

## CHANGES IN LEASE ACCOUNTING PRACTICES ARE ON THE HORIZON

The Financial Accounting Standards Board, which sets American standards, has been working with the International Accounting Standards Board to merge its generally accepted accounting principles, or GAAP, with international standards. One major piece of the puzzle is the accounting for leases.

The two boards have come up with a new standard, which will be completed next year and enacted in 2013, that will require companies to book leases as assets and liabilities on their balance sheets. Currently, American and foreign companies list many leases as footnotes in their financial statements. As a result of the change, public companies will have to put some \$1.3 trillion in leases on their balance sheets, according to estimates by the Securities and Exchange Commission. Because many private companies also follow GAAP accounting, the number could be closer to \$2 trillion; experts said The FAS 13 changes proposed in the March discussion paper would require that all operating leases be reclassified as capital leases.

While these changes will affect all companies that lease equipment or property, retailers, airlines, and banks will feel the effects most strongly.

### Accounting Implications

- All leases would appear on the balance sheet, eliminating the distinction between operating and finance leases = more debt on companies balance sheet
- Assets and liabilities would be grossed up
- Lease liabilities would be re-evaluated at each reporting date when indications of significant changes exist, likely requiring substantial changes to internal controls and information systems
- Leverage ratios and capital ratios would deteriorate
- Timing of expense recognition would accelerate and expense would be recharacterized as interest expense and amortization instead of rent
- Earnings before interest, taxes, depreciation and amortization (EBITDA) would be more favorable
- Cash flows from operating activities, as presented in the statement of cash flows, would be more favorable
- Tax issues could arise

### Lease vs. Buy Implications

Companies in buildings with multiple tenants such as downtown offices, however, often don't want to own their space. Technology, professional services and other companies that emphasize human capital want the flexibility to scale up and scale down according to their level of business activity.

The proposed standards will affect landlords as well, especially public entities with audited financial statements like real estate investment trusts (REITs). Major mall owners and other trusts will be required to go through the same analysis with every

tenant in each of their buildings or malls, evaluating their likely terms of occupancy and contingent rental rates.

One of the main changes is to remove many of the differences in the way companies account for property that they own and property they lease. This may cause more companies to buy their offices and drive down demand for leased space.

There may also be an impetus to shrink the length of a lease. For example, if you have a 10-year lease, it will mean putting twice as much debt on the balance sheet as a five-year lease, so some companies may want to go short term.

Further complicating matters is the accounting for lease renewals. Many companies sign leases with renewal terms, like a 10-year lease with an option to renew for another five years. Under the new rules, if it is likely that the company will execute the renewal option, they must account for the lease as if it were actually 15 years. Because this will mean adding more debt to the balance sheets, renewal options could become less popular.

#### What Should Companies Do?

Companies with substantial leasing activity, both lessees and lessors, would benefit from an initial assessment of the proposal's effect on their financial statements and operations. At the very least, companies should become knowledgeable of the proposals requirements and consider them as they enter into any significant lease transactions. Gaining a better understanding of the proposal will help companies plan for an orderly and efficient transition to the new standard in a way that reduces financial reporting, tax, operational, and business risks.

#### Timetable for New Regulation

- August 7, 2010--Exposure Draft Issued
- December 15, 2010--Public comment period ends
- 2011--Final Rule Expected
- 2013--Implementation Anticipated

#### In Conclusion

It is important to keep in mind that the proposed FAS 13 lease accounting changes do not have a direct effect on cash flow; arguably the most important indicator of financial performance. However, companies will need to invest time and money to evaluate lease structures, determine the impact to financial statements, and communicate the impact to investors well in advance. Although this exercise is critical, real estate executives and professionals must not lose focus on the primary goal to align real estate assets with the business strategy. Although the proposed FAS 13 rule change may alter the buy versus lease decision or add a new variable to lease negotiations, accounting rules are seldom a primary driver of real estate decisions.

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