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End of Operating Leases? Watch for Lease Accounting Changes

The Financial Accounting Standards Board ("FASB") and the International Accounting Standards Board ("IASB") are proposing dramatic changes to lease accounting rules that would virtually eliminate operating lease accounting treatment. The changes would affect all companies that lease real estate, and their company balance sheets, as a result of how leases would be classified under the proposed new rules as a capital lease transaction. One of the goals of the proposed revisions is to improve transparency in the financial reporting of lease transactions.

Under current FASB lease accounting rules, tenants are required to classify their leases as either capital leases or operating leases. The vast majority of leases are treated as operating leases. Under operating leases, the lease payments are considered a rental expense and there is no asset or liability recognized on the balance sheet. Capital leases, on the other hand, treat the tenant more like the owner of the leased property and the lease as a means to finance the acquisition of the leased property. Consequently, lease payments are treated as a liability over the term of the lease and the right to use the leased property as an asset.

A recent survey, conducted by accounting firm Grant Thornton of 2,800 businesses across the globe, found that 54% of businesses "are not aware of, and are therefore unprepared for, one of the most significant global accounting changes in the past decade: the virtual elimination of off-balance sheet leases." The Securities and Exchange Commission estimates that the accounting changes would lead public companies to put $1.3 trillion in leases on their balance sheets.

The potential impact from these accounting rule modifications will manifest themselves in a number of ways, including but not limited to: (i) balance sheets: tenants will have to recognize assets and liabilities for leases where in the past, as an operating lease, they did not; (ii) owning/leasing property: the distinction between owning and leasing property will diminish leading companies to perhaps look more favorably upon owning property rather than leasing; (iii) lease terms: lease terms will be shorter without renewal options to avoid putting more debt on tenant balance sheets; and (iv) loan covenants: tenant balance sheets will look more leveraged which may result in a tenant not being in compliance with loan covenants.

It is anticipated that the new lease accounting standards will be issued in 2012 with an effective date not likely before 2015.

If you have questions on this or any Real Estate or Tax matter, you may contact your Thompson Coburn attorney or one of the Real Estate or Tax attorneys listed below.

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