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Fine Print: Could Accounting Rule Changes Magnify Real Estate Woes?

Real Estate Companies Try to Assess Impact of Accounting Changes That Could Severely Impact the Real Estate Decisions -- And Bottom Lines -- of Companies Globally

Proposed accounting changes requiring companies to capitalize their property leases on their financial statements and recent rules requiring owners to mark their property values to current market prices could have wide-ranging effects on the balance sheets and income statements of most businesses. The lease accounting changes alone could potentially cost U.S. companies well over $1 trillion -- and more ominously, few corporate real estate departments are prepared, according to a new report from CB Richard Ellis.

CBRE's white paper, "FAS Talking: Unpacking Real Estate's Impact on Financial Statements," is the latest in a series of reports by commercial real estate companies hoping to alert C-suites about the lease accounting changes proposed by the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) which potentially affect the earnings, capital requirements, debt covenant ratios and credit ratings of many if not most companies in the U.S. and globally.

A recent survey by Jones Lang LaSalle and CoreNet Global found that 99% of respondents had not fully evaluated the impact the lease accounting change would have on their financial statements and operations. Companies could be in for a massive shock, as two-thirds of respondents predicted that the new lease accounting standards -- characterized as a "stealth issue" by JLL officials in light of the recession and other significant accounting rule changes -- would have a significant or major impact on the size and health of their company's balance sheets.

The Securities and Exchange Commission estimated in 2005 that U.S. public companies would be forced to capitalize about $1.3 trillion in operating leases, which cover both real estate and leased equipment, under the new rules. Industry experts estimate that approximately 70% of all operating leases are for real estate, impacting balance sheets by $1 trillion or more.

The changes, currently under review by the two boards, would go into effect as early as 2011 or 2012. Editor's note: View the FASB lease accounting project web page here. But their effects could be felt sooner as corporate suites become aware of the changes and begin evaluating their real estate lease holdings and property portfolios, and begin making leasing decisions to head off potential negative impacts.

While regulators, enforcement authorities and the media are currently focused mostly on financial instruments, "real estate reporting is equally impacted" by the changes in accounting standards designed to improve transparency, efficiency and the need for accurate financial reporting in a volatile and distressed market, said Todd P. Anderson, CBRE senior managing director, global corporate services. Anderson co-authored the report with Michael M. Omiya, chief financial officer of Boeing Realty Corp., a wholly owned subsidiary of the Boeing Company.

"For many companies, the adjustments made to the financial treatment of these assets may have one of the strongest impacts to a corporation's financial outlook. The reality is, most companies are only beginning to understand these changes," Anderson said.

Lease Rule Changes: A Capital Idea

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The proposed changes to the Statement of Financial Accounting Standards No. 13, known as FAS 13, which governs the accounting of leases, would reclassify "operating" leases as "capital" leases, ending the long-standing and long-debated practice of accounting for leases as off-balance-sheet transactions. Operating leases typically represent more off-balance-sheet activity for a business than any other form of financing, according to the CBRE white paper.

In March of this year, FASB and IASB proposed that all operating leases be capitalized on the reporting entity's balance sheet. Initially, the standard would apply only to financial reporting by tenants, who would have to calculate the value of current leases and report them on their balance sheets. Depreciation and interest would be reflected on income statements as expenses.

Making matters more complex, the effect of the proposed change to the existing standard could be felt much earlier than the expected 2011 or 2012 implementation because FASB "has indicated that leases will not be grandfathered, so 2010 [lease] commitments could end up on the balance sheet in 2011," according to a May business briefing by Cushman & Wakefield.

"While the capitalization of operating lease changes could be a few years away, many corporations are evaluating their real estate portfolio strategies today in light of the potential impacts," Anderson and Omiya said in the CBRE report.

As a result, tenants will have to think carefully about the length of their leases and even whether it's in their continued financial best interest to lease property or to become owners in the near term. Each of the options come with their own pros and cons, the CBRE study points out:

Own Or Lease? Companies that own the majority of their properties won't see much of a change. However, a competitor that leases most of its space may see significant negative impacts to earnings and liabilities. Companies that own real estate can report depreciation and liability for the duration of their financing or even longer, however, the depreciation schedule for capitalized leases lasts only as long as the lease term.

Short- Or Long-Term Lease? Shorter-term leases will reduce the impact to financial statements. However, most commercial real estate leases are for longer terms due to a number of economic factors that benefit both the landlord and the tenant. Longer-term leases will increase the exposure of tenants to balance sheet assets and liabilities.

Mark-To-Market Changes

The FASB in 2006 adopted the mark-to-market standard -- Statements of Financial Accounting Standards No. 157, Fair Value Measurements -- commonly known as FAS 157. The standard went into effect for financial assets as of Nov. 15, 2007 and for non-financial assets, including real estate, as of Nov. 15, 2008. The IASB issued a similar standard that went into effect internationally on Jan. 1, 2009.

The FAS/IASB standards attempt to clarify the definition of fair-market value and the methodology required to recognize fair value and expand transparency and disclosure of fair-value measurements under generally accepted accounting principles (GAAP), including capitalized assets whose values may be impaired relative to their net book value.

With commercial real estate values having declined at an unprecedented rate during the recession, recognizing and recording real estate impairment write-downs produces a financial "double whammy." The write down reduces the asset value on the balance sheet while generating a pre-tax profit loss on the income statement. The new standard clarifies that the exchange price of a property is the value achieved in an "orderly market," while recognizing that an inactive market could lead to distressed, improper valuations due to the absence of comparable sales data.

"If a corporation has the financial wherewithal to carry the property until normalized market conditions return, the argument exists that the company should be able to avoid a distressed sale scenario in which

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the asset would be valued at a 'fire-sale' price," the CBRE white paper suggests.

All real estate service companies agree that understanding and education about the new reporting standards is the first step that will allow real estate departments to develop well timed, proactive portfolio strategies that could reduce the negative impacts of the accounting changes.

"Corporations conducting 'business as usual' without embracing the importance of financial accounting and reporting transparency for their real estate may be at the mercy of their own ignorance," warns CBRE, adding that the lack knowledge could cause companies to suffer year-end audits, unnecessary detrimental financial adjustments, "or in a worst-case scenario, years of competitive disadvantage due to the duration of the real estate transactions negotiated."

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