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Commentary with

Revisions Could Change Playing Field for Treating Leases

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The Financial Accounting Standards Board is considering significant changes to ASC 840 (formerly known as FAS 13). These changes would affect the way commercial real estate leases are treated for accounting purposes by both lessors and lessees.

The International Accounting Standards Board has undertaken a joint project with the FASB as part of their Memorandum of Understanding (See Note below) for convergence projects. This joint project is intended to address criticism of accounting for operating leases.

Standards currently require off-balance sheet accounting and provide users of the financial statements with inadequate information regarding the obligation of lessees. The two boards' project to revise applicable standards may lead to a complete overhaul of lease accounting, eliminating the need to distinguish between operating and finance leases and resulting in all leases being reflected on the balance sheets of both lessors and lessees. The exposure draft of the new standard is expected later this summer, and FASB and IASB will seek comments from constituents.

Since the proposed revision of standards is expected to address the treatment of leases by both landlords and tenants, critics of the

proposed accounting changes have commented that it could have the potential to change the way both parties approach lease transactions in the future. It is possible that some tenants, those with good access to capital, may decide to purchase their premises and therefore benefit from any potential future appreciation and the tax benefits of depreciation since the lease itself would be recorded on the balance sheet. This could, for example, result in the transformation of more multitenant office buildings to office condos.

Tenants without the financial wherewithal to buy their real estate may make the strategic decision to seek shorter-term leases, or not include extension options, to reduce the proposed lease model's effect on their balance sheets. This, in turn, may lead landlords to seek higher lease payments to cover the perceived non-renewal risk of shorter term leases.

And neither of the factors previously mentioned even touch on the impact the leasing project could have on the processes and technology used to calculate, monitor and record leases.

While the lease accounting rule is not final, it is likely to take effect in the near future and needs to be paid close attention now, especially by real estate owners, users and investors. For more information on these and other regulatory, tax and accounting issues, visit **www.ey.com/realestate**.

(NOTE: In February 2006, the FASB and IASB issued a Memorandum of Understanding, setting forth the relative priorities within their joint work program in the form of specific milestones to be reached by 2008, related mainly to converging accounting standards. The MOU was updated in 2008 and in 2009 as a further affirmation of that commitment. The two boards also issued a joint statement describing their plans and milestone targets for completing the major MoU projects in 2011.)

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