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## Proposed Lease Accounting Changes Could Impact Commercial Real Estate

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A CxO To Go White Paper

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# Proposed Lease Accounting Changes Could Impact Commercial Real Estate

By Keith McAslan, Partner, CxO To Go

## Introduction:

The Financial Accounting Standards Board (FASB) on August, 17, 2010 released their “exposure draft” requiring companies to record nearly all leases on their balance sheets as a “right to use” asset, and a corresponding “future lease payment - liability”. What does this mean to your business in layman terms? This proposal in essence does away with operating leases; all leases (unless immaterial) would be capitalized using the present value of the minimum lease payments. Therefore, businesses who in the past had off-balance sheet lease obligations, must now record these obligations on their balance sheet.

A key point to consider with regards to the proposed lease accounting changes is that, in all likelihood, existing operating leases, signed prior to the implementation of the new rules, will require reclassification as capital leases that must be accounted for on the balance sheet. This means that real estate professionals must immediately consider the effect that existing and planned leases will have on financial statements once the proposed rules are implemented. Since operating lease obligations can represent a larger liability than all balance sheet assets combined, lease reclassification can significantly alter the businesses balance sheet.

The impact of recording these lease obligations on the balance sheet can have multiple impacts, such as: businesses needing to alert their lenders as they will now be non-compliant with their loan covenants, negotiating new loan covenants with the lenders due to the restated financial statements, ratios used to evaluate a businesses potential of credit will be adversely impacted and the restatement of a lessee’s financial statement once the change takes effect may result in a lower equity balance, and changes to various accounting ratios

The conceptual basis for lease accounting would change from determining when “substantially all the benefits and risks of ownership” have been transferred, to recognizing “right to use” as an asset and apportioning assets (and obligations) between the lessee and the lessor.

As part of FASB’s announcement, the Board stated that in their view “the current accounting in this area does not clearly portray the resources and obligations arising from lease transactions.” This suggests that the final result will likely require more leasing activity to be reflected on the balance sheet than is currently the case. In other words, many, perhaps virtually all, leases now considered operating are likely to be considered capital under the new standards. Thus, many companies with large operating lease portfolios are likely to see a material change on their corporate financial statements.

Part of the purpose for this is to coordinate lease accounting standards with the International Accounting Standards Board (IASB), which sets accounting standards for Europe and many other countries. The IASB and FASB currently have substantial differences in their treatment of leases; particularly notable is that the “bright line” tests of FAS 13 (whether the lease term is 75% or more of the economic life, and whether the present value of the rents is 90% or more of the fair value) are not used by the IASB, which prefers a “facts and circumstances” approach that entails more judgment calls. Both, however, have the concept of capital (or finance) and operating leases, however the dividing line is drawn between such leases.

The FASB will accept public comments on this proposed change through December 15, 2010. If FASB makes a final decision in 2011 regarding this proposed change to lease accounting, the new rules will go into effect in 2013.

Additionally, the staff of the Securities and Exchange Commission reported in a report mandated under Sarbanes-Oxley, that the amount of operating leases which are kept off the balance sheet is estimated at \$1.25 trillion that would be transferred to corporate balance sheets if this proposed accounting change is adopted.

### **Commercial Real Estate:**

The impact on the Commercial Real Estate market would be substantial and will have a significant impact on commercial tenants and landlords. David Nebiker, Managing Partner of ProTenant (a commercial real estate firm that focuses on assisting Denver and regional companies to strategize, develop, and implement long-term, comprehensive facility solutions) added “this proposed change not only effects the tenants and landlords, but brokers as it increases the complexity of lease agreements and provides a strong impetus for tenants to execute shorter term leases”.

The shorter term leases create financing issues for property owners as lenders and investors prefer longer term leases to secure their investment. Therefore, landlords should secure financing for purchase or refinance prior to the implementation of this regulation, as financing will be considerably more difficult the future.

This accounting change will increase the administrative burden on companies and the leasing premium for single tenant buildings will effectively be eliminated. John McAslan an Associate at ProTenant added “the impact of this proposed change will have a significant impact on leasing behavior. Lessors of single tenant buildings will ask themselves why not just own the building, if I have to record it on my financial statements anyway?”

Under the proposed rules, tenants would have to capitalize the present value of virtually all “likely” lease obligations on the corporate balance sheets. FASB views leasing essentially as a form of financing in which the landlord is letting a tenant use a capital

asset, in exchange for a lease payment that includes the principal and interest, similar to a mortgage.

David Nebiker said “the regulators have missed the point of why most businesses lease and that is for flexibility as their workforce expands and contracts, as location needs change, and businesses would rather invest their cash in producing revenue growth, rather than owning real estate.”

The proposed accounting changes will also impact landlords, especially business that are publicly traded or have public debt with audited financial statements. Mall owners and trusts will required to perform analysis for each tenant located in their buildings or malls, analyzing the terms of occupancy and contingent lease rates.

Proactive landlords, tenants and brokers need to familiarize themselves with the proposed standards that could take effect in 2013 and begin to negotiate leases accordingly.

### **Conclusion:**

The end result of this proposed lease accounting change is a greater compliance burden for the lessee as all leases will have a deferred tax component, will be carried on the balance sheet, will require periodic reassessment and may require more detailed financial statement disclosure.

Therefore, lessors need to know how to structure and sell transactions that will be desirable to lessees in the future. Many lessees will realize that the new rules take away the off balance sheet benefits FASB 13 afforded them in the past, and will determine leasing to be a less beneficial option. They may also see the new standards as being more cumbersome and complicated to account for and disclose. Finally, it will become a challenge for every lessor and commercial real estate broker to find a new approach for marketing commercial real estate leases that make them more attractive than owning.

However, this proposed accounting change to FAS 13 could potentially stimulate a lack luster commercial real estate market in 2011 and 2012 as businesses decided to purchase property rather than deal with the administrative issues of leasing in 2013 and beyond.

In conclusion, it is recommended that landlords and tenants begin preparing for this change by reviewing their leases with their commercial real estate broker and discussing the financial ramifications with their CFO, outside accountant and tax accountant to avoid potential financial surprises if/when the accounting changes are adopted.

Both David Nebiker and John McAslan of ProTenant indicated their entire corporate team are continually educating themselves and advising their clients about these potential changes on a pro-active basis.

### **Addendum - Definition of Capital and Operating Leases:**

The basic concept of lease accounting is that some leases are merely rentals, whereas others are effectively purchases. As an example, if a company rents office space for a year, the space is worth nearly as much at the end of the year as when the lease started; the company is simply using it for a short period of time, and this is an example of an operating lease.

However, if a company leases a computer for five years, and at the end of the lease the computer is nearly worthless. The lessor (the company who receives the lease payments) anticipates this, and charges the lessee (the company who uses the asset) a lease payment that will recover all of the lease's costs, including a profit. This transaction is called a capital lease, however it is essentially a purchase with a loan, as such an asset and liability must be recorded on the lessee's financial statements. Essentially, the capital lease payments are considered repayments of a loan; depreciation and interest expense, rather than lease expense, are then recorded on the income statement.

Operating leases do not normally affect a company's balance sheet. There is, however, one exception. If a lease has scheduled changes in the lease payment (for instance, a planned increase for inflation, or a lease holiday for the first six months), the rent expense is to be recognized on an equal basis over the life of the lease. The difference between the lease expense recognized and the lease actually paid is considered a deferred liability (for the lessee, if the leases are increasing) or asset (if decreasing).

Whether capital or operating, the future minimum lease commitments must also be disclosed as a footnote in the financial statements. The lease commitment must be broken out by year for the first five years, and then all remaining rents are combined.

#### **A lease is capital if any one of the following four tests is met:**

- 1) The lease conveys ownership to the lessee at the end of the lease term;
- 2) The lessee has an option to purchase the asset at a bargain price at the end of the lease term
- 3) The term of the lease is 75% or more of the economic life of the asset.
- 4) The present value of the rents, using the lessee's incremental borrowing rate, is 90% or more of the fair market value of the asset.

Each of these criteria, and their components, are described in more detail in FAS 13 (codified as section L10 of the FASB Current Text or ASC 840 of the Codification).

### **About the Author:**

Keith McAslan is a Partner with CxO To Go a national professional services company headquartered in Denver, Colorado that provides on-demand C-Level expertise and best practices to client companies on a part time, flexible, and affordable basis. Keith is sought after to provide advisory services as the Trusted Advisor to Owners and CEO's. By utilizing his extensive experience as a successful financial and operational C-level executive, Keith brings a results driven leadership style to complex situations.



McAslan's expertise includes: financial advisory; management consulting; part time, interim & virtual CFO, COO and CEO; debt and equity financing; turnaround management; acquisition and divestiture advisory. Most recently Keith, was instrumental in the successful sale of Western Forge to Ideal Industries. As the interim CFO with finance and private investment transaction experience, he guided the management team through the complex sale and due diligence process completing the sale from prospective buyer presentation to close within 60 days to discuss your business needs.

### **Who We Are:**

CXO To Go LLC is a national company with thousands of combined years experience. At its core CxO To Go is a team of true "pros" each of whom have 25+ years providing enlightened thought leadership, creative solutions, a real ethos of trust, and ethical business practices. We are bound by a belief that the relationship with our customers is not only essential, but is our business mantra. We only do business where we have an existing trusted relationship. You don't invite strangers into your home, so why would you invite them into your business? If you have the need and are ready, we'd like to form that kind of relationship with you.



We have equally powerful resources in Finance, Sales, Marketing, Operations, IT, etc. We are a one-stop shopping partner for all of your corporate needs. Ask us about our services offers in these and other areas. It is our goal to become your trusted advisor partner in all aspects of your business. Ask us about our service offers in these and other areas.

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