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To: Clients and Friends of LesMark Capital
From: Mark Hill
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Re: Lease Accounting Standards Update – Commercial Real Estate

For the past seven years the U.S. Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) have jointly pursued a sweeping overhaul of the current lease accounting standards. This lease accounting reform process has not been easy, as this is one of the most important and controversial projects the FASB and IASB have ever undertaken. The FASB's original exposure draft, issued in 2010, was so widely criticized that it was shelved, reworked, and reissued in May 2013. The purpose of this LesMark Update is to advise our clients how the revised lease accounting standards will impact (1) lessee and lessor financial statement presentation and (2) commercial real estate finance in general.

Current Lease Accounting Standards

Lease accounting under U.S. Generally Accepted Accounting Principles (GAAP) was originally established under FAS13 and revised over the years through various amendments and interpretations. Lease accounting outside of the U.S. is governed by IAS17. The two standards are very similar, basically categorizing leases as either operating or capital for financial statement classification purposes. If the lease terms meet the capital lease criteria, the lessee treats the lease as a financing and recognizes a real estate asset and a debt liability on the balance sheet, while the lessor removes the real estate asset from its books and debits a lease receivable. Operating leases are completely off the lessee's balance sheet, but the lease obligations are disclosed in the financial statement footnotes.

Although the current FASB and IASB capital lease criteria triggers are specific, financial statement classification has been inconsistent from company to company, primarily due to varying ways accountants determine certain criteria calculation inputs, such as the asset's "useful life" and "fair market value", or the company's "incremental borrowing rate". The result is that some companies book 15-year leases as capital leases while others book 25-year leases as operating. This has driven the FASB crazy over the years, as they are determined to require that almost all lease contracts be included on the balance sheet. It appears they are going to get their wish.

Proposed Lease Accounting Standards

On May 17, 2013 the FASB and the IASB published nearly identical revised exposure drafts outlining the proposed lease accounting changes. The new standards will require all leases longer than 12 months be booked on the balance sheet by the lessee as a "right-of-use asset" and a "lease liability". Balance sheet accounting for the lessor is a bit trickier, and depends on whether the underlying asset is equipment or real estate. For "Type A" leases (equipment, aircraft, cars, trucks and the like) the lessor would be required to derecognize the underlying asset, replaced by a complex lease receivable and residual model, which we will not go into here. For "Type B" leases (primarily land and buildings), the lessor would continue to recognize the real estate asset, similar to the way operating leases are currently accounted for. Lessor and lessee income and expense would be recognized on a straight line basis for Type B leases.

Conceptually, the new standards redefine a lease as a contract that conveys the right to use an asset for a period of time in exchange for consideration. Key in this classification the lessee's ability to control the use and benefits of the asset, and the whether the lessee "is expected to consume more than an insignificant portion of the economic benefits embedded in the underlying asset". We expect this not unambiguous principle to receive a fair amount of scrutiny during the exposure period. Recognition of the right-to-use asset by the lessee would be measured at the present value of the lease payments. The effective date of the proposed new lease accounting standards will be set based on the nature and extent of the incoming public comments, but no one expects the revision to go into effect for at least five years.

The Good News

1. The proposed lease accounting changes certainly standardizes the bookkeeping across all companies, industries and countries. All leases greater than 12 months go on the balance sheet. No exceptions.
2. For real estate landlords, the proposed changes will not significantly change their balance sheet or lease revenue recognition.
3. Existing leases that need to be reclassified and restated can be done so using a simplified retrospective approach.
4. The new standards' effective date will be no earlier than 2017, and will likely get pushed out even further.

The Bad News

1. Lease accounting and disclosures, particularly for lessees under Type A leases, will be much more complex.
2. For real estate tenants, the proposed changes will require capitalizing all existing operating leases, which will certainly gross up the balance sheet and could negatively impact debt ratios and performance metrics.
3. As a result of the lease capitalization mentioned above, the lessee may be in violation of existing bank and bond debt covenants and may be at risk of a rating agency downgrade.
4. There is no doubt that more companies will, at least in the short run, opt to buy rather than lease. This will likely curtail traditional single tenant commercial real estate finance transactions.

Summary

The effect of the new lease accounting standards will be seismic and the FASB and AISB know it, which is why it will probably take a dozen years from start to finish to complete the project. The FASB revised exposure draft alone is 339 pages long (see link below). It has been estimated that between $1.0 and $1.3 trillion in operating leases will have to be reclassified and placed on the balance sheet in the U.S., much of this involving commercial real estate. Accountants and CFOs are going to be very busy dealing with this for the foreseeable future.

Our view is that, although the lease accounting changes are not very intuitive and a bit draconian, the new standards aren't necessarily a bad thing in the long run. We are in for a half dozen rough years while a major accounting "reset" is effectuated by the market. Keep in mind that the underlying lease contracts and economics are not going to change, just the way in which we have chosen to present the data. This is form over substance, but it will take a while for everyone to adjust. When the dust settles late in this decade, financial statement users should be able to consistently evaluate statements of financial position with leases counted as assets. Hopefully, by then companies will be making leasing decisions based solely on strategic and economic reasons, rather than bookkeeping.

Link to FASB and IASB exposure drafts:
www.aicpa.org/InterestAreas/FRC/AccountingFinancialReporting/Pages/AFR_Leases.aspx