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Donald Greenhalgh - U.S. Financial Accounting Standards Board may ease new lease accounting standards

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As a regional CPA firm that specializes in real estate, we are vigilant when it comes to issues that could have a significant impact on our clients' businesses. New lease accounting standards are currently top of mind. Here is our take on the situation, as well as some insight into how we are preparing to advise clients regardless of the outcome.

Will proposed international lease accounting standards suffer the same fate in the U.S. as the metric system? Both lessors and lessees certainly hope so and have let the U.S. Financial Accounting Standards Board (FASB) know it, sending the board more than 800 comment letters in response to proposed standards.

While proposed standards would create greater transparency, as well as consistency, for companies that lease internationally, the potential harm they would cause appears to outweigh the benefits, as the new standards could potentially transform market behavior.

Critics say the new standards would create a heavy regulatory burden, result in more buying and less leasing, make it more difficult than ever to obtain financing and create pressure for lessors to lease property for shorter periods. In addition, lower demand would cause rental prices to drop. With the commercial real estate industry still reeling from the financial crisis, it would have to endure one more major hardship.

The FASB has taken notice and appears to be easing up on the proposed new standards. Initially, new lease accounting regulations were supposed to be issued by June 2011. Now FASB is saying it will issue new standards in the second half of the year, although the proposed effective date of Jan. 1, 2015 remains the same.

Uncertain Compromise

If there is an easing of the new standards, it's uncertain what will emerge as a compromise. Currently, companies leasing space treat lease contracts as an operating expense. Under the proposed new regulations, lessees would have to show the full value of lease contracts on their balance sheets as a liability.

One option would be to develop separate lease accounting standards for public and private companies. Since about 90% of commercial real estate is privately owned, that approach would be preferable to most lessors, assuming that private owners would be exempt from radical changes.

FASB is also beginning to take a hard look at the regulations from the lessor's perspective. Although FASB has been working with the International Accounting Standards Board (IASB) to standardize worldwide accounting standards since 2002, its work on lease accounting standards has until now focused almost exclusively on the lessee.

As FASB shifts its attention to the lessor, property owners hope FASB will recognize that

transparency is not a major issue for the industry, since most commercial property is privately owned.

And while convergence of U.S. Generally Accepted Accounting Principles (GAAP) with International Financial Reporting Standards (IFRS) would help large lessees, such as international retailers, lessors would like FASB to recognize that it would create a severe hardship for smaller companies.

To conform with new standards, both tenants and lenders will be hard pressed to develop an in-depth understanding of everything in their financial statements, including the footnotes. They will also have to understand the economics of the real estate they own, including the impact of changing interest rates.

Standardization could also impact the give-and-take negotiations that have been essential to the landlord-tenant relationship since the first lease was written. In the world of commercial real estate, leases are like snowflakes - no two are alike. Flexibility is needed to ensure that the needs of both landlord and tenant are taken into account.

Income-Tax Basis of Reporting

If the proposed changes are approved without a significant easing from what is being proposed, lessors do have another option. The new standards will not apply to property owners who use the income tax basis of reporting, which allows property owners to prepare their financial statements in a manner similar to preparing their income tax returns.

Even if the new standards are never approved, the income tax basis of reporting has become an increasingly attractive option as reporting requirements under GAAP have become more complex.

In anticipation of the new standards, property owners are advised to negotiate with lenders for permission to use this approach. Given that the new standards would also create a hardship for lenders, they are likely to be open to reporting on an income tax basis if it appears that the new standards are going to be approved.

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