CHANGES IN FASB 13 RULES TO CHANGE COMMERCIAL REAL ESTATE INDUSTRY

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As a child growing up to the late 1970s, I remember the push for the metric system in the United States to have the same standard of measurement as the rest of the world.

President Gerald Ford signed the Metric Conversion Act on December 23, 1975, strongly suggesting the use of metric, but just stopping it short of being the "law of the land".

The 1975 Act didn't last very long. American scientists, who had long been using metric units to describe their work to others in the international scientific community, were excited about the conversion. I remember the PSAs and jingles about metric measurements (recall "Take 10 America" similar to the Schoolhouse Rock series?). Public opposition to the process of officially converting to the metric system (called metrication) was strong. The result was a law passed in 1982 that repealed the metrication.

Unlike the failed attempt to bring the US to an international standard with the metric system, dramatic changes will occur over the next 24 months that will forever change how accounting standards are made for handling leases on a company's balance sheet. It would also replace rent payment expense reporting with interest and depreciation expense reporting. The Financial Accounting Standards Board ("FASB") will implement legislation that will effectively eliminate all operating leases, and have U.S. accounting standards consistent with those of companies on an international basis.

New lease accounting standards are currently being developed in a joint project between the International Accounting Standards Board ("IASB") and FASB that could result in a complete overhaul of the way in which leases are reported in financial statements.

According to the Securities and Exchange Commission, industry projections estimate over $1.3 trillion would be transferred to U.S. corporate balance sheets, with roughly 70 percent being in real estate leases.

DEFINITION OF CAPITAL AND OPERATING LEASES

The basic concept of real estate accounting is that some leases are simply rentals, whereas others are effectively purchases. For example, if a company rents office space for a year, the space is worth nearly as much at the end of the year as when the lease started; the company is simply using it for a short period of time, and this is an example of an operating lease.

For example, if a company leases a printer for five years, at the end of the lease the printer is nearly worthless. The lessor (the company who receives the lease payments) anticipates this, and charges the lessee (the company who uses the asset) a lease payment that will recover all of the lease's costs, including a profit. This transaction is called a capital lease. In this case, it is essentially a purchase with a loan, as such an asset and liability must be recorded on the lessee's financial statements. Essentially, the capital lease payments are considered repayments of a loan; depreciation and interest expense, rather than lease expense, are then recorded on the income statement.

Operating leases do not typically impact a company's balance sheet. There is, however, one exception. If a lease has scheduled changes in the lease payment (for instance, a planned increase for inflation, perhaps tied to Consumer Price Index), the rent expense is to be recognized on an equal basis over the life of the lease. The difference between the lease expense recognized and the lease actually paid is considered a deferred liability (for the lessee, if the leases are increasing) or asset (if decreasing).

A lease is capital if any one of the following four tests is met:

1. The lease conveys ownership to the lessee at the end of the lease term;

2. The lessee has an option to purchase the asset at a bargain price at the end of the lease term

3. The term of the lease is 75 percent or more of the economic life of the asset.

4. The present value of the rents, using the lessee's incremental borrowing rate, is 90 percent or more of the fair market value of the asset.

INTRODUCTION TO FASB 13 CHANGES

On August, 17, 2010, FASB released their "exposure draft" requiring companies to record nearly all leases on their balance sheets as a "right to use" asset, and a corresponding "future lease payment – liability." What does this change mean to owners and tenants of commercial real estate in simple terms?

This proposal does away with operating leases; all leases would be capitalized using the present value of the minimum rental obligations under a lease. Businesses who in the past had off-balance sheet lease obligations, will now record these obligations on their balance sheet.

A key point to consider with regards to the proposed accounting changes is that, in all likelihood, existing operating leases, signed prior to the implementation of the new rules, will require reclassification as capital leases that must be accounted for on the balance sheet. This means that real estate professionals must immediately consider the effect that existing and planned leases will have on financial statements once the proposed rules are implemented. Since operating lease obligations can represent a larger liability than all balance sheet assets combined, this reclassification could significantly alter the business's balance sheet.

The impact of recording these rent obligations on the balance sheet can have multiple impacts, including: businesses needing to notify their lenders of potential non-compliance with their loan covenants, negotiating new loan covenants with the lenders due to the restated financial statements, ratios used to evaluate a business's potential of credit will be adversely impacted and the restatement of a lessee's financial statement once the change takes effect may result in a lower equity balance, and changes to various accounting ratios

The conceptual basis for lease accounting would change from determining when "substantially all the benefits and risks of ownership" have been transferred, to recognizing "right to use" as an asset and apportioning assets (and obligations) between the tenant and the landlord

As part of FASB's announcement, the Board stated that in their view "the current accounting in this area does not clearly portray the resources and obligations arising from lease transactions." This suggests that the final result will likely require more leasing activity to be reflected on the balance sheet than is currently the case. In other words, many, perhaps all, leases now considered operating are likely to be considered capital under the new standards. Thus, many companies with large operating lease portfolios are likely to see a material change on their corporate financial statements.

Part of the purpose for this is to coordinate lease accounting standards with IASB, which sets accounting standards for Europe and many other countries. IASB and FASB currently have substantial differences in their treatment of leases; particularly notable is that the "bright line" tests of FAS 13 (whether the lease term is 75 percent or more of the economic life, and whether the present value of the rents

is 90 percent or more of the fair value) are not used by the IASB, which prefers a "facts and circumstances" approach that entails more judgment calls. Both, however, have the concept of capital (or finance) and operating leases, however the dividing line is drawn between such leases.

FASB will accept public comments on this proposed change through December 15, 2010. If FASB makes a final decision in 2011 regarding this proposed change to lease accounting, the new rules will go into effect in 2013.

IMPACT ON COMMERCIAL REAL ESTATE

The impact of the FASB 13 changes on the commercial real estate market will be substantial and will have material impact on commercial tenants and landlords. The proposed changes not only impact landlord and tenants, but will affect commercial real estate brokers as it increases the complexity of lease agreements and provides an impetus for tenants to execute shorter term leases to mitigate the liability on their balance sheet.

The shorter term leases create financing issues for property owners as lenders and investors prefer longer term leases to secure their investment. Therefore, landlords should secure financing for purchase or refinance prior to the implementation of this regulation, as financing will be considerably more difficult the future. This will most dramatically impact new construction. In today's environment, it takes three things to secure financing for new construction: (1) an investment grade tenant; (2) a lease term of at least 12 years; and (3) a building that is not overly specialized and is "market accepted" in both layout and location.

This accounting change will increase the administrative burden on companies and the leasing premium for single tenant buildings will effectively be eliminated. The impact of this proposed change will have a profound impact on leasing behavior of tenants. Companies that are the single tenant in a building may find it advantageous to simply own the building since a lease of the property will be of record on its financials due to the FASB 13 changes.

Under the proposed rules, tenants would have to capitalize the present value of virtually all "likely" lease obligations on the corporate balance sheets. "Likely" includes renewal options, even if they are not firm obligations but simply an option that is exercised solely by tenant's election. FASB views leasing essentially as a form of financing in which the landlord is letting a tenant use a capital asset, in exchange for a rent payments that includes the principal and interest, similar to a mortgage.

Unfortunately regulators have missed the point of why most businesses lease and that is for flexibility as their workforce expands and contracts, as location needs change, and businesses would rather invest their cash in producing revenue growth, rather than owning real estate.

In my experience, companies achieve a better return on investment in their core business or service than return on ownership of bricks and mortar. A lease provides greater flexibility to meet unknown future space needs, and can be a lower cost "exit" strategy for many companies.

The proposed accounting changes will also impact landlords, especially business that are publicly traded or have public debt with audited financial statements. Retail owners and some Real Estate Investment Trusts ("REITs") may be required to perform analysis for each tenant located in their buildings or malls, analyzing the terms of occupancy and contingent lease rates.

Proactive landlords, tenants and brokers need to familiarize themselves with the proposed standards that could take effect in 2013 and begin to negotiate leases accordingly.

CONCLUSION

The end result of this proposed lease accounting change is a greater compliance burden for the tenants as all leases will have a deferred tax component, will be carried on the balance sheet, will require periodic reassessment and could require more detailed financial disclosure.

Therefore, landlords will need to know how to structure leases and sale transactions that will be desirable to Tenants in the future. Many tenants will realize that the new rules take away the off balance sheet benefits FASB 13 afforded them in the past, and will determine leasing to be a less beneficial option. They may also see the new standards as being more cumbersome and complicated to account for and disclose. Finally, it will become a challenge for every landlord and commercial real estate broker to find a new approach for marketing commercial real estate leases that make them more attractive than owning.

However, this proposed accounting change to FAS 13 could potentially stimulate a lack luster commercial real estate market in 2011 and 2012 as businesses decided to purchase property rather than deal with the administrative issues of leasing in 2013 and beyond.

I am not an accountant, and I do not play one on TV. I recommend that landlords and tenants begin preparing for this changes by reviewing their leases with their commercial real estate broker and discussing the financial ramifications with their chief financial officer or outside accountants to avoid potential financial surprises when the accounting changes are adopted. For the most up to date information on FASB change, visit http://www.fasb.org/home.

While the metric system never became the law of the land in the US, our global economy will cause the FASB changes that will result in the US being consistent with the rest of the world. With change comes opportunity, and those that address this reality sooner rather than later can benefit than those that wait and respond after the fact. ■

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