New accounting standard to change how leased real estate reported on financial statements

By Paul Becht, CPA

A new accounting standard will significantly change the way leased real estate is reported on financial statements. Since the new guidance came out in early 2016, companies with long term leases have been digesting the new standard and determining how to adapt. Much has been written about the impact to tenants’ financial reporting. As the understanding of the accounting pronouncement comes into focus, commercial property owners are also beginning to see how it may impact behavior and could affect their business models.

For over ten years, the U.S. financial accounting standard setter, the Financial Accounting Standards Board (FASB), debated how to better reflect the way leased real estate and other assets are reported on financial statements in order to allow investors to compare such leases between companies. The argument being that companies could potentially modify lease terms in order to achieve different accounting on otherwise similar transactions. Therefore, the new guidance removed the bright-line rules that are in place and replaces them with principles-based criteria. The new standard is focused on control of the real estate or asset being leased. The standard is generally effective for public companies beginning in 2019 and for all other companies in 2020, with early adoption permitted for all.

Under existing guidance, a lease is categorized as either an operating lease or a capital lease with only capital leases presented on the lessee’s balance sheet. Operating leases were only described in the footnotes to the financial statements.

The new guidance categorizes leases as either operating or finance leases with all leases presented on the lessee’s balance sheet, with the exception of short-term leases of 12 months or less with no option to buy the asset that the lessee will likely exercise. Most lease agreements will be considered “right-to-use” assets and a lease liability will be recognized for future payments.

While the lease accounting for tenants will change, the accounting for lessors will be mostly unchanged from existing guidance with most of the change coming in the form of new terms. Certain components of tenant payments under a lease agreement may soon fall under the new revenue recognition guidance which takes effect beginning in 2018. Lessors may wish to early adopt the leasing standard to coincide with adoption of the revenue standard. Payments such as CAM charges and payments based on a percentage of sales may fall under either the new revenue guidance or the new lease guidance depending on the language and economic effect. Also, the treatment of initial direct costs will change in that the new guidance only allows incremental costs (i.e. commissions or early termination fees) to be capitalized. Other costs such as payroll and legal fees incurred during negotiation of a lease would be expensed. For most lessors, they will continue to classify their leases as operating leases and for financial reporting purposes they will typically recognize the income for those leases on a straight-line basis over the lease term.

The accounting impact of the new guidance is lessees will present a larger balance sheet as they reflect the right-to-use
assets and the related liabilities. However, of particular interest to lessors is the impact on tenant behavior. As more assets and liabilities are added to balance sheets, financial ratios will be impacted, bank debt covenants may need to be adjusted and more capital may need to be set aside. Banks are expected to adjust to the guidance by either scoping out such liabilities or adjusting debt covenant ratios. Keep in mind though, any operating lease liability will not be classified as debt but instead it will be presented along with other liabilities on the balance sheet. Another result of the ballooning of balance sheets could be lessees demanding shorter lease terms with no stated renewal options. Companies may also determine they are better off simply acquiring property rather than leasing.

Tenants in certain industries such as retail, where a company may have hundreds of leased properties, may find they require sophisticated software to help them comply with the new guidance. Employee training, processes, ERP systems and internal controls may require significant investment to implement the new rules. Likewise, lessors will likely be asked to provide tenants a detailed accounting of the lease and non-lease components of the payments associated with each lease so tenants can determine the proper accounting at the date of transition to the new guidance. Will lessors be prepared to share this pricing data?

Lessors should begin to consider the impact the new lease standard may have on their financial statements and operations. They should have an on-going dialogue with tenants to discuss the change and how the two parties anticipate the guidance will impact them, if any. By starting to consider the effect the new accounting for leases will have on their business, lessors can get ahead of the coming changes.

**About Paul Becht, CPA**

Paul’s practice is focused on overseeing audits and reviews of companies in a variety of industries, including real estate, manufacturing and distribution, the service industry and debt collection. He is also skilled at auditing employee benefit plans. Paul also assists clients in performing due diligence for mergers and acquisitions and collateral reviews for financial institutions. He offers guidance on accounting policies and procedures to improve operations and strengthen internal controls and has also done work advising clients on the accounting and reporting aspects of stock-based compensation plans.

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