



## INSIGHTS

### ***PREPARING FOR CHANGE: FASB'S IMPACT ON REAL ESTATE PORTFOLIO FINANCIAL REPORTING***

For years, FASB (Financial Accounting Standards Board) and IASB (International Accounting Standards Board) have been working on a project that will change the way real estate lessees account for their real estate leases that will result in significant balance sheet impact. The changes may become effective as early as June 30, 2011. The total balance sheet impact of these changes is estimated to be over \$1.25 trillion. Every company or firm that leases real estate or equipment will be impacted. This paper discusses the implications of these changes and how corporations should promptly consider strategies to prepare for them.

**The Issues.** A recent study by CoreNet Global showed that 99% of corporate real estate executives are substantially unprepared for this major change in U.S. and international accounting standards for the treatment of real estate lease commitments. 66% of respondents said the changes would have a significant or major impact on the size of their company's balance sheets.

There are two primary reasons for changing the regulations, which are more than three decades old. The common belief is that transparency is lacking in off balance sheet obligations. Further, current lease accounting lacks clarity and is confusing. Frequently, the lines are blurred between operating and financial leases. Similar transactions can even have different accounting models.

Leases are classified as operating or capital leases. Operating leases are off balance sheet and rent payments are reported on the income statement as a rent expense. Alternatively, capital leases appear on a company's balance sheet as both an asset and debt. The asset is depreciated and the debt is retired by the principal portion of "rent" payments split between interest and principal. The new FASB rules will require that all leases are treated as capital leases and as such will appear on the company's balance sheet.

#### **Implications for Corporate Real Estate.**

- Initial occupancy expenses could be as much as 20% higher. Rent obligations will no longer be a straight-lined expense. They will be exchanged for straight-line depreciation and imputed interest, which will be a higher expense at the front end of the lease.
- Debt to equity ratios and other balance sheet ratios will be adversely affected by the change.
- Earnings pressure will increase.
- EBITDA will be improved as rent that was previously "above the line" is changed to interest expense and amortization "below the line."
- Deferred tax liabilities will be created as an additional complication to the balance sheet.
- The complexity of reporting may add information system requirements to meet increased reporting requirements for audit preparation and support.
- Expense allocations to business units would change.

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- Strategies for lease terms and structures will change as there will be new consideration given to the effect of option dates, contingent rents, future sublease income, debt rates and exit costs to name a few.
- Lease vs. own decision criteria will change.

**Be Proactive.** The best approach for any corporate real estate executive is to plan ahead. There are several steps that can be taken to prepare for the looming deadline to minimize its sudden “shock” to the company, as many business leaders may not be anticipating these changes in real estate reporting. It is not too early to start your work now.

Create a team that includes all key stakeholders to be involved in the evaluation and implementation process. Communicating the proposed changes and potential issues early is important. Prepare an implementation strategy and timeline and coordinate with Finance, Accounting and Treasury. Together, the company can develop a comprehensive understanding and plan to proactively deal with the impact of the new FASB regulations. The corporate real estate department should then consider any changes required to its leasing policy. The leasing policy would likely change if the switch to capital lease treatment results in other than a minor change on its financial statements and whether such changes put the firm at a competitive disadvantage.

Corporate real estate departments should start by leveraging their existing information to quantify the impact of the change. Review the lease abstracts for actual terms per lease and sublease, cash security deposits and tenant improvement allowances. Evaluate a variety of approaches to lease structures and terms and lease vs. own decisions for current portfolio lease obligations and assets. Take a look at planned projects and consider new guidelines to avoid surprises and determine if the approach to these should be modified. Identify enhancements for the company’s lease administration system and determine the cost and timeline for implementing these changes.

It will be awhile before anyone knows if these changes will, indeed, be implemented. In the meantime, the smart corporate real estate executive will want to proactively evaluate the impact these changes in real estate reporting will have on the company’s financial statement and how the real estate portfolio strategy should change as a result.

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