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New lease rules could change how leases are reported

December 09, 2010 - Financial Digest

As if demand wasn't already an issue, new accounting standards could make purchasing more attractive than leasing. The changes will effectively eliminate most of the accounting differences between owning and renting a building. And in a market that has already been hindered by the economy, this may further decrease demand if lessees start to exit the rental market to purchase their own space.

The Financial Accounting Standards Board (FASB) and International Accounting Standards Board (IASB) have been working on a project to significantly modify the way that leases are reported by lessees. This new standard is going to completely change how tenants will record their leases. The FASB expects to issue a final standard in June 2011 and the effective date may follow that by two years.

Current standards require that lessees evaluate the lease to determine if it is a capital or operating lease. Capital leases are recorded as an asset and a related liability on the balance sheet while operating leases are expensed as the lease period passes and any future lease obligations are disclosed in the footnotes to the financial statements. Most real estate leases are currently recorded as operating leases. The proposed standard will require all leases to be recorded as a "right to use" asset and a related lease obligation liability, calculated using the present value of the lease payments. This essentially eliminates operating leases as an option. The right to use asset will be amortized over the life of the lease and the lease obligation will be reduced as lease payments are made, with an interest component to recognize the time value of money. The asset and liability along with the interest and amortization would have to be separately stated on the statements or in the footnotes. The lease term will require auditor judgment and must be reevaluated at each reporting date. Some estimates indicate that more than $1 trillion in leases will be brought onto the balance sheet of tenants.

One possible side effect of this change in standard would be its impact on financial loan covenants, such as the debt to equity ratio. A company that rents their space could shorten the length of its lease term in order to meet its covenants. A shorter lease would require a fraction of the debt to be recognized on the balance sheet. This would be an attractive option for those with strict loan covenants. Renewal terms, under the new guidance, would have to be recorded if it is likely that the renewal option will be exercised. This could also decrease the number of renewal options in future leases.

The proposed standard also changes the way lessors treat their leases. Landlords, under the proposed standard, have two ways of recording the leases. Under leases that have significant risks and benefits associated with the underlying assets, the lessor would be required to use the performance obligation approach and for all other leases the derecognition approach would be used. Under the performance obligation approach, the lessor would have to record a liability for the obligation to provide space and an asset for the rents to be received. Under the derecognition approach, the lessor would record a lease receivable for the future rents and a residual asset representing the lessor's right to the underlying asset at the end of the lease term. Similar to the lessee, the term of the lease would require auditor judgment and must be reevaluated at each reporting date.

There are big changes for both lessors and lessees in the future. They are likely to affect leasing decisions in the near future as the standard is set to be completed next year.

Both commercial and real estate entities should be aware of the changes and should contact their accountant and/or business advisors with questions as the FASB and IASB attempt to complete the convergence of lease standards.

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