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Accounting Boards Take Aim At Leases

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The Financial Accounting Standards Board and the International Accounting Standards Board are proposing significant changes to real estate lease accounting. At the prodding of the Securities and Exchange Commission, the Boards are attempting to ensure that the assets and liabilities associated with leases are more accurately reflected on a company's balance sheet, thereby creating more transparency of financial information and permitting easier comparability of balance sheets.

The Boards' proposed new regulations would in effect treat all leases as an asset with respect to the use of the leased property for the lease term, and a liability with respect to the obligation to pay rent, thereby eliminating the classification of leases as either operating leases or finance leases.

The following are some of the highlights of the proposal:

1. Leases with a term greater than one year would be affected.
2. Rent for the entire lease term due under a lease would be discounted to present value using the tenant's incremental borrowing rate and would be included on the tenant's balance sheet as a liability.
3. A lease with a renewal option would be treated as if the renewal option will be exercised if it is likely that the tenant will exercise the renewal option.
4. Contingent rental agreements (i.e., percentage rent in a retail lease) would require the tenant to forecast its future sales and include on its balance sheet the percentage rent based on such sales forecast together with minimum rent payable during the lease term.

The effect of the proposed changes could significantly impact the leasing market. Tenants may be inclined to negotiate shorter lease terms (including foregoing renewal options) in order to avoid increasing their debt. Commercial condominiums may gain in popularity as prospective tenants turn to purchasing their space rather than leasing it. Percentage rent deals may disappear altogether as retailers will not want to carry increased debt on their balance sheet based on speculative sales forecasts. Potentially there will be more breached debt covenants on loan documents. Clearly, the balance sheets of companies with hundreds or thousands of lease locations will be adversely affected as their debt levels would increase significantly.

The Boards are still in the process of taking comments on their proposals and will soon resume discussions to develop new standards for landlord accounting. The tentative effective date for the revised accounting standards is the second quarter of 2011. We will continue to monitor the development of the new accounting standards as the comment process unfolds.

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