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Which is the 'lessor' of two evils?

What is the one contract that every company in the United States has contemplated and, in most cases, is the first legally binding contract of a start-up? CREJ readers who engage in leasing activities know it is the old-fashioned lease. Lease rules (operating vs. capital) are changing, and there could be serious implications to companies – nearly all of which have leases.

In the United States, the Financial Accounting Standards Board establishes accounting standards for public and private companies. New lease accounting rules are being finalized in a joint project with the International Accounting Standards Board, which will streamline and standardize the rules for all companies that engage in global financial reporting. These accounting standards will not have tax implications as the current tax rules will still apply. However, lessees (such as all public companies and most medium- to larger-sized private companies), which present their financial statements in accordance with "generally accepted accounting principles" will be seeing some significant changes in the lease accounting rules. If you don't have to engage an audit firm or report financial results on a GAAP basis, you still may be impacted operationally, as either a lessor or a lessee, due to some of the marketplace reactions that will occur upon implementation of the new lease rules.

Currently, and until the pro-



**Brian P. Callahan,
CPA**

Audit partner, Eide
Bailey CPAs and
Business Advisors,
Denver

posed rules are implemented, lessees record leases as operating leases. There are rules under which the lessee could record a capital lease and, hence, record the liability associated with the capital lease. However, leases, especially those for rental properties and office spaces, historically have been structured to achieve the end goal of keeping lease obligations off the balance sheet. The current accounting rules allow for these exceptions depending upon the manner in which the lease is structured.

Under the proposed rules (the final rules are likely to mirror what has been proposed), lessees will now record a "right-to-use" asset, and they also will record a "discounted-to-present-value" lease liability on their balance sheets. They will depreciate the right-to-use asset but also incur interest expense on the liability when making lease payments. In essence, the term "rent expense" will disappear from income statements, as will "off-balance-sheet" obligations and commitments. Much like long-term debt, there will be full disclosure on the face of the financial statements; and financial statements will become more transparent for

investors, creditors and for the real estate community.

The rules also will change for lessors as they will apply the right-to-use model and recognize assets and liabilities arising from the lease. While similar to current concepts of financing or sales-type leases, the new rules will codify and standardize the accounting for both lessor and lessee. However, for the lessor, the FASB will introduce two new concepts or models to assist in determining the values or amounts of assets and liabilities to be recorded on lessor's financial statements. The first model is the "performance obligation approach" and is applied to leases where the lessor retains exposure to significant risks or benefits associated with the underlying asset during or after the expected lease term. The second model is the "derecognition approach" and is applied when the lessor does not retain the exposure to the significant risks or benefits associated with the underlying asset during or after the expected lease term. The derecognition approach views the lessor as transferring to the lessee economic benefits associated with the underlying asset during or after the expected lease term. In exchange, the lessor receives an unconditional right to receive payments from the lessee.

For real estate entities engaged in leasing activities, the use of the performance obligation approach likely will be utilized by those companies actively managing the assets they are leasing (such as property management companies).

The derecognition approach will be utilized by real estate financing companies and leasing companies; as that type of entity's business model is primarily the provision of finance because the profit of that business is derived from interest income.

Leases of land, noncore assets, equipment, and all leases greater than 12 months are or will be affected by the new standard. Renewal periods or extensions will be evaluated and reviewed to determine applicability.

The impact on lease rates, lease terms and other lease conditions could be wide-ranging and severe. For public companies, lease terms in number of years will start to decrease as they minimize the number of years' liabilities recorded on their balance sheets. The calculations of asset ratios, and thus, debt covenants, could be thrown into disarray, which will require lenders to increase their regulatory capital. Because renewal options will be more complicated, lessees may be less inclined to tack on renewals to the leases. On the positive side, shorter lease terms and fewer renewal terms will cause an increase in rates for lessors.

* The proposed rules are expected to be effective in fiscal year 2013, which gives us 18 months to prepare. If you haven't already, contact your certified public accountant, leasing agent or other real estate professional who can better advise you of the implications to your leases.▲