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The Impact of Lease Accounting on Corporate Real Estate

The commercial real estate industry is no stranger to big accounting changes – all we have to do is look at how fair value accounting impacted the industry. However the impending update to lease accounting has a potential impact beyond obvious accounting. The best way to prepare for this latest update is to consider the proposed changes for lessees and lessors in today's lease transactions, anticipating what will follow in the next two to three years.

Current Practice

Under the current guidelines, when a company enters into a "leasing" transaction for equipment or a facility, the lessee accounts for it as either a finance lease or an operating lease. Lease payments made under an operating lease are recorded as an expense in the statement of operations on a straight-line method over the term of the lease.

In contrast, a building that is purchased and financed or leased under a finance lease is recorded as an asset and a corresponding liability on the balance sheet and depreciation and interest expense are recorded on the statement of operations. As you can see, two economically similar transactions can end up being accounted for very differently.

The accounting board and the users of financial statements believe this long-standing practice has led to a lack of comparability and undue complexity. In addition, current US GAAP is undergoing significant convergence with International Accounting Standards (IFRS) on this issue.

The current lease accounting practice will change as the most recently proposed lease accounting guidelines will generally require all long-term (i.e. over one year) leases to be accounted for similar to a finance lease and as such result in a uniform method on how these transactions will be recorded. As this paper goes on to illustrate, the new lease accounting concept may provide some challenges.

Proposed Changes – Lessees

On the lease commencement date, a lessee would recognize a "right-of-use" asset and a corresponding liability to make lease payments. The asset will be amortized over the "term" of the lease on a straight-line method. The lessee will recognize interest expense on the liability to make lease payments, which will be front loaded in the earlier years.

Factors to Consider:

- The asset and corresponding liability at commencement will be recorded at the present value of lease payments, discounted using the lessee's incremental borrowing rate.
- Irrespective of the contracted lease term, the "term" of the lease for accounting purposes shall include the contractual terms as well as the expected options to extend or termination in arriving at the estimated term.
- Contingent rentals, residual value guarantees need to be considered in arriving at the computation.
- Service components of the lease contract need to be accounted for separately and expensed in the statement of operations over the term.
- The lessee is required to reassess the carrying amount of the liability if circumstances surrounding the contingent rentals or estimated remaining lease term change.

Proposed Changes – Lessors

The lessor using the right-of-use method would apply one of two approaches, depending on whether it retains exposure to significant risks and benefits associated with the underlying asset:

Performance Obligation Approach

If the lessor retains exposure to significant risks and benefits associated with the underlying asset, it would use the performance obligation approach to recognize an asset for its right to receive lease payments and a lease liability. The lessor would continue to recognize the underlying asset under current accounting guidelines.

Derecognition Approach

If the lessor does not retain exposure to significant risks and benefits associated with the underlying asset, it would use the "derecognition approach" to recognize the asset for its right to receive lease payments (as above) however would derecognize the asset that it transfers to the lessee.

Factors to Consider:

- The asset and corresponding liability at commencement will be recorded at the present value of lease payments; discounted using the interest rate the lessor charges the lessee.
- Irrespective of the contract lease term, the "term" of the lease for accounting purposes shall include the contractual terms as well as the expected options to extend or termination in arriving at the estimated term.
- Contingent rentals, residual value guarantees and term option penalties need to be considered in arriving at the computation.
- Interest income will be recorded in the statement of operations on the right to receive lease payments
- Lease income is recorded in the statement of operations as the lease liability is satisfied

Accounting and Industry Implications

- *Statement of Operations* – The lessee's net income in earlier years of a lease will probably be lower due to the recognition of interest expense on the lease liability which is front loaded. Rental expense will be eliminated which will lead to change in EBITDA compared to that of pre-adoption. Lessor's net income in the earlier years of a lease will probably be higher due to the recognition of interest income.
- *Balance Sheet* - The proposed changes will eliminate off-balance sheet accounting, adding significant assets and liabilities to the balance sheet. Debt to equity covenants will increase significantly, leading to potential issues with lenders. Lessors could have two assets presented, one being the underlying asset and the second representing the right to receive lease payments.
- *Lease Term Negotiation* – Lessees may be motivated to negotiating shorter lease terms, potentially excluding options to extend whilst lessors will be challenged as they prefer longer-term leases to satisfy lenders and investors.
- *Increased Accounting and Administration Efforts* – Both lessees and lessors will require more resources to evaluate, record and continually monitor all lease transactions.

Next Steps

The current exposure draft on lease accounting is widely expected to become a final standard. However the exact timing and effective dates are still uncertain. Some believe it to be in 2013 or 2014. Rather than wait until the draft is finalized, companies are advised to take these lease accounting updates into consideration during current lease negotiations in order to ensure proper resources are in place for the eventual implementation of these standards.

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