

White Paper

Changes in Lease Accounting – Now Simplified

FASB and IASB Boards Revise Proposed Lease Accounting

March 3, 2011

The Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) tentatively agreed to revise some of the proposed lease accounting standards. Nearly 800 letters and comments had been sent to the Boards in response to the proposed changes, and as a result, the Boards are simplifying portions of the new lease standards. However, the Boards remain firmly committed to requiring that all leases be recognized on balance sheet.

What Has Changed?

The tentative changes from the Exposure Draft which will have the biggest impact to corporate tenants are:

- Defining Lease Term as the base term plus only option periods for which there is significant economic incentive to extend.
- Leases with variable lease payments (such as percentage or contingent rent) will have a threshold for inclusion in lessee's lease liability and asset.
- Creating two classifications of leases: (1) Finance Leases, and (2) Other-Than-Finance Leases.
- Affirming the direction of the Exposure Draft to require all leases be reflected on balance sheet as both an asset and a liability.

What Are the Specifics of the Changes?

In a significant change from the Exposure Draft, the Boards decided that all lease terms will be the contractual minimum period plus any optional renewal periods for which an exercise of the renewal option is reasonably certain. Reasonable certainty will be based solely on economic factors within the lease, such as bargain pricing on renewals. The Board plans to provide specific criteria to be used in this assessment. These tests likely will be very similar to the current GAAP standard concerning renewals. The ED had proposed including renewal terms if they were more-likely-than-not to occur based on a wide variety of factors, included lessee past practice, market conditions, and lessee intent.

One change which will greatly simplify life for corporate lessees is that there will be fewer reassessments of renewal options during the lease term than the Exposure Draft had proposed. Reassessments will only need to occur when economic factors affecting the decision to extend or terminate a lease change significantly. Lessees will not need to search for reassessment events.

The Boards also decided that variable lease payments tied to an index or rate would be included in lease calculations using the current rate, or spot market, for that index or rate, rather than a forward projection. There will also be thresholds for including contingent rents in leases (such as percentage of sales). Such contingent payments will only be included when such are virtually certain. If variable payments are, in substance, minimum lease payments they shall be included based on such minimum.

There were discussions regarding several other issues including: which agreements shall be defined as a Lease, Residual Value Guarantees, and Lessor accounting.

Two Types of Leases:

In another significant change from the Exposure Draft, the Boards tentatively decided there will be two classifications for leases and each type will have a different pattern of recognition in an income statement. All leases will either be a (1) Finance lease, or (2) Other-Than-Finance Lease. The Boards will develop criteria for distinguishing between these two types of leases.

A finance lease will be viewed as a financing. The pattern of income for a finance lease will be consistent with the methodology presented in the Exposure Draft as it will be treated as a financing, with more expense early in the lease term. If the lease is similar to a rental transaction and financing is not considered to be a significant part of the transaction, the lease will be treated as an Other-Than-Finance Lease. The pattern of income for an Other-than-finance lease will be consistent with current US GAAP (straight lined or leveled).

What Is Next?

Deliberations will continue and other changes may be forthcoming before a final lease accounting standard is issued. June 30, 2011 is still the target date for finalizing the new standards. The exact schedule for formal adoption of the new standards has not been set, however most observers expect larger corporations to begin reporting under the new standards with their 2012 fiscal year end.

CresaPartners Capital Markets group works with clients to provide financing solutions for real estate problems. It is actively monitoring the developments in lease accounting and is available to discuss the coming changes in lease accounting and how it may impact your situation. For more information, visit www.cresapartners.com, contact your Cresa advisor, or call one of our experts in Capital Markets at 972-713-4000.