new lease accounting standard by 2011 dealing with lessee accounting, with lessor accounting to be addressed separately. The objective of the project is to capitalize all material leases on lessees' books. The scope will be leases of PP&E.

The proposal is for the lessee to account for the lease contract's rights & obligations as assets & liabilities. The Boards do not want to classify leases as those where the rights are ownership rights versus those where the rights are rights to use the leased asset. Rather, they want to use the finance lease accounting method in IAS 17 for ***all*** leases.

The favored initial measurement is to estimate likely lease payments including estimating renewals, contingent rents, purchase options and residual guarantees and record the PV (using the lessee's incremental borrowing rate) as an asset and a liability. Catch-up adjustments for ***any*** changes in estimates will be required on reporting dates.

The favored subsequent accounting is to amortize/depreciate the asset on a straight line basis and account for the liability as a loan with imputed interest expense, thus ***front-ending*** the lessee's expense compared to current GAAP for operating lease rent expense (straight line).

Why is the Project Important?

Estimates are US public cos. have $1.3 trillion in op lease payments which will be capitalized on B/S adding assets & liabilities.

When is a contingent rent a liability & what is the value to be recorded? Capitalizing contingent rents is a new concept that could significantly increase capitalized amounts & complexity.

What is the **nature of the P&L** impact of a lease? The P&L impact comparing the current straight line pattern of operating lease accounting versus finance lease accounting could significantly front-end lease expense and cause temporary book tax differences that do not reflect the economic impact of leases. The potential first year increase in lease expense for a 3 year lease is 7% & for a 10-year lease, the increased expense is 21%!

Lease capitalization, recalculating changes in estimates & deferred tax accounting for leases will be **complex & burdensome**

Who Will Be Impacted and How?

All companies lease, with real estate representing about 70% of lease volume. The Retail segment that has the ***highest level of operating leases***, 15 of the largest 30 lessees are retailers.

The PV of the lease rents will be recorded as an asset and liability. In a 10-year mall lease with annual rents of $450,000, the capitalized amount would be $3,019,537 @ an 8% discount rate.

The P&L pattern ***will not*** represent the economic nature of a rental agreement as it will be front-ended as level rent expense is replaced by imputed interest on the liability at 8% and straight line depreciation of the capitalized asset. For a 10-year lease with annual rents of $450,000, the increase in ***first year expense is $94,000 or 21% higher than straight line***.

P&L Pattern	YR 1	YR 2	YR 3	YR 4	YR 5	YR 6	YR 7	YR 8	YR 9	YR 10	Total
Current GAAP	450	450	450	450	450	450	450	450	450	450	4,500
Proposed GAAP	543	526	508	489	468	445	421	394	366	335	4,500
Difference	(93)	(76)	(58)	(39)	(18)	5	29	56	84	114	0
% Difference	-21%	-17%	-13%	-9%	-4%	1%	6%	12%	19%	25%	0%
Cum % Diff	-21%	-38%	-51%	-60%	***-64%***	-63%	-56%	-44%	-25%	0%	0%

Contingent rent is common for retail RE leases & could cause large amounts of "estimated" contingent rents to be capitalized where no "true" liability exists until incurred. The ***estimate of future contingent rents would be capitalized at inception***, increasing the asset & liability & exacerbating the front-ending of expense. The estimates would be reviewed & adjusted at each reporting date with complex calculations and catch-up adjustments to be made.

The P&L pattern & estimation of contingent rents will not match the IRS tax treatment so ***deferred tax accounting will be necessary***.

What Should Be Done?

Lessees and lessee groups should become involved in the project and comment on the FASB/IASB discussion papers and exposure drafts as they are issued. Only then will the standards-setting bodies be aware of the controversial views taken in the project that **do not reflect economic reality** and the real-life business impact if these rules changes are adopted. The responses have to be based on theoretical arguments like the nature of liabilities, the economics of transactions, the needs of users of financial statements, and clarity in financial statements. **Cost/ benefit** and **complexity** must be considered as well.

Specifically, the following should be emphasized:

1) The rights in lease contracts must be considered & lease classification is an important distinction for readers of financial statements.
2) A straight line expense pattern for P&L reporting more truly reflects the economics of a true lease.
3) Certain contingent rents are not liabilities until they are probable to occur.