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## On the Horizon:

### CORPORATE REAL ESTATE EXECUTIVES PREPARE FOR LEASE ACCOUNTING CHANGES

In the past year, corporate real estate (CRE) directors have gained a greater understanding of proposed changes in lease accounting and what it will mean to their companies. Many, however, still face the daunting challenge of preparing their existing lease portfolio and reassessing the criteria for structuring effective leases going forward.

The U.S. Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB), are expected to issue an Exposure Draft in June or July clarifying changes to lease accounting standards that will capitalize all leases on the balance sheet by recognizing a lessee's rights and obligations. This article went to press before release of the Exposure Draft, but CoreNet Global members can download a Jones Lang LaSalle paper with the latest details in the Knowledge Center at [www.corenetglobal.org](http://www.corenetglobal.org).

The general direction that change will take is already known even though certain significant details may be lacking. The effective date of the new rule will be presumably in 2012 or 2013, and the Boards have established an anticipated issuance date for a final standard for mid-2011.

Organizations will no longer choose between two methods to classify leases today—as operating or capital leases—and instead will recognize an asset representing its right to use leased

property and a liability for its obligation to pay rent and other amounts.

The decision to change the standard is driven by the perceived lack of transparency around off-balance sheet obligations and the complexity of current lease accounting. Its impact is potentially significant. In 2005, public reporting companies in the U.S. were estimated to have a capitalized equivalent of \$1.3 trillion in operating leases, about 70 percent of the dollar amount in real property.

CRE directors have become increasingly aware of the proposed changes and impact in the past year. When Jones Lang LaSalle and CoreNet Global surveyed the latter's U.S. members in 2009, many CRE executives were hearing about the lease accounting change for the first time, and many more were only vaguely aware of its impact. A follow-up survey less than a year later showed much greater levels of awareness and engagement.

Features of the proposed standard include:

- Capitalization of leases based upon the present value of lease obligations, discounted at the lessee's incremental borrowing rate
- Capitalized value to include base rent, plus an estimate of contingent rent and other expected payment amounts, for the longest possible term considered likely to occur
- Elimination of the distinction between operating leases and capital leases

- Change in pattern of rent expense from straight line to a method similar to capital leases which results in front-loading expenses

- Reassessment of leases in subsequent reporting periods triggered by changes in estimates of lease term and contingent rent, leading to an adjustment of the right-of-use asset in most cases

- Simplified accounting for leases less than 12 months

- Lessor accounting that recognizes a lease receivable and corresponding liability for the lessor's performance obligation under the lease arrangement, leading to grossing up the balance sheet and income statement

The expected effects from the new standard will be significant and include:

- Substantially larger balance sheets from reporting leased assets and lease obligations
- Higher reported initial occupancy expenses as straight-line rent expense is replaced by amortization of the leased asset and high front-end interest expense
- Pressure on existing borrowing agreements related to covenants for leverage ratios and earnings
- Greater complexity in reporting and investment in information
- Higher reported cash flow (EBITDA) as rent that was previously "above the line" is changed to interest expense and amortization