

## Impact Of Proposed FASB Rule Changes

In March of 2009, a discussion paper titled *Leases-Preliminary Views* was published by the International Accounting Standards Board (IASB) working jointly with the U.S. Financial Accounting Standards Board (FASB) as part of their ongoing efforts to converge U.S. and international financial reporting. The proposal may create a major shift in how companies account for lease agreements in their financial statements. The new accounting standard could have sweeping effects on how owners and tenants choose to structure their leases, on how businesses choose to own or lease space, and on how public and private companies account for leases on their balance sheets. Financial statements aside, the potential impact could be substantial on measurements under borrowing agreements (such as financial debt covenant compliance ratios), employee incentive compensation plans, shareholder agreements and other agreements that use financial ratios and results to set pricing or calculate terms under such agreements. The FASB is expected to issue an "Exposure Draft" of the proposed new accounting rules in early 2011. Typically, there is a "comment period" where companies, industry groups, accounting firms, and other interested parties or individuals may submit "comment letters" on the proposed new rules. The FASB is expected to issue its final rules in late 2011 with expected effective dates for 2012.

The purpose of this paper is to describe the proposed accounting standard, outline the implications for businesses and for the broader commercial real estate industry, and answer some of the commonly asked questions regarding the proposed FASB changes. Cassidy Turley will continue

to monitor developments related to the proposed accounting changes and will provide updates as new information is released.

### Overview

The crux of the issue is how businesses report leases on their balance sheets. The current lease accounting standards require tenants to classify their leases as either "capital" leases or "operating" leases. Currently, capital leases are recorded as assets on balance sheets, with a corresponding liability for the future obligation. The assets are "depreciated" as an expense item in the income statement. Operating leases are simply recorded as an expense in the income statement over the life of the lease term. Companies are required to record capital leases if one of four criteria are met, based on the terms of the lease. Critics of the current standard argue companies recording operating leases (an "off balance sheet transaction"), do not give a complete and accurate picture of a company's liabilities. Moreover, proponents for the rule change argue that the dual method of reporting leases as either capital or operating creates less transparency when comparing the financial statements from one company to the next. The proposed FASB rule change is aimed at resolving these issues by requiring all companies to list their property leases directly on their balance sheets. According to estimates by the Securities and Exchange Commission, the changes would prompt public companies to put over \$1 trillion in assets and liabilities on their financial statements when submitting their 10-Q and 10-K filings to the SEC. As a result, the proposed changes will result in changes in the timing and classification of expenses on corporations' income

statements, which will impact key financial metrics such as debt to capitalization ratio, EBITDA, interest coverage, and other metrics.

### Implications for Commercial Real Estate

Although the proposed FASB rule changes may change from the current draft to the final rules that are expected to be rolled out in 2011, here are some speculative implications for commercial real estate industry:

- With companies forced to record leases as liabilities, the new standards may create an incentive for more companies to buy their offices rather than rent. Although this will prompt some businesses to rethink their real estate portfolio strategies, the rule changes are likely to have only a marginal impact on net demand for leasing office space.
- Short-term leases may grow in popularity. The FASB rule changes require recording the bulk of long-term lease obligation liabilities on the balance sheet. Thus, companies looking to attract capital in the short-term will seek 3-5 year deals versus 10-year deals.
- Renewal options and expansion options will become less popular. Under the new rules, companies will be required to include their renewal options, if they expect to execute in the future, as part of their upfront lease obligation liability. Consequently, businesses may shy away from built in renewal clauses and instead choose to revisit their leasing agreements as the expiration approaches.

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- Landlords currently record all leased space as rental income. The new rules may require landlords to record obligations, to provide space as a liability, and to record leased space as an asset.
- Large Commercial Banks, Fortune 500 companies, as well as large retailers will be the most impacted by the proposed FASB changes. Many of these companies have thousands of leases around the globe, therefore shifting their leases from “off balance sheet” to liabilities may prompt a change in real estate decision making.

### What can you do to prepare?

Barring some unforeseeable event or dramatic revisions to the draft paper, the proposed FASB rule changes will move forward and will be applicable in 2011 or 2012. Now is the time to become knowledgeable on the proposed lease accounting changes, to measure how your portfolio strategy may be affected, and to formulate a real estate strategy that aligns with your business strategy for the future. Cassidy Turley will continue to study the issue and new developments in great depth. Our real estate professionals are well equipped to help you understand and navigate the forthcoming rule changes, and we can work with you to adjust your real estate strategies going forward.

The following addresses some of the FAQ's surrounding lease accounting, now and after any changes are implemented as a result of the proposed FASB changes.

### Frequently Asked Questions:

#### **Q1. What is the difference between a capital lease and an operating lease in current accounting practice?**

**A1.** Capital leases are defined as leases that transfer substantially all of the risk or reward of ownership to the lessee. If not classified as a capital lease, then the lease is an operating lease, and no liability is recorded on the balance sheet of the lessee.

#### **Q2. How does current accounting differ for a capital lease vs. an operating lease?**

**A2.** Capital leases are recorded in a manner similar to the purchase of an asset with the recording of a related corresponding liability for the obligation to make on-going payments. Under today's GAAP, the lessee depreciates the assets and allocates a portion of each periodic payment between a reduction of the lessee's lease liability and the remaining amount to interest expense. Under operating leases, generally the periodic lease payments are recorded as rent expense on a “straight line” basis over the term of the lease.

#### **Q3. What are the drivers for changing the way a company accounts for its leases?**

**A3.** Current accounting standards for leases under GAAP have long been debated and criticized. Frequently, many lessees attempt to structure leases to permit operating lease classification which often smoothes the lessee's operating results and keeps the balance sheet free of additional assets and liabilities. The two most cited shortcomings are:

- a lack of comparability for similar companies with similar leases
- the exclusion of liabilities on the entity's balance sheet

#### **Q4. How does the proposed lease accounting change impact a company's balance sheet?**

**A4.** The proposed rules as presented by the FASB would primarily require all leases to be treated in a manner similar to current day capital leases by creating an asset and correspondingly, an obligation for the lease payments. The scheduled payments would be initially recorded as a liability at their present value. While these would initially increase assets and liabilities on an equal one-to-one basis at the inception of the lease, financial ratios, commonly included in debt and other agreements, can be affected such as debt to equity and debt coverage ratio.

#### **Q5. What is the expected impact on a company's income statement from such proposed lease accounting changes?**

**A5.** The asset recorded would be depreciated according to the company's accounting policy. Future lease payments would be allocated between a reduction of the lease obligation and interest expense on the lease obligation. For an operating lease under the new proposed standard, depreciation and interest expense will be greater in the earlier years and less in the later years than the lease rent expense recorded using the current operating lease guidance.

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**Q6. Is the FASB proposed accounting rule change applicable to just lessees?**

**A6.** No. Recently, the FASB indicated that the lessor's accounting would also be affected, in essence establishing a receivable for the lease payments and a performance obligation.

**Q7. Will the difference in a company's reported earnings before interest, taxes, depreciation and amortization (EBITDA) and net income be the same dollar amount after a change in lease accounting than it was under current accounting?**

**A7.** No. Frequently EBITDA will increase under the proposed method by the amount of rent expense under annual operating leases, as payments would be added back to current EBITDA calculations and be replaced by depreciation and interest, both of which are not included in EBITDA.

**Q8. How would this lease accounting change affect leases already in place and being accounted for as operating leases?**

**A8.** FASB has indicated that there would be no grandfathering in of existing leases. Therefore, once the changes are required to be adopted, all leases would be treated in the same manner regardless of execution date.

**Q9. What term would be assigned a lease with renewal option(s) under the proposed new change in accounting rules?**

**A9.** The recognized lease term would be the longest lease term that is most likely

to occur. Thus, companies must evaluate the likelihood of renewal; considerations will include past history, investment in leasehold, and other business factors.

**Q10. What are "contingent rentals" and how will they be treated under the FASB proposed rule changes?**

**A9.** Contingent rentals include all payments that are most likely to be incurred in a lease. Using the "expected outcome" criteria, this would mean that in addition to rent, all other forms of payments such as expense pass-through's, CPI adjustments, percentage rents, etc. would be measured in the set up of a lease asset/obligation if payment is deemed likely.

**Q11. What are some of the considerations a company or its real estate advisors should be evaluating?**

**A11.** There are many operating and financial considerations that come into play, including;

- Determining what the pro forma financial effect is today of the proposed rule changes on the lease portfolio.
- Analyzing the impact on the various borrowing agreements, employment plans, shareholder agreements and other agreements that use financial ratios and results, and assess whether those agreements should be amended to account for the effects of the rule changes.

- Discussing current new lease strategies in light of the results of the financial impact determined above, including (a) lease vs. own; (b) term of new leases; and (c) renewal options, to name a few.

Real estate advisors along with the company's accounting firms can assist with calculations and underlying valuations; as for many companies these new rules will be an administrative burden.

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### Financial Statement Impact Example

Assume in this hypothetical example that Example Company, Inc. commits to 30,000 square feet of office space in a new multi-tenant building under the following terms and conditions:

- 10 year term (no option to renew) at \$725,000 per year
- Present value of lease payments is \$5,720,000, assuming an incremental borrowing rate of 5%.
- The first year of the lease (having been recorded as an operating lease) and the company's initial assets and liabilities are shown in "Existing" column.
- "FASB Lease" reflects the capitalization of the lease under proposed accounting guidelines
- "Annual Entries" reflects the annual treatment of the recorded asset and liability under the capitalized lease scenario
- "Pro Forma" reflects financial statements after first year of lease capitalization

	Existing	FASB Lease	Annual Entries	Pro Forma
<b>Assets</b>				
Current Assets	\$1,800,000	–	–	\$1,800,000
<b>Long Term Assets</b>				
Original Cost	\$350,000	\$5,720,000		\$6,070,000
Accumulated Amortization	–	–	(\$572,000)	(\$572,000)
	\$350,000	\$5,720,000	(\$572,000)	\$5,498,000
<b>Total Assets</b>	<b>\$2,150,000</b>	<b>\$5,720,000</b>	<b>(\$572,000)</b>	<b>\$7,298,000</b>
<b>Liabilities and Equity</b>				
Current Liabilities	\$600,000	–	–	\$600,000
Long Term Liabilities	\$400,000	\$5,720,000	(\$453,000)	\$5,667,000
<b>Total Liabilities</b>	<b>\$1,000,000</b>	<b>\$5,720,000</b>	<b>(\$453,000)</b>	<b>\$6,267,000</b>
Equity	\$1,150,000	–	(\$119,000)	\$1,031,000
<b>Total Equity</b>	<b>\$1,150,000</b>	<b>–</b>	<b>(\$119,000)</b>	<b>\$1,031,000</b>
<b>Total Liabilities &amp; Equity</b>	<b>\$2,150,000</b>	<b>\$5,720,000</b>	<b>(\$572,000)</b>	<b>\$7,298,000</b>

Capitalizing the lease obligation has a notable effect on total assets and liabilities in the balance sheet.

	Existing	FASB Lease	Annual Entries	Pro Forma
<b>Statement of Income</b>				
Revenues	\$14,650,000		–	\$14,650,000
Expenses (Before Interest and Depreciation)	\$12,200,000		(\$725,000)	\$11,475,000
<b>EBITDA</b>	<b>\$2,450,000</b>		<b>\$725,000</b>	<b>\$3,175,000</b>
Depreciation and Amortization	(\$150,000)		(\$572,000)	(\$722,000)
Interest	(\$300,000)		(\$272,000)	(\$572,000)
	(\$450,000)		(\$844,000)	(\$1,294,000)
<b>Net Income</b>	<b>\$2,000,000</b>	–	<b>(\$119,000)</b>	<b>\$1,881,000</b>

Both EBITDA and net income are affected in this example, although EBITDA more materially.

Below are several of the more common financial ratios used to assess a company's performance. Existing is with the lease accounted for as an operating lease, and then pro forma after the subsequent capitalization.

	Existing	FASB Lease	Annual Entries	Pro Forma
<b>Financial Ratios</b>				
Interest Coverage Ratio (EBIT/Interest)	7.67			4.29
EBITDA to Total Liabilities	2.45			0.56
Debt to Equity	0.87			5.50

This example highlights how certain ratios can be impacted by changes in lease capitalization rules, and reinforces the need to review all agreements that use such ratios to assess results.

## For Additional Information:

### **Discussion Paper: 'Leases Preliminary Views'**

<http://www.iasb.org/NR/rdonlyres/FF3A33DB-E40D-4125-9ABD-9AF51EB92627/0/DPLLeasesPreliminaryViews.pdf>

### **FASB Official Page – Lists of all documents**

<http://www.fasb.org/cs/ContentServer?c=Page&pagename=FASB%2FPage%2FSectionPage&cid=1175801893139#fasbiasb>

### **FASB: 'Introduction to Staff Draft'**

[http://www.fasb.org/cs/ContentServer?c=Document\\_C&pagename=FASB%2FDocument\\_C%2FDocumentPage&cid=1176156966475](http://www.fasb.org/cs/ContentServer?c=Document_C&pagename=FASB%2FDocument_C%2FDocumentPage&cid=1176156966475)

### **FASB: 'Staff Draft'**

[http://www.fasb.org/cs/ContentServer?c=Document\\_C&pagename=FASB%2FDocument\\_C%2FDocumentPage&cid=1176156966501](http://www.fasb.org/cs/ContentServer?c=Document_C&pagename=FASB%2FDocument_C%2FDocumentPage&cid=1176156966501)

### **New York Times Article: 'New Accounting Rules Ruffle the Leasing Market'**

<http://www.nytimes.com/2010/06/23/realestate/commercial/23fasb.html>

### **'One Step Closer to Lease Accounting Changes'**

<http://www.tririga.com/information-center/infocenter-insights?aid=34>

### **'Boards Issue Preliminary Views on Lease Accounting'**

<http://www.iasplus.com/iasplus/0904leasingdp.pdf>

### **'KPMG's response to FASB and IASB'**

<http://www.kpmg.com/Global/en/IssuesAndInsights/ArticlesPublications/IFRS-comment-letters/Documents/IFRS-Comment-letter-29-Jul-09.pdf>

### **PriceWaterhouseCoopers Documents**

<http://www.cfodirect.pwc.com/CFODirectWeb/Controller.jspf>

### **FDIC Rules Changed due to FASB**

<http://www.fdic.gov/news/board/DEC152009no2.pdf>

### **Deloitte IAS Plus – Global Accounting News Source**

<http://www.iasplus.com/index.htm>

### **IFRS Foundation of IASB formerly IASC**

<http://www.iasb.org/Home.htm>

### **IASB: 'Who We Are and What We Do'**

<http://www.iasb.org/NR/rdonlyres/F9EC8205-E883-4A53-9972-AD95BD28E0B5/0/WhoWeAreJULY2010.pdf>