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Accounting Boards Agree to Compromise
Lease Accounting Proposal Moving Forward

Highlights

- The FASB and IASB now acknowledge that not all leases are created equal.
- The Boards reached a compromise on the expense recognition pattern for capitalized leases, resulting in a dual-approach methodology:
  - o Front-Loaded Expense Approach – Results in the acceleration of expenses into the early years of a lease.
  - o Straight-Line Approach – Results in a straight-line lease expense similar to current accounting requirements.
- Both approaches require all leases to be capitalized, except for leases with a maximum lease term of 12 months.
- The Boards determined leases of "Property" (i.e. "land or a building; or part of a building; or both") will fall under the Straight-Line Approach, unless:
  - o The lease term is for the major part of the economic life of the underlying asset, or
  - o The present value of fixed lease payments accounts for substantially all of the fair value of the underlying asset.
  - o If either of these conditions exists, the Front-Loaded Expense Approach must be used.
- Lessor accounting for companies following U.S. GAAP will be symmetrical with lessee accounting:
  - o Revenue related to leases of Property will be recognized on a straight-line basis similar to current accounting requirements.
  - o The Receivable and Residual Approach will generally apply to leases where a lessee has the right to acquire (or consume) more than an insignificant portion of the underlying asset.
- There will be no changes to lessor accounting for companies that are subject to International Financial Reporting Standards (IFRS) and that choose to account for investment property in accordance with IAS 40.
- The revised Exposure Draft is expected to be re-issued by year-end 2012 with a 120-day comment period.
- In the best case scenario, the new standard will be issued in the latter part of 2013 with a possible effective date of 2016 (or 2017).

After months of debate and outreach activities, the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB), respectively the "Boards," have finally acquiesced and now acknowledge that not all leases are created equal – a point argued by CBRE since December 2010 in our original comment letter to the Boards. As a result of this enlightenment, the Boards have now reached a compromise on the expense recognition pattern for capitalized leases. Until now, this contentious and divisive topic had caused a stalemate between FASB and IASB board members.

The compromise agreed to now supports a dual approach to the expense recognition quandary for lessees. At the heart of this decision is the realization of the inherent complexities in developing a standard to address all types of leases (i.e. real estate, equipment, airplanes, etc.). This realization was best captured in a statement by Leslie Seidman, chairperson of the FASB, who stated, “I have been convinced that just because you write ‘Lease’ at the top of the paper does not mean that they all convey the same rights and obligations.” Stated another way, the dual approach now affirms the fundamental argument that not all leases are a form of financing.

EXPENSE RECOGNITION – A DUAL APPROACH

The newly proposed dual approach for lessees incorporates two methodologies relating to the expense recognition pattern for capitalized leases:

- Front-Loaded Expense Approach (the original approach from the Exposure Draft) – This approach considers a lease a form of financing and results in the undesirable front-loaded expense pattern caused by the Effective Interest Method (i.e. interest expense declines over the term of the lease in the same manner the interest component of a mortgage payment declines over time). The fundamentals of this approach include:
  - The lease is capitalized by recording a right-of-use asset and a corresponding liability on the balance sheet based upon the present value of the lease payments to be made over the primary term of the lease.
  - The right-of-use asset is amortized on a straight-line basis over the term of the lease.
  - Interest expense is incurred relating to the liability based on the Effective Interest Method.

- Straight-Line Approach (previously referred to as the Whole Contract Approach) – This approach, “treats lease contracts as paying for access to (and use of) the underlying asset over time.” In contrast to the Front-Loaded Expense Approach, this approach does not consider a lease a form of financing. The fundamentals of this approach include:
  - The lease is capitalized by recording both a right-of-use asset and corresponding liability on the balance sheet based upon the present value of the lease payments to be made over the primary term of the lease.
  - A straight-line lease expense is reported on the profit and loss statement.
  - The right-of-use asset and corresponding lease liability are considered “inextricably linked” for the term of the lease. As a result, the asset is “rebalanced” (i.e. the accounting term for plug figure) at each reporting date to equal the liability.

It is important to emphasize that no matter the approach, all leases will be required to be capitalized (i.e. recorded on the balance sheet). The only exception will be leases deemed short term in nature (i.e. those with a maximum lease term of 12 months).

The Boards have stated that a lessee should determine which of these two approaches should be applied to a specific lease based upon whether the “lessee acquires and consumes more than an insignificant portion of the underlying asset over the lease term.” However, rather than relying on this metric for the initial hurdle, the Boards have decided, as a practical matter, the decision will be driven by the nature of the underlying asset.

PROPERTY LEASES – STRAIGHT-LINE APPROACH

Fortunately for the real estate industry, the Boards have presumed that leases of Property (i.e. “land or a building; or part of a building; or both”) will follow the Straight-Line Approach, unless it is determined:

1. The lease term is for the major part of the economic life of the underlying asset, or
2. The present value of fixed lease payments accounts for substantially all of the fair value of the underlying asset.

If either of these two conditions exists, a lease is presumed to be a form of financing, which requires the use of the Front-Loaded Expense Approach. (Note: Equipment leases are presumed to fall under the Front-Loaded Expense Approach.)

Companies operating outside of the U.S. are already familiar with these metrics as they are part of the current IAS 17 criteria (i.e. the current international accounting standard for leases). Companies operating under the U.S. GAAP requirements of SFAS 13 will notice these metrics have a familiar ring to them as well, minus the “bright lines” (i.e. specific criteria embedded within the existing standard in order to determine whether a lease passes or fails the capitalization test). Although the bright lines will no longer exist for the U.S., it does not take a significant leap of logic to presume the bright line metrics will still serve as an implicit guide in determining the appropriate expense recognition pattern to apply. As a refresher, the current SFAS 13 bright lines are:

1. The lease transfers ownership of the property to the lessee by the end of the lease term.

2. The lease contains a bargain purchase option.

3. The lease term is equal to 75% or more of the estimated economic life of the property.

4. The present value of the minimum lease payments equals or exceeds 90% of the fair value of the property.

Since only a small percentage of today’s real estate leases are classified as capital leases using the above bright lines, this would support the Boards’ comment that most Property leases will qualify for the Straight-Line Approach. The exception could be leases with extremely long lease terms since they may have issues with the present value test.

LESSOR ACCOUNTING

Note: The following discussion only applies to companies following U.S. GAAP. There will be no changes to lessor accounting for companies subject to International Financial Reporting Standards (IFRS) and who choose to account for Investment Property in accordance with IAS 40.

As it relates to lessor accounting, the Boards agreed there should be symmetry between how the lessee and lessor determine which approach to apply. Therefore, the same determining factor of whether or not a lease provides a lessee the “the right to acquire or consume more than an insignificant portion of the underlying asset” is applied to lessors. In the case of lessors, there are also two approaches for the recognition pattern of lease income:

1. The first approach is similar to today’s operating lease treatment, which requires the underlying asset to remain on the balance sheet with income recognized on a straight-line basis. Thankfully, once again, this will generally apply to Property leases.

2. The second approach, known as the Receivable and Residual Approach, which will generally apply to leases where a lessee has the right to acquire (or consume) more than an insignificant portion of the underlying asset. In general, this approach requires:

    a. The lessor to “derecognize” the underlying asset (remove it from the balance sheet).

    b. Record a receivable for the right to receive future lease payments.

    c. Record an asset for the residual asset to be returned to the lessor at the end of the lease term.

    Fortunately, this approach will generally involve equipment-related leases; however, lessors with extremely long real estate leases may need to familiarize themselves with this approach as well.

THE BOTTOM LINE

So, what does all of this mean? As currently proposed, the profit and loss impact of most real estate leases should not differ significantly from current accounting requirements. This, of course, is what many of us have argued for since day one of this process. Combined with revisions to the original Exposure Draft related to options, contingent rent, etc., the interests of the real estate industry seem to have aligned with the changes made since the original Exposure Draft was issued in August 2010. The most significant exception is the continued requirement that all leases be capitalized.

Estimated by the SEC as having a $1.25-trillion impact to corporate balance sheets, this is a stark reminder that, at the end of this long and contentious process, there will still be significant headwinds to battle. Whether it is addressing debt covenants, performance metrics, system implementations, etc., this topic warrants continued attention as it slowly works its way towards implementation. More importantly, for the first time since issuance of the original Exposure Draft, we now have a road map as to the direction the Boards are heading. This is not to say there won't be more changes along the way; however, it appears for now, the over-arching framework is in place for the final standard. Given this, we can now begin to formulate a broad strategy for understanding the impact this change will have on the systems, personnel and financial metrics of a company and its competitors.

So, what is next? The Boards intend to re-expose the entire Exposure Draft in the fourth quarter of 2012 with a probable 120-day comment period. Given a reasonable timeframe to assemble and address public comments, the standard will most likely not be issued until the latter part of 2013 at the earliest. The effective date is speculated to be 2016 (or 2017).

As yet another summer will now pass without the need to draft another comment letter to the Boards, CBRE's Global Task Force on Lease Accounting wishes you a relaxing summer enjoying the company of family and friends. The Task Force will keep you apprised as further developments arise prior to the re-issuance of the Exposure Draft.

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