

New Commercial Lease Accounting Rules—How They May Affect Both Owners/Landlords and Lessees

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As two of the accounting world's major governing bodies work to converge their standards on the recognition of revenue of contracts with customers, they are changing the rules on how lessees must address leases on their balance sheets and profit and loss statements. The result may drastically alter how commercial leases are negotiated.

Accounting rules require businesses to keep two basic financial statements which affect a business's tax liability as well as its ability to attract investors and obtain financing:

- A balance sheet listing assets and liabilities, with recorded assets equaling or balancing recorded liabilities plus equity; and,
- An income statement (sometimes referred to as a profit and loss, or "P&L," statement) listing the business's revenues and expenses making it possible to calculate the business's profits and losses.

Leasing is an important activity for many businesses because it is a means for gaining access to assets, obtaining financing, and reducing exposure to the risks of asset ownership. As two of the accounting world's major governing bodies—the Financial Accounting Standards Board ("FASB") and the International Accounting Standards Board ("IASB")—work to converge their standards on the recognition of revenue from contracts with customers, they are scrutinizing how businesses track lease expenses. New lease accounting rules ("Rules") are on the horizon, and they will change the way in which lessees must address leases with a maximum duration of more than 12 months on their balance sheets and P&L statements. Leases of 12 months or less must also be included if, considering all relevant economic factors, the lessee is "reasonably certain" to exercise an option to extend the lease beyond 12 months.

How do the Current Lease Accounting Rules Work?

There are two types of leases:

- Operating Leases; and,
- Capital Leases.

Operating Leases are those in which the owner of an asset gives the lessee a right to use the owner's land or other asset. The lessee never owns the asset and must return it to the owner/landlord after the lease ends. Most standard commercial leases are Operating Leases. The lessee's rent payments are listed as operational expenses on the P&L statement, but the leased asset stays off of the lessee's balance sheet for the simple reason that the lessee doesn't own it.

By contrast, Capital Leases (also referred to sometimes as "Finance Leases") are those in which the lessee ultimately acquires ownership of the leased asset by making a series of payments for the use of the asset, and then exercising an option to acquire ownership of the asset at the end of the lease term. Non-real estate assets such as vehicles, copiers, and computer equipment are often "leased" this way. For accounting purposes, a Capital Lease is treated similarly to a loan: the

asset is treated as being owned by the lessee and must be recorded as an asset on the lessee's balance sheet. Under the current lease accounting rules, only assets leased pursuant to Capital Leases are required to be recorded on a lessee's balance sheet. Under the new Rules, all leased assets will have to be shown on the lessee's balance sheet.

Why the Change?

FASB and IASB have decided that allowing lessees to keep certain assets off their balance sheets has created too large of a "blind spot" in the system. In other words, because of the prevalence of capital leasing for many companies, FASB and IASB have concluded that it is important for users of financial statements (investors, lenders, the Securities and Exchange Commission, and the Internal Revenue Service) to have a complete and understandable picture of a business's leasing activities. The existing rules have been criticized by the users of financial statements and other stakeholders for failing to provide a faithful representation of leasing transactions. The objective of the new Rules is to increase transparency and comparability among businesses by requiring them to recognize their leased assets and liabilities on their balance sheets.

The pending Rules will change how businesses calculate their value and will have an impact on real estate management systems, financial planning, budgeting and forecasting systems, and tax planning.

How do I Comply with the New Rules?

Essentially, leases will no longer be classified as "capital" or "operating." If (a) the lease is effectively a sale or method of financing, (b) the term of the lease represents most or all of the remaining economic life of the asset, and (c) the rent represents most or all of the fair market value of the asset, it will be considered a "Type A Lease." It will also be a Type A Lease if it includes an option for the lessee to purchase the asset and the lessee has a significant economic incentive to do so such as when the lessee has the option to purchase the asset for a token price less than its fair market value at the time of the purchase.

On the other hand, if the lease is essentially an Operating Lease such as an office building, retail, or other standard commercial real estate lease, it will be referred to as a "Type B Lease."

In connection with a Type B Lease, the new Rules will cause a lessee to account for the lease on the lessee's balance sheet by recognizing the right to use the underlying property as an asset, assigning a value to the right to use the asset, and the obligation to make the lease payments as a liability equal to the net present value of all rent payments remaining over the term of the lease. Type B Leases will be included as an operating activity.

Type A Leases will continue to have a more significant impact on the lessee's balance sheet because the asset—also known as the "right of use," or "ROU," asset—will be amortized differently: it is a front-loaded interest expense and a constant amortization expense. As a result, the impact on the P&L statement is higher at the beginning of the lease term than at the end. Whereas Type B Leases will be included under operating activities, Type A Leases will be included under financing activities.

Lessees will also have to monitor the "triggering" events of further mandatory reporting such as a lease renewal, modification, or termination.

How the New Rules Will Affect Both Lessees and Their Owners/Landlords

Lessees will list their leased assets on their balance sheets, and they will also record their future lease payment obligations over the course of the lease as an up-front liability at the start of the lease. Adding such a significantly-sized liability to the balance sheet may prove harmful to the ability of certain businesses to attract investors and lenders.

In many cases, this could cause a business to default on its current loans, such as when the lessee's financial covenants require it to maintain a debt-to-equity ratio that is only achievable without its significant Type B Leases listed as liabilities.

Therefore, owners/landlords can expect not only new lessees to raise new negotiated terms, but also current lessees to seek renegotiation of their existing leases, as follows:

- **Shorter Lease Terms.** The longer the lease term, the greater the up-front future lease payment liability a lessee must record on its balance sheet. Therefore, owners/landlords can expect lessees to ask for shorter lease terms and more renewal options.
- **Triple Net Leases.** The new Rules will require a lessee to record only the present value of future lease payments such as fixed rent during the initial term of the lease. As a result, lessees will want to reduce the liability reported on their balance sheets by separating the non-reportable future variable payments (such as taxes, insurance, and CAM expenses) separately from fixed payments. The clearest way to accomplish this is to structure a triple net lease in which the lessee agrees to pay a smaller fixed rent augmented by a pro-rata share of taxes, insurance, and CAM expenses, and repair and maintenance expenses that were previously included in the fixed rent.

The New Rules and Tax Treatment of Leases

While the new Rules will work a considerable change in accounting practices for businesses with leased assets, it is important to understand that they will **not** affect how a lease will be treated for tax purposes.

Conclusion

FASB and IASB are still working on the proposed Rules, which are unlikely to take effect until January 1, 2017, at the earliest. This date is closer than it sounds because existing leases will be subject to the new Rules, regardless of when they were initially executed, and many will need to be renegotiated and restructured based upon the lessee's existing loan terms or desire to attract investors.

In addition, lessees will need to develop acceptable methods for determining the monetary value of their leases which must be added to their balance sheets.

While the new Rules will undoubtedly affect lessees more than they affect owners/landlords, the latter will surely be affected as the new Rules cause lessees to make new demands during lease negotiations. To attract and retain lessees in this new accounting landscape, owners/landlords will need to be able to understand the financial pressures that will be placed on their lessees in connection with the new Rules. This will require owners/landlords and lessees to work hand-in-hand with their accountants and legal counsel in order to carve out leases which protect owners/landlords while allowing lessees to maintain control of their financial statements.

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