CBRE
ENTERPRISE NOTES

September 2014

Proposed Changes to Lease Accounting: Update
To Converge or Not to Converge… That is the Question!

Highlights

- The FASB and IASB continue to meet on a regular basis to deliberate various aspects of the proposed changes to lease accounting.
- Lease classification for lessees is still a polarizing issue for which compromise appears unlikely.
- The IASB supports a single approach to lease classification with all leases having a front-end-loaded expense pattern.
- The FASB supports a dual approach to lease classification:
  - Leases similar to today's capital/finance leases will have a front-end-loaded expense pattern.
  - Leases similar to today's operating leases will have a straight-line expense recognition pattern consistent with current lease accounting.
- Both Boards support all leases being capitalized, except for short-term leases (defined as leases with a duration of one year or less).
- Consensus appears to be reached on option periods, which will be considered part of the lease term if it is "reasonably certain" after considering all "relevant factors" that an economic incentive exists to exercise the option.
- The new standard will most likely be issued in 2015 with an effective date no sooner than 2018.

The Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB), collectively the "Boards," continue to meet on a regular basis to deliberate various aspects of the proposed changes to lease accounting. While some progress is being made, the Boards are still at odds over one of the more important aspects of the proposal involving the classification of leases and the associated expense-recognition patterns.

At the heart of the conflict is the critical question of whether all leases represent a form of financing. While the IASB believes this is the case, the FASB fundamentally disagrees. This issue is jeopardizing one of the Boards' primary objectives, which is to attain a fully converged standard allowing all leases to be accounted for uniformly around the world.

This polarizing issue is not new to the deliberation process. In fact, CBRE's Lease Accounting Task Force (Task Force) reported on this issue more than two years ago in our July 2012 update. Leslie Seidman, who was chairperson of the FASB at that time, stated "I have been convinced that just because you write 'Lease' at the top of the paper does not mean that they all convey the same rights and obligations." This belief is fundamental to the FASB's position that not all leases should be treated in the same manner, which is in direct conflict with the IASB's belief that all leases are created equal and are, in essence, a form of financing. While back in 2012, the Boards seemed willing to compromise to resolve this issue, compromise does not appear likely today.

IASB Perspective: Single Approach

The IASB would like all leases capitalized by lessees (except for short-term leases, which are defined as leases with a duration of one year or less) and classified as what is being referred to as "Type A" leases. The accounting treatment of Type A leases is based on the belief that this type of lease represents a form of financing. Type A leases will, therefore, have a front-end-loaded expense pattern similar to that originally proposed in the 2010 Exposure Draft (i.e., the expense will be higher in the early years and lower in the latter years of a lease). The accounting for these leases recognizes a combination of interest expense (associated with the liability) and amortization expense (associated with the right-of-use asset).

FASB Perspective: Dual Approach

The FASB also supports capitalizing all leases by lessees (except for short-term leases, which are defined as leases with a duration of one year or less). However, they believe a dual approach should be taken, whereby leases will be classified as either "Type A" or "Type B" in accordance with the principles of current lease accounting:

- **Type A** – Generally, leases that in today's environment are considered capital/finance leases based on current Generally Accepted Accounting Principles (GAAP) or International Financial Reporting Standards (IFRS) will be considered Type A leases. These leases will be accounted for in the same manner as the Type A leases proposed by the IASB (i.e., front-end-loaded expense pattern).

- **Type B** – Generally, leases that in today's environment are considered operating leases based on current GAAP/IFRS will be classified as Type B leases. These leases will be afforded a straight-line expense pattern, similar to today's operating leases, and the expense associated with these leases will be classified as rent expense. The typical real estate lease will be considered a Type B lease.

To be clear, while the Boards disagree about the classification of leases and the expense-recognition patterns, they agree that all leases (except short-term leases) should be recorded on a lessee's balance sheet.

Unfortunately, given the gridlock surrounding the lease classification issue, there is a real possibility that, despite four years of deliberations, the end result could be different lease classifications and expense-recognition patterns applied based on whether a company follows GAAP or IFRS. This "non-convergence" could require multi-national companies to integrate two methodologies into existing systems and processes. This will require a longer integration process to implement the new standard and an increase in the associated costs, both in terms of monetary and human capital.

The Boards have indicated they will revisit the lease classification and expense-recognition pattern issue in the near future; however, as each Board appears to be entrenched in its own philosophical framework, it is hard to envision consensus being reached on this topic.

Option Periods
On a positive note, the Boards appear to have reached consensus on one of the more contentious topics originally put forth in the 2010 Exposure Draft; whether or not option periods should be taken into account in determining the capitalized amount to be recorded on the lessee's balance sheet. After multiple false starts, the Boards seem to have decided that an option should be included in the lease term if it is "reasonably certain" after considering all "relevant factors" that an economic incentive exists to exercise the option. This threshold is similar to the one in today's accounting standards, and, like today, will not result in many options being taken into account in the determination of the lease term.

Timing
The Boards have recently acknowledged it is no longer realistic to issue the final standard in 2014. The standard is now expected "sometime in 2015." Given this timing, and the fact that the recently issued revenue recognition standard has an effective date of 2017 for public companies and the following year for private companies, it seems likely that the effective date for the lease accounting standard will be no sooner than 2018 for public companies and 2019 for private companies. However, for companies with comparative financial statements, the two years prior to the effective date will have to be restated to conform to the new standard.

For further information on the topic you can visit the websites of the FASB, IASB and the CBRE Task Force.

The CBRE Task Force will continue to keep you apprised on this important topic as further Board deliberations take place.

For more information, please contact:

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