Revised Exposure Draft on Lease Accounting Issued: Back on the Front Burner

FREQUENTLY ASKED QUESTIONS

On May 16, the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB), collectively the "Boards," issued the long-awaited Revised Exposure Draft for the "Leases" project. Just shy of three years after issuing the Original Exposure Draft in August 2010, the Revised Exposure Draft represents the culmination of the Boards' deliberations after receiving nearly 800 comment letters and holding numerous joint working group meetings, public roundtables, workshops, webcasts, and other outreach activities. (Note: The FASB and IASB have each released their own version; they are nearly identical in their proposed requirements)

CBRE's Global Task Force on Lease Accounting ("Task Force") has been tracking this issue from the very beginning and has provided numerous updates along the way. In order to provide a high-level of understanding regarding this topic and what is currently being proposed in the Revised Exposure Draft, the Task Force has prepared the following Frequently Asked Questions narrative focused on the questions/concerns from a real estate lessee's perspective.

For a more in-depth and detailed discussion of the topic, please refer to the Task Force's Global ViewPoint titled Revised Exposure Draft on Lease Accounting Issued: Back on the Front Burner.

1. What is being proposed by the Boards?

The Boards are proposing that ALL leases be capitalized by recording what is referred to as a Right-of-Use Asset (RoU) and a corresponding lease liability on a company's balance sheet.

2. Does this only apply to real estate leases?

No. The proposed changes apply to ALL types of leases. This includes leases of property (defined as "land and/or a building or part of a building"), equipment, automobiles, copy machines, airplanes, and a multitude of others. The all-encompassing nature of the proposed changes made it extremely difficult for the Boards to develop an approach that can be equitably applied to all lease types. While they have developed a new approach, some will argue that the approach as outlined in the Revised Exposure Draft is not being equitably applied. The most vocal critics being those representing the equipment leasing industry.

3. Are there any exceptions?

Yes. Leases that have a maximum lease term of 12 months or less, including any renewal option periods, are not required to be capitalized.

4. Will existing leases be grandfathered under current accounting rules?

No. At the effective date, all leases outstanding as of the beginning of the earliest period presented in a company's financial statements will be subject to the revised guidance and will need to be recorded on the balance sheet.

5. Will all companies be impacted by these proposed changes?

All companies who follow U.S. Generally Accepted Accounting Principles (GAAP) and International Financial Reporting Standards (IFRS) will be required to follow these new requirements. In the U.S., this includes all publicly-held companies as well as some privately-held companies.

6. How are the proposed changes different from current lease accounting?

Current accounting standards require that real estate leases be classified as an operating lease or a capital/finance lease. This classification is based on criteria established by the Boards for their respective constituencies. In the U.S., this is part of FASB Accounting Standards Codification (ASC) Topic 840 (previously known as FAS 13); internationally, this is International Accounting Standard (IAS) 17. No matter the jurisdiction, the majority of real estate leases are classified as operating leases, which do not need to be recorded on a company's balance sheet. Rather, the information related to a company's operating leases is simply a disclosure in the notes to the financial statements. This is why the term "off balance sheet" is used when referring to the contractual liability associated with an operating lease.

7. What is driving this change to lease accounting?

The off-balance-sheet treatment of operating leases is the primary driver behind the Boards' desire to overhaul lease accounting. If the changes as proposed by the Boards are implemented, it has been estimated the balance sheets of U.S. publicly traded companies alone could increase by $1.5 trillion, with $1.1 trillion associated with real estate operating leases.

There have been several high-profile instances in the past where U.S. companies had significant off-balance-sheet liabilities that were not readily apparent to investors and users of their financial statements. The most notable example in the U.S. is Enron, where the existence of billions of dollars in off-balance-sheet liabilities was generally unknown to investors and stakeholders. It is this lack of transparency the Boards are trying to remedy, and one that has been a major concern of the U.S. Securities and Exchange Commission (SEC), the true driving force behind the initiative.

The issue is exemplified in an oft-quoted comment by the past chairman of the IASB, Sir David Tweedie, who believes current lease accounting is broken. "One of my great ambitions before I die is to fly in an aircraft that is on an airline's balance sheet." (Almost all commercial airplanes are held as operating leases and are therefore off balance sheet.)

8. What does it mean to "capitalize" a lease?

In the Revised Exposure Draft, the Boards propose that a RoU model be applied to all leases. The RoU model requires a lessee to record an asset on its balance sheet representing its right to use the underlying asset for a specified period of time, while at the same time recording a corresponding liability representing the lessee's obligation to make future rent payments. The amount initially recorded on a lessee's balance sheet will generally be determined by calculating the present value of the lease payments for the term of the lease.

9. Is the rent paid during an option period included in the present value calculation?

An option period will be included in the lease term, and the related rent is to be included in the present value calculation, if there is a "significant economic incentive" to exercise the option. There is no specific quantitative guidance as to what is considered a "significant" economic incentive; however, the Revised Exposure Draft states that "contract-based, asset-based, market-based, and entity-based factors" should be taken into account.

10. Is percentage/turnover rent still included in the present value calculation?

Variable payments that depend wholly on the performance of the leased asset (e.g., percentage/turnover rent) are excluded from the calculation. Variable lease payments that depend on an index or rate, such as CPI increases, should be included.

11. What discount rate will be used to determine the present value?

Ideally, the interest rate the lessor charges the lessee will be used as the discount rate. However, in cases where the interest rate being charged by the lessor is unknown (which will be the case in most real estate leases), a lessee is to use its "incremental borrowing rate" at the lease commencement date as the discount rate. The incremental borrowing rate is defined as "the rate of interest the company would pay to borrow over a similar term as the lease term, with a similar security, an amount necessary to obtain an asset of similar value."

12. Will all leases be treated the same?

The Revised Exposure Draft now requires a lease be classified as either a Type A or Type B lease, each with its own expense recognition methodology. As a matter of practical expediency, the Boards have determined the classification of a lease will be driven by the nature of the underlying asset. Fortunately for the real estate industry, the Boards have stated leases of "Property," defined as "land or a building, or part of a building, or both," are presumed to be Type B leases. Type B leases will follow an expense recognition approach similar to the current accounting treatment for operating leases (i.e. straight-line expense pattern), unless it is determined:

a) The lease term is for the major part of the remaining economic life of the underlying asset, or

b) The present value of the fixed lease payments accounts for substantially all of the fair value of the underlying asset at the commencement date.

If either of these two conditions exists, a Property lease will be considered a form of financing, which will require the lease to be classified as a Type A lease. Type A leases will have the front-end-loaded expense recognition pattern similar to that proposed in the Original Exposure Draft. Equipment leases are generally presumed to be Type A leases unless select factors prove otherwise.

13. Will lessees begin shortening the term of their leases to minimize the impact to their balance sheet?

It is the opinion of the Task Force that the overall duration of leases will not change as a result of the proposed changes. While some companies may opt to mitigate the impact to their balance sheet by reducing the duration of their lease terms, the Task Force believes companies will continue to negotiate lease agreements based on specific business objectives and allow the accounting department to determine how to appropriately account for the transactions. Another factor that will diminish a lessee's desire to consider leases of shorter duration will be the varying economic terms presented by the landlord for short term leases. Shorter terms will likely result in reduced tenant improvement allowances, limited or no free rent and/or higher rent.

14. Will these changes impact a company's decision-making process?

As proposed, the Task Force believes there could be a change to the decision-making process of a lessee. Since leases will have to be recorded on the balance sheet, they will likely come under greater scrutiny from a company's chief financial officer and their financial team. This could result in a longer decision-making process, as well as a requirement for the lessee's real estate personnel to develop multiple sensitivity analyses for material leasing transactions identifying the balance sheet impact of each possible scenario.

15. What can a company begin doing now in advance of these changes?

See the section entitled "What Should Companies Be Doing Now?" in CBRE's white paper.

16. What strategies should a company begin evaluating given these proposed changes?

See the section entitled "Strategic Considerations to Address Prior to Issuance of the Final Standard" in CBRE's white paper.

17. Can there still be changes to what is being proposed?

Yes, the Boards have provided a 120-day comment period ending September 13, 2013. During this period, we encourage any interested party to provide a comment letter to the Boards (comment letter instructions). These comment letters should address those portions of the Revised Exposure Draft you disagree with, and, equally as important, express your support for those sections you agree with. It is important the Boards do not regress on this topic and re-introduce requirements the real estate industry has fought so valiantly against over the past few years (e.g., accelerated expense recognition, inclusion of percentage/turnover rent, a lower threshold for the inclusion of option periods, etc.). As the seven-member FASB board voted 4-3 in support of issuing the Revised Exposure Draft, they are still a house divided, with some members desiring an approach more closely resembling the Original Exposure Draft. Additionally, the equipment leasing industry is also pressuring the Boards, as they are staunchly opposed to the Type A classification for equipment leases.

18. What happens after the 120-day comment period?

After the comment period, the Boards will redeliberate the issues based on comment letters and input from various outreach activities they will conduct.

19. When can we expect the Boards to finalize their decision?

Once the Boards have completed their redeliberations, they will draft and issue the new accounting standard. While no formal date has been communicated by the Boards, the final standard could be issued in mid- to late -2014 at the earliest.

20. When will the new changes become effective?

An effective date has not been communicated by the Boards. It is estimated the effective date of the new standard will be no sooner than 2017. While this seems a long ways off, it is important to note a look-back period will be required for any comparable periods presented in a company's financial statements. In the case of most publicly held companies, the look-back period will be for two years. For example, if the effective date is calendar year 2017, any leases in place at any time during 2015 and 2016, including those that expire during this period, will have to be factored into the restatement.

21. How will we know if the Boards make further changes or clarifications relative to the proposed changes?

As always, the Task Force will continue to keep you apprised as any additional information becomes available on the topic.

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