Accounting for Real Estate Leases or We're not in Kansas anymore!

Big news folks, the Financial Accounting Standards Board is modifying how real estate leases will be presented on a company's financial statement. (YAWN) But wait, this is very meaningful to both real estate owners and tenants, especially if you borrow (LOL).

Now for some details. In 2013 the Financial Accounting Standards Board ("FASB") issued a proposed Accounting Standards Update regarding leases (Topic 842 of the FASB Codification). Historically companies classified their leases as either a capital lease or an operating lease. Real estate rental agreements have been classified as operating leases. Under an operating lease there has generally been no asset or liability set up on the company's balance sheet. Users of financial statements, such as commercial lenders, have requested to have the assets and liabilities related to these leases reported on the balance sheet to provide greater transparency in understanding an entity's true financial position.

Currently Generally Accepted Accounting Principles ("GAAP") related to operating leases is as follows <u>for LESSEES</u>. The lessee records rent expense over the term of the lease. If the lease includes predetermined rent escalations or rent abatements, the rent expense must be recognized on a straight-line basis over the lease term, with a deferred rent liability or asset reported on the balance sheet for the difference between cash paid and rent expense. In addition, GAAP requires footnote disclosure of the future minimum rental commitments, by year for the subsequent five years and in aggregate for all years thereafter.

For example, assume the following fact pattern. On 1/1/20X0, ABC Co. ("lessee") enters into a contract to lease property to be used as office space from XYZ Landlord Co. ("lessor"). The lease term is for 5 years with payments beginning at $60,000 per year due at the end of the year, and increasing 3% each year. The lessor bought the building on 1/1/20X0 for $1,000,000 and it has a useful life of 30 years. The lessee's incremental borrowing rate would have been 5% for a five year term.

	20X0	20X1	20X2	20X3	20X4	Total
Cash Outlay	$ 60,000.00	$ 61,800.00	$ 63,654.00	$ 65,563.62	$ 67,530.53	$318,548.15
Rent Expense	$ 63,709.63	$ 63,709.63	$ 63,709.63	$ 63,709.63	$ 63,709.63	$318,548.15
Change in Deferred Rent Liability	$ 3,709.63	$ 1,909.63	$ 55.63	$ (1,853.99)	$ (3,820.90)	$ (0.00)
Deferred Rent Liability	$ 3,709.63	$ 5,619.26	$ 5,674.89	$ 3,820.90	$ (0.00)	

<u>For LESSORS</u> current GAAP states that the lessor records rent revenue over the term of the lease. The real property remains on the lessor's balance sheet, as they own the asset; the lessor records depreciation expense over the useful life of the asset. Similar to lessee accounting, if the lease includes predetermined rent escalations or rent abatements, the rent income must be recognized on a straight-line basis over the lease term, with a deferred rent asset or liability reported on the balance sheet for the difference between cash received and rent revenue. An example of the lessor's accounting using the same fact pattern as above is as follows.

	20X0	20X1	20X2	20X3	20X4	Total
Cash Received	$ 60,000.00	$ 61,800.00	$ 63,654.00	$ 65,563.62	$ 67,530.53	$318,548.15
Rent Revenue	$ 63,709.63	$ 63,709.63	$ 63,709.63	$ 63,709.63	$ 63,709.63	$318,548.15
Change in Deferred Rent Asset	$ 3,709.63	$ 1,909.63	$ 55.63	$ (1,853.99)	$ (3,820.90)	$ (0.00)
Deferred Rent Asset	$ 3,709.63	$ 5,619.26	$ 5,674.89	$ 3,820.90	$ (0.00)	
Building Asset	$1,000,000.00	$1,000,000.00	$1,000,000.00	$1,000,000.00	$1,000,000.00	
Depreciation Expense	$ 33,333.33	$ 33,333.33	$ 33,333.33	$ 33,333.33	$ 33,333.33	
Accumulated Depreciation	$ 33,333.33	$ 66,666.67	$ 100,000.00	$ 133,333.33	$ 166,666.67	

Under the proposed new standard, the lessee would record a right-of-use asset and lease liability, calculated as the present value of lease payments. The amortization of the right-of-use asset and discount on the lease liability would be calculated on a straight-line basis and recognized as a single lease cost on the income statement. Using the preceding example, the present value of lease payments would be $274,151.84. Once again, an example of the proposed rule for lessees looks like:

	20X0	20X1	20X2	20X3	20X4	Total
Cash Outlay	$ 60,000.00	$ 61,800.00	$ 63,654.00	$ 65,563.62	$ 67,530.53	$318,548.15
Right-of-use Asset	$ 224,451.96	$ 172,415.51	$ 117,814.48	$ 60,422.80	$ 0.00	
Lease Liability	$ 228,161.59	$ 178,034.77	$ 123,489.37	$ 64,243.70	$ 0.00	
Total Lease Expense	$ 63,709.63	$ 63,709.63	$ 63,709.63	$ 63,709.63	$ 63,709.63	$318,548.15
Interest Expense	$ 14,009.75	$ 11,673.18	$ 9,108.60	$ 6,317.95	$ 3,286.83	$ 44,396.31
Amortization Expense	$ 49,699.88	$ 52,036.45	$ 54,601.03	$ 57,391.68	$ 60,422.80	$274,151.84

However, unlike, the proposed accounting changes for lessees, there are not significant changes for the lessor. The lessor would continue to recognize the owned asset (i.e. real property) on their balance sheet; would continue to record rent revenue over the term of the lease on a straight-line basis.

As there are not significant changes for the lessor, the proposed new standard would not have a substantial impact on lessor's financial statements. However, it would have a substantial impact on lessee's financial statement. Lessee's assets and liabilities would increase based on the calculated present value of the lease payments; thereby increasing important factors and ratios that banks look at when analyzing a borrower's financial statements. Most notably, this would increase a lessee's debt and debt-to-equity ratio. Although this would result in a negative impact to these items on the balance sheet, the effect on the income statement would be positive as the expense would be a below the line deduction, therefore, increasing the lessee's EBITDA.

These changes would only affect leases with a term of greater than 12 months. For those leases with a maximum term of 12 months or less, they would still be treated under the current GAAP for operating leases.

It is essential if you have existing loans, accompanied by lender covenants, to explain the new accounting regulations to your banker before they call your loan in default for non-compliance with covenants. More than likely, the lender will be required to re-write its covenants to comply with the newly proposed regulations. And inevitably, the cost of re-writing the covenants will be borne by the borrower (YOU).

So GAAP for operating leases is being changed for "transparency." As the Wizard said "Why, anybody can have a brain. That's a very mediocre commodity. Every pusillanimous creature that crawls on the Earth or slinks through slimy seas has a brain. Back where I come from, we have universities, seats of great learning, where men go to become great thinkers. And when they come out, they think deep thoughts and with no more brains than you have. But they have one thing you haven't got: a diploma."

Do not hesitate to call or email if you have any questions or require additional information on this subject.

Maura Lange is a Certified Public Accountant. She graduated from James Madison University and has both a B.B.A. and M.S.A. in Accounting. Maura started her career in the audit department of a Big 4 accounting firm. In June 2009, she joined Santos, Postal & Company [www.SantosPostal.com]. Maura is currently a Manager with Santos, Postal and provides a variety of services including audit, review, compilation, bookkeeping, tax, and consulting. Maura can be reached at mlange@santospostal.com or 240-499-1200.