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# For companies, big changes to lease accounting on horizon

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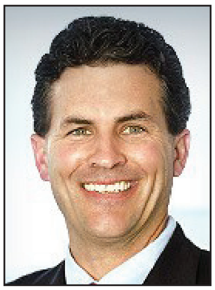

For many years, the U.S. Securities and Exchange Commission and others have complained that lease accounting standards are not transparent enough, allowing too many off-balance-sheet lease transactions to occur, which are not properly disclosed to investors.

New and dramatic changes to the lease reporting standards of the Financial Accounting Standards Board, and similar changes made earlier by the International Accounting Standards Board, should give companies good reason to quickly re-examine their overall approach and property portfolios.

The FASB's new accounting standards, issued in February, affect all types of lease assets, including real estate, airplanes and equipment.

Although the changes go into effect in 2018 for public companies and 2019 for others, it is important for companies to understand how these changes may impact their property portfolios. This starts with examining the current benefits of different lease types and sale-leaseback transactions, which many companies have used to their advantage.

With an understanding of the current accounting standards and the new changes, companies can begin planning a strategy for success moving forward.

## Defining capital and operating leases

Under the current accounting standards, leases are categorized as either "capital" or "operating" leases.

Through a capital lease, a lessee enjoys essentially the same benefits as if it owned the real estate. There are tests used to determine whether a lease is a capital lease, such as whether the lease's term encompasses at least 75 percent of the useful life of the property, the lessee has a bargain purchase option at the end of the term, or the minimum lease payments due under the lease equal 90 percent or more of the fair value of the property at the lease's inception.

> The question for all companies moving forward, then, will be whether it is more advantageous to lease or own their properties in light of these new standards.

Any lease not classified as a capital lease is called an operating lease and is subject to very different reporting requirements. Under the current accounting standards, while capital leases are recognized on the balance sheet, operating leases are recorded only as a footnote on financial statements.

Classifying a lease as an operating lease can significantly improve a company's balance sheet.

If, for example, a property is leased under an operating lease versus owned with an accompanying mortgage, the rent payments owed in the future do not show up as debt on the balance sheet, and the property does not show up as an asset owned by the company.

As a result, controlling property through operating leases can improve certain financial ratios, such as return on assets and debt to equity, creating an opportunity to greatly enhance a company's overall financial picture and increase its borrowing ability.

## Benefits of sale-leaseback transactions

To leverage this opportunity, many companies have engaged in sale-leaseback transactions, which are accomplished through one-off transactions or in large multi-property transactions.

In a sale-leaseback transaction, a company that owns real estate sells it to a landlord investor, who, in turn, leases it directly back to the company under an operating lease.

In addition to the current benefits of operating leases, sale-leasebacks create favorable tax benefits for companies and free up cash that can be reinvested in core operations.

Sale-leasebacks also relieve companies of the concerns of longer-term ownership if they need a property only for a fixed number of years.

## Planning a strategy under the new standards

Under the new accounting standards, leases will be classified as either a "finance" lease, which is similar to a capital lease, or as an operating lease.

The liabilities under all leases, with the exception of those with a term shorter than 12 months and certain low-value leases, will need to be reported on balance sheets. This will impact all companies that have off-balance-sheet operating leases, and will have a large impact on many national retailers, restaurants, banks and others that have traditionally financed much of their business and expansion through sale-leaseback transactions.

Highly regulated businesses, such as health care, financial services and utility companies also will be heavily affected by these changes.

The question for all companies moving forward, then, will be whether it is more advantageous to lease or own their properties in light of these new standards. For certain high-credit companies, the cost of borrowing to purchase and own their real estate may be much less than the cost of their current operating leases, which may have been done originally to maximize benefits under the current accounting standards.

Under the new standards, since all leased real estate will affect financial ratios, more scrutiny will need to be given to when and how lease extensions and early terminations are exercised and how those provisions are negotiated for new leases.

Companies also will need to collect and manage much more information about the properties that they lease for disclosure purposes, such as the timing, cash requirements and future obligations under those leases.

As part of the analysis of existing leases, companies need to carefully analyze whether any changes to those leases will better maximize their benefit under the new accounting standards.

For example, because service charges, maintenance charges, operating expense payments and tax payments under leases do not get recorded on balance sheets, it is important that those types of charges are clearly delineated from other rent obligations.

Further, the way in which the lease's term and any renewal periods are described in the lease will have an effect on whether renewal periods will need to be included in the total term of the lease for accounting purposes.

If, for example, a tenant has significant financial incentives to exercise a renewal, the reported term also will need to include the renewal term. Occasionally, companies also will have a leasing arrangement embedded in other corporate agreements, such as service contracts, and those embedded leasing obligations will now need to be reported.

There will always be reasons for companies to either own or lease property based on other factors beyond these changes to the accounting standards. Given the immediate impact these changes will have on many companies, however, they should begin reviewing their property portfolios now.

In many instances, companies also will also want to renegotiate certain provisions of their existing leases, and may decide to own their real estate instead of leasing it.

Ultimately, companies will need to work closely with both their accounting consultants and legal team to both anticipate and minimize any adverse impacts of these new standards and plan a strategy going forward. MLW