

TRANSWESTERN

Lease Accounting

Accounting Standards:

The Exposure Draft and
What It Means for Lease Accounting

Proposed Accounting Standards & the Effects on Our Industry

The Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) issued an Exposure Draft of proposed changes for lease accounting in August 2010. The draft creates common standards for lease accounting to ensure that the assets and liabilities arising from lease contracts are recognized on the financial statements in a consistent manner. Under the current regulations, similar transactions can be accounted for very differently, reducing both the transparency and comparability for users of financial statements.

Many industries utilize leasing as an important source of finance to the business. The proposed lease accounting standards will require all operating leases to be treated as capital leases and assets and liabilities arising from lease contracts are recognized on the balance sheet. The standards will impact all publicly traded companies and companies who produce financial statements in accordance with Generally Accepted Accounting Principles (GAAP).

The draft addresses some of the criticisms with the current standards, but it also creates new concerns for both the lessee and the lessor:

- Complexity and subjectivity of measuring lease terms and rental payment amounts.
- Accounting standards may drive business decisions.
- Shorter lease terms will impact building values.
- Costs associated with the transition (systems, staffing, audit and legal fees).
- Lease negotiations will become more complex.

- Standards will impact build-to-suit, sale-leasebacks and net lease transactions.
- Timing of the change given today's challenging economic climate.

The proposed regulations will be finalized sometime in 2011 with possible adoption in 2013. Once implemented, accounting for leases from the lessee and lessor perspective, financial reporting for the commercial real estate industry, as well as any industry where leasing is utilized, will change significantly.

This white paper on the effects of the [Exposure Draft](#) is an update to our previous [Lease Accounting white paper](#) published in February 2010.

Lessee Accounting

Lessees will recognize an asset representing the right-to-use the leased asset for the lease term and a liability for the obligation to pay rentals. The amount to be recorded for the asset is based on the expected lease payments to be made over the lease term. Expected lease payments require estimates and judgments about uncertain future events including renewal options, termination option penalties, contingent rents and residual value guarantees.

LEASE TERM

A lessee must first determine the lease term to estimate expected rental payments. The lease term is the longest possible lease term that is more likely than not to occur (probability of occurrence is greater than 50 percent). A lessee will need to consider:

- Contractual factors such as contingent rentals, termination penalties and residual value guarantees.
- Non-contractual factors such as significant tenant improvements, local regulations and tax consequences.
- Business factors such as the importance, the nature and the location of the asset.
- Other factors such as lessee's intentions and past practices.

ESTIMATING LEASE TERM (EXAMPLE):

A lessee executes a lease for office space with a 10-year non-cancellable term with two, five-year options to renew. The possible lease terms are:

- 10 years with no renewals
- 15 years exercising the first renewal option
- 20 years exercising both renewal options

The lessee must determine the probability of occurrence for each lease term. Lessee estimates the probability of each term:

- 50 percent for a 10-year term
- 25 percent for a 15-year term
- 25 percent for a 20-year term

The lease term would be at least 10 years with a 50 percent chance that the term would be 15 years or longer. There is a 50 percent chance that either 15 or 20-year terms will occur; however, there is only a 25 percent chance that the 20-year term will occur. The lease term more likely than not to occur is 15 years.

LEASE PAYMENTS

Initial Measurement

The lessee will measure the lease liability using the present value of the lease payments discounted using the lessee's incremental borrowing rate or if it can be determined, the rate the lessor charges the lessee. Lease payments include fixed rentals and other rentals subject to uncertainty including contingent rentals, residual value guarantees and termination penalties. The right-of-use asset equals the liability of the lease payments plus any initial direct costs incurred by the lessee.

The FASB and IASB Boards will need to clarify treatment for the service component of real estate leases and whether these costs should be included in the present value calculation of the lease payments or if these costs will be treated as a service component and expensed. Under a net lease, rental payments are separate from the service component (operating expenses, real estate taxes, insurance), and the guidance indicates these

payments will continue to be expensed. But, under gross and modified gross leases, the service component is not easily identifiable.

Subsequent Measurement

When facts or circumstances indicate a significant change in the liability from a prior reporting period, the lessee will need to reassess the carrying amount. The lessee will need to reevaluate the liability for any changes to the lease term or if estimated lease payments have changed related to contingent rentals, residual value guarantees and termination penalties.

LESSEE EXAMPLE: *A lessee executes a six-year lease with two, four year renewal options. The base rent is fixed at \$144,000 annually and the lessee’s incremental borrowing rate is five percent. The lessee determines the longest possible lease term that is more likely than not to occur is 10 years (original term plus one renewal option).*

New accounts that will be recorded on income statements or balance sheets for lessees under the new pronouncements:

Lessee Income Statement

- Interest expense
- Amortization of the right-of-use asset
- Impairment losses on the right-of-use asset
- Changes in the liability to make lease payments

Lessee Balance Sheet

- Liability to make lease payments
- Right-of-use asset

ENTRIES RECORDED					
	Lease Inception	Year 1	Year 2	Year 3	
Amortization Expense		113,600	113,600	109,000	
Right-of-Use Asset	\$1,136,000	113,600	113,600	351,700*	109,000
Interest Expense		54,000	49,000	62,200	
Obligation to Pay Rentals	1,136,000	90,000	95,000	81,800	351,700*
Cash		144,000	144,000	144,000	
NOTES	Record asset and rental obligation from lease contract at the present value of expected lease payments.	Amortize right-of-use asset over lease term. Record lease payments.	Amortize right-of-use asset over lease term. Record lease payments.	Amortize right-of-use asset over lease term. Record lease payments.	

*At the beginning of year three of the lease, the lessee determines the second, four year renewal option will be exercised. The lessee records the additional expected lease payments. Record asset and rental obligation at reassessment of lease term (exercise four year option) expected lease payments at present value.

Lessor Accounting

The exposure draft outlines two methods for lessor accounting - the performance obligation and the derecognition approach. The method to be used depends on whether the lessor retains significant rights and benefits associated with the underlying asset (1) during the expected lease term, or (2) after the expected lease term, having the ability to re-lease or sell the underlying asset.

If the lessor retains significant risks or benefits associated with the underlying asset, the lessor shall apply the performance obligation approach to the lease. If not, the derecognition approach should be used. In general, most landlords will likely apply the Performance Obligation Approach because the lease term(s) are substantially less than the economic life of the building.

Performance Obligation Approach

Lessor will record a lease receivable (right to receive lease payments) based on the lease payments expected over the lease term plus any direct costs incurred by the lessor. Lease payments include amounts the lessor expects to receive from fixed rentals and from other rentals subject to uncertainties including contingent rentals, residual value guarantees, and termination penalties. The lease receivable will be discounted using the rate the lessor charges the lessee. Effectively, the yield on the properties represented by the lease rentals.

The lessor will also record a lease liability using the present value of the lease payments discounted at the rate the lessor charges the lessee. This liability represents the right of the lessee to use the leased asset

during the term of the lease. The leased asset remains the lessor's economic resource.

PERFORMANCE OBLIGATION EXAMPLE: A lessor executes a five year lease with two, three year renewal options with a lessee. The base rent is fixed at \$100,000 annually and the lessor will charge the lessee interest at 10 percent. Lessor estimates that the lease term will be eight years.

	ENTRIES RECORDED		
	Lease Inception	Year 1	Year 2
Lease Receivable	\$533,800		
Lease Liability	533,800	100,000	100,000
Lease Revenue		100,000	100,000
Cash		100,000	100,000
Lease Receivable		47,000	52,000
Interest Income		53,000	48,000
NOTES	Record asset and rental obligation from lease contract at the present value of expected lease payments.	Record lease revenue and reduce lease liability straight-line over lease term. Record lease and interest payments received and reduction to lease receivable.	Record lease revenue and reduce lease liability straight-line over lease term. Record lease and interest payments received and reduction to lease receivable.

New accounts that will be recorded on income statements or balance sheets using the Performance Obligation Approach under the new pronouncements:

Lessor Income Statement

- Interest income
- Lease income
- Changes in lease liability
- Impairment losses

Lessor Balance Sheet

- Underlying assets
- Right to receive lease payments
- Lease liability

Derecognition Approach

Under the derecognition approach, all significant risks and benefits of the underlying asset are considered to transfer to the lessee. The lessor will derecognize an amount of the asset’s carrying value representing the lessee’s right-to-use the asset. The remaining carrying value of the asset is a residual asset. The derecognized portion is determined by multiplying the fair value of the lease payments divided by the fair value of the leased property. This could result in a gain (loss) to the lessor at the start of the lease (i.e., the difference between the lease receivable and the cost of sale). The lease receivable is calculated using the same method as the performance obligation.

DERECOGNITION EXAMPLE: *A lessor executes a four-year lease for equipment with a lessee. The fair market value of the equipment is \$25,000 with a \$20,000 carrying value, and the estimated useful life is five years. The lease is non-cancellable with no renewal options and the annual rent is \$6,000. The lessor will charge the lessee five percent interest. The lessor calculates the amount to be derecognized.*

CALCULATION OF EQUIPMENT LEASE	
Carrying Value	\$20,000
Fair Value of Lease Payments	21,800
Fair Value of Asset	25,000
	\$17,400
NOTES	The remaining carrying value of \$2,600 will be recorded as a residual asset.

	ENTRIES RECORDED	
	Lease Inception	Year 1
Lease Receivable	\$21,800	5,000
Lease Revenue	21,800	
Residual Asset	2,600	
Cost of Sales	17,400	
Equipment	20,000	
Cash		6,000
Interest Income		1,000
NOTES	Record lease receivable and revenue of expected lease payments at present value. Reclass the carrying amount of the residual asset, and derecognize the remaining portion of the asset as a cost of sale. Net profit recorded of \$4,400.	Record lease and interest payments received and reduction to lease receivable.

New accounts that will be recorded on income statements or balance sheets using the Derecognition Approach under the new pronouncements:

Lessor Income Statement

- Lease income
- Interest expense
- Lease income and lease expense from reassessments
- Changes in the right to receive payments from reassessments
- Impairment losses

Lessor Balance Sheet

- Right to receive lease payments
- Residual assets

Other Changes in the Exposure Draft

Short-term leases

Under a short-term lease (twelve months or less), a lessee can elect to measure the right-of-use asset and obligation to pay rentals at the undiscounted amount of lease payments plus initial direct costs. The lessee will then recognize lease payments in the income statement over the lease term.

A lessor may elect to use the performance obligation or the derecognition approach, or a lessor may choose to recognize lease payments in the income statement over the lease term as they do today.

Subleases

Under the proposed standards, the intermediate lessor will account for the sublease as both a lessor and a lessee. The intermediate lessor will use the lessee accounting model to account for the assets and liabilities that arise under the head lease and apply the lessor accounting model for the assets and liabilities under the sublease.

Sale-Leasebacks

Sale-leasebacks will no longer provide off-balance sheet financing since all leases will be recorded to the balance sheet under the proposed standards. To qualify as a sale, at the end of the contract both control of the asset and all but a trivial amount of the risks and benefits will have been transferred to the buyer.

Disclosures

Entities will have to identify and explain amounts recognized in their financial statements that arise from leases and explain how their leases may affect the amount, timing and uncertainty on future cash flows. The extent of disclosure is very significant and we encourage you to review the [Exposure Draft](#) for examples of the required disclosures.

Summary

There will be new considerations that will affect commercial real estate lease arrangements under the proposed accounting standards for leases. Companies will want to proactively structure real estate transactions to fit their financial profile and avoid unexpected effects from accounting for leases. In order to avoid any unexpected covenant and ratio issues, companies should communicate as early as possible with prospective and current lenders to ascertain that financial statement covenants appropriately reflect the proposed changes. It is also recommended that business leaders and corporate executives discuss possible scenarios with their accounting and real estate advisors in order to obtain strategic advice on how the new standards will impact current or future leasing and financial decisions.

We strongly encourage tenants and landlords to read the [Exposure Draft](#) and some of the white papers and commentary on the proposed changes and then let the Boards know how you feel. Interested parties should submit their comments by e-mail to director@fasb.org. Please note all comments received are part of the FASB's public file and are posted on its website.

Contact Us

For a more in-depth discussion about the implications of the proposed accounting standard, please contact:

STEVE HARDING
Chief Financial Officer

DEBBY LASSWELL
Senior Corporate Controller

713.270.7700
transwestern@transwestern.net

The information contained in this document is for general guidance on matters of interest only. The application and impact of laws, rules and regulations can vary widely based on the specific facts involved. Given the changing nature of laws, rules and regulations, there may be omissions or inaccuracies in information contained in this document. Before making any decision or taking any action, you should consult a professional advisor.

ATLANTA

3340 Peachtree Road, NE
Suite 1000
Atlanta, Georgia 30326
404.842.6600 Fax: 404.842.6601

AUSTIN

901 South MoPac Expressway
Bldg. 4, Suite 250
Austin, Texas 78746
512.328.5600 Fax: 512.328.9309

BALTIMORE

8820 Columbia 100 Parkway, Suite 310
Columbia, Maryland 21045
443.285.0770 or 301.621.8800
Fax: 443.285.0660

BETHESDA

6700 Rockledge Drive, Suite 400-A
Bethesda, Maryland 20817
301.571.0900 Fax: 301.571.0901

CHICAGO

200 West Madison Street, Suite 3300
Chicago, Illinois 60606
312.881.7000 Fax: 312.881.7084

DALLAS

5001 Spring Valley Road, Suite 600W
Dallas, Texas 75244
972.774.2500 Fax: 972.991.4247

DENVER

4643 S. Ulster Street, Suite 900
Denver, Colorado 80237
303.639.3000 Fax: 303.407.1453

DETROIT

32255 Northwestern Highway
Suite 206
Farmington Hills, Michigan 48334
248.932.2840 Fax: 248.932.1108

FT. LAUDERDALE

110 Southeast 6th Street
Ft. Lauderdale, Florida 33301
954.761.2311 Fax: 954.761.2381

FT. WORTH

100 Throckmorton Street, Suite 700
Ft. Worth, Texas 76102
817.877.4433 Fax: 817.870.2826

HOUSTON

1900 West Loop South, Suite 1300
Houston, Texas 77027
713.270.7700 Fax: 713.270.6285

LOS ANGELES

601 South Figueroa Street, Suite 2750
Los Angeles, California 90017
213.624.5700 Fax: 213.624.9203

MIAMI-DADE

201 South Biscayne Blvd, Suite 1210
Miami, Florida 33131
305.808.7310 Fax: 305.808.7309

MILWAUKEE

234 W. Florida Street, Suite 310
Milwaukee, Wisconsin 53204
414.937.5030 Fax: 414.224.7780

MINNEAPOLIS / ST. PAUL

706 Second Avenue South
100 Baker Building
Minneapolis, Minnesota 55402
612.343.4200 Fax: 612.343.4201

NEW ORLEANS

650 Poydras Street, Suite 2300
New Orleans, Louisiana 70130
504.528.9910 Fax: 504.528.9924

NEW YORK

10 East 53rd Street, 24th Floor
New York, New York 10022
212.537.0370 Fax: 212.537.0380

NORTHERN VIRGINIA

8614 Westwood Center Drive
Suite 800
Vienna, Virginia 22182
703.821.0040 Fax: 703.734.2837

OKLAHOMA CITY

235 North MacArthur, Suite 500
Oklahoma City, Oklahoma 73127
405.789.0900 Fax: 405.789.0905

ORANGE COUNTY

535 Anton Boulevard, Suite 150
Costa Mesa, California 92626
949.553.8500 Fax: 949.553.8510

ORLANDO

158 Tuskawilla Road, Suite 2324
Winter Springs, Florida 32708
407.253.3140 Fax: 407.253.3150

PHILADELPHIA

1700 Market Street, Suite LL06
Philadelphia, Pennsylvania 19103
215.568.2520 Fax: 215.751.9697

PHOENIX

2415 East Camelback Road, Suite 900
Phoenix, Arizona 85016
602.956.5000 Fax: 602.956.5333

SALT LAKE CITY

11778 S. Election Road, Suite 160
Draper, Utah 84020
801.972.5200 Fax: 801.972.5207

SAN ANTONIO

8200 IH-10 West, Suite 800
San Antonio, Texas 78230
210.341.1344 Fax: 210.377.2797

SAN DIEGO

5935 Cornerstone Court West
Suite 200
San Diego, California 92121
858.452.8668 Fax: 858.452.2585

SAN FRANCISCO

1390 Market Street, Suite 316
San Francisco, California 94102
415.503.1781 Fax: 415.503.1580

WASHINGTON, D.C.

1700 K Street, NW, Suite 660
Washington, D.C. 20006
202.775.7000 Fax: 202.775.7009



www.transwestern.net