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ENTERPRISE NOTES

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Lease Accounting Update
Accounting Boards at Odds = More Delays!

Highlights

- The FASB and IASB now differ in the methodology they support for amortizing the rightof-use asset (i.e. the capitalized lease on the balance sheet).
- FASB supports the "Interest-Based Amortization Approach," which, like current lease accounting, requires determining whether a lease is a finance lease or an operating lease. For operating leases, a straight-line expense pattern will result for leases without free rent or any rent increases.
- IASB supports the "Underlying Asset Approach," which is based on the "consumption" of the asset and requires knowledge of the fair value of the underlying asset. This approach does not require a lessee to distinguish between a finance lease and an operating lease; however, the real-world application of this approach is both complex and potentially subject to financial engineering.
- Both approaches still require all leases to be capitalized.
- The revised Exposure Draft will most likely not be published until fourth quarter 2012.
- Best-case timing for issuing the new standard appears to be mid- to late-2013.
- The effective date has not been stated; however, it is "more likely than not" to be 2016.

At a recent joint meeting of the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB), collectively the "Boards," it became readily apparent there is now a philosophical difference of opinion between them. This difference relates to how the subsequent measurement of the right-of-use asset is determined. As a reminder, the right-of-use asset represents the capitalized lease recorded on a company's balance sheet and is determined by calculating the present value of the rent payments (using the lessee's incremental borrowing rate) for the primary term of the lease.

As proposed in the original Exposure Draft issued August 2010, the Boards supported the Effective Interest Method to subsequently measure the right-of-use asset, which results in the front-end loading of expenses in the early years of a lease. This approach was a significant point of contention in the comment letters received by both Boards, as well as in comments made by many constituents participating in the Boards' outreach activities.

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The Boards, to their credit, took notice of this concern and have since pursued alternative approaches. This topic was once again addressed in the recent joint meeting, with each Board putting forth their own proposed methodology. Despite much debate, the Boards are now at odds, with members essentially voting along "party lines" and supporting the methodology put forth by their respective Boards. The two approaches currently being considered include:

1) **The "Interest-Based Amortization Approach," supported by the FASB.** Similar to current lease accounting, this approach will require leases to be classified as either a finance lease or an operating lease. Finance leases would be accounted for in much the same manner as put forth in the original Exposure Draft (i.e. a front-end loading expense pattern). Operating leases, on the other hand, would use an Interest-Based Amortization Approach, which would result in a total lease expense pattern similar to current operating lease accounting, or a straight-line pattern. However, this would only be the case for leases without rent increases or free rent periods. At this time, specific criteria for how to distinguish between a finance lease and an operating lease has not been provided.
2) **The "Underlying Asset Approach," supported by the IASB.** This approach will require the lessee to amortize the right-of-use asset based on the estimated "consumption" of the asset over the lease term, which will certainly pose a unique challenge for real estate leases. This approach also requires the lessee to have knowledge of the fair value of the underlying asset. In the case of the Underlying Asset Approach, the higher the rate of consumption, the greater the financial impact in the early years of a lease (i.e. front-end loaded expenses). If there is no consumption of the underlying asset (i.e. the residual value of the asset is equal to or greater than the original value), the financial impact will be equal to a straight-line methodology. While this approach does not require a lessee to distinguish between a finance lease or an operating lease, the determination of the level of consumption would be very subjective, especially in the case of real estate, and the valuation of the underlying asset could be challenging and potentially subject to financial engineering.

As of this update, the Boards have instructed their staff to undertake further outreach efforts on this issue and report back at their next meeting. This is expected to be no sooner than May 2012.

It is important to note that both approaches still require all leases to be capitalized. At this juncture, this seems to be the only significant point the Boards agree on. Of course, given the history of this proposal, it is possible the final methodology may still be an approach other than what has been put forth by either Board.

The Boards have also discussed the consequences any further changes in lessee accounting may have on their decisions to date for lessor accounting, as they would prefer the two approaches somewhat mirror each other in methodology and philosophy.

Based on the latest sequence of events, the revised Exposure Draft is once again delayed and will probably not be published until sometime in fourth quarter 2012. This would imply the earliest date a new standard could be released would be mid- to late-2013. Although an effective date has not been

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addressed by the Boards, speculation is that 2016 is, to echo a past phrase of the Boards, "more likely than not" the earliest the new standard would take effect.

The CBRE Global Task Force on Lease Accounting will keep you apprised as this issue continues to evolve.

For more information, please contact:

Jeff Beatty
Senior Managing Director, Financial Consulting Group
Director, Task Force on Lease Accounting
+1 602 735 5608
jeff.beatty@cbre.com

Ian Billenness
Director, Global Corporate Services
+44 20 7182 3039
ian.billenness@cbre.com

The CBRE Global Task Force on Lease Accounting is composed of the following team members:

- **Jeff Beatty,** Financial Consulting Group (Task Force Director)
- **Mike Nelson,** Strategic Consulting
- **Nick Tansey,** Portfolio Administration Services
- **Ian Billenness,** Global Corporate Services
- **Richard Hurst,** Global Corporate Services
- **Xavier Menendez,** Global Corporate Services
- **Judy Dahlke,** Client Accounting Service
- **Jennifer Pazzia,** Global Financial Reporting
- **Andrew Steinberg,** Global Financial Reporting

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