Proposed Major Changes in Lease Accounting

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This article provides an overview of the more important aspects of the proposed changes to Generally Accepted Accounting Principles for leases; discusses the potential impact of the changes, assuming they are adopted, as well as certain problem areas associated with the new standards; and outlines practical steps which landlords and tenants should consider taking in light of that impact.

On August 27, 2010, the Financial Accounting Standards Board ("FASB") and International Accounting Standards Board ("IASB") jointly published an Exposure Draft, outlining proposed major changes to Generally Accepted Accounting Principles ("GAAP") for leases. The changes would modify GAAP accounting standards to require the capitalization of most leases now treated as operating leases.

This article is intended to: (i) provide an overview of the more important aspects of the proposed changes; (ii) discuss the potential impact of the changes, assuming they are adopted, as well as certain problem areas associated with the new standards; and (iii) outline practical steps which landlords and tenants should consider taking in light of that impact.

The Proposed Accounting Changes: An Overview

What types of leases would be covered?

Nearly all leases of real (and personal) property would be covered by the proposed changes. Exceptions include leases of biological and intangible assets, and leases of natural resources, such as oil and gas leases.

What is the general nature of the changes?

From its broadest perspective, the proposal would change GAAP accounting standards so as to capitalize most leases that are currently treated as operating leases. Generally speaking, the proposal would require: (i) tenants to carry on their books leasehold interests, as depreciable assets, and the associated rental obligations as liabilities and (ii) landlords to carry on their books leasehold receivables, representing

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the landlords' entitlement to rental payments from tenants during the lease terms, and liabilities representing the landlords' obligation to provide the tenants occupancy rights, and otherwise perform the landlords' lease obligations, during the lease terms. Note that rights and obligations relating to separately charged "distinct service components" would not be required to be capitalized under the new standards. While the Exposure Draft is not entirely clear as to what constitute charges for "distinct service components," the term may cover charges to tenants such as those for parking, insurance and utilities.

Would these changes also affect non-GAAP accounting?

These changes would not affect non-GAAP accounting, nor income taxes or cash flow.

Why are FASB and IASB proposing these changes?

The changes are intended to provide greater disclosure in GAAP financial statements, since operating leases are not generally reflected on the balance sheets of either landlords or tenants, and to harmonize GAAP treatment of leases with international accounting standards.

What are the proposed accounting changes for tenants, under most leases?

Tenants would be required to state as liabilities future lease payment obligations under leases, and capitalize as assets the leaseholds, on a discounted present value basis over the anticipated lease terms.

What would the impact of these changes be on tenants' financial statements?

The changes would result in increased liabilities and assets on tenants' balance sheets. On tenants' income statements, the revised treatment would have the effect of increasing expenses realized by tenants during the early years, and decreasing expenses incurred by tenants during the latter years, of the anticipated lease terms, when compared to the expenses which would be realized under the current straight-line method. This would in turn result in reduced net income, and increased earnings before interest, taxes, depreciation and amortization ("EBITDA"), during the early years of their lease terms, and increased net income, and decreased EBITDA, during the latter years of their lease terms. Note that the longer the anticipated lease terms, the greater the disparity between the effect the new treatment would have on tenants' net income and EBITDA during the early years, and the effect the new treatment would have during the latter years, of the anticipated lease terms.

What are the proposed accounting changes for landlords, under most leases?

Landlords would be required to book as assets their rights to receive lease payments, and book as liabilities their obligations to perform under their leases, on their balance sheets, in each case on a discounted present value basis over the anticipated terms of the leases.

What would the impact of these changes be on landlords' financial statements?

As with tenants, the changes would result in increased liabilities and assets on landlords' balance sheets. As to their income statements, landlords would realize greater net income during the early years, and less net income during the latter years, of the lease terms.

Key Issues and Problem Areas Under the New Standards

How would the anticipated lease terms be determined?

Landlords and tenants would generally be required to independently assess the anticipated lease terms, based on the "longest possible term that is more likely than not to occur." Where leases contain options to renew or extend, or early termination options, landlords and tenants would be required to each independently assess the longest possible terms which have more than a 50% chance of occurring.

How would contingent or uncertain rentals be calculated under the new standards?

Contingent rentals (for example, percentage rent under retail leases) and uncertain rentals (for example, CPI-based rent escalations) would have to be estimated by landlords and tenants, using the best available data.

Would calculations of leasehold assets and liabilities be subject to periodic reevaluation?

Yes. Landlords and tenants would be required to review, and where necessary reassess, all of the factual bases for their accounting treatments of leases, in connection with each new set of financial statements. Where the factual bases for their accounting treatment of leases have changed since the prior set of financial statements (for example, where the lease term is anticipated to be shorter or longer than was previously estimated), adjustments would have to be made in the current year.

Would landlords and tenants be required to disclose on their books the assumptions they used in calculating their leasehold assets and liabilities?

Yes. The proposed standards would require disclosure of all significant assumptions and judgments upon which the landlords' or tenants' lease accounting treatments have been based, including, in the case of tenants, disclosure of their anticipated lease terms, and the assumptions upon which those lease term assessments were based.

Timing and Transition

What is the timing of the finalization and implementation of the proposed changes?

Comments on the Exposure Draft were due by December 15, 2010. FASB has stated that the final standards are to be announced some time in 2011. Implementation dates are uncertain at this point, but it is anticipated that the new standards will take effect in either 2012 or 2013.

Would existing leases be "grandfathered"?

No. The new standards, once they take effect, would generally affect leases in existence at that time.

Is it possible that the final standards may differ in certain respects from those set out in the Exposure Draft?

Yes. Extensive input from the real estate industry, and other affected parties, was furnished by the December 15, 2010, deadline, and such input included opposition to certain features of the proposed standards.

Recommended Practical Steps for Tenants

Tenants should consider taking the following practical steps now, in addition to reviewing the final FASB rule changes once they are announced.

Review the impact of the proposed standards on their financial statements.

Tenants should carefully evaluate their current and anticipated leases under the proposed standards, and analyze the likely impact of the proposed new accounting standards, assuming they are adopted in substantially the same form as the Exposure Draft, on their GAAP financial performance.

Review their credit agreements.

Tenants should review their credit agreements as to: (i) their financial covenants; (ii) the likely impact of the accounting changes on their ability to comply with those covenants; and (iii) whether or not such covenants are already subject to a provision for automatic adjustment of those covenants based upon changes in GAAP standards. Covenants likely to be impacted would include net income tests, EBITDA tests, and debt (leverage) ratios.

Contact their lenders, if appropriate, to renegotiate financial covenants.

Once tenants understand the impact of the proposed changes on their financial condition, they should consider contacting their lenders to request modifications of their financial covenants to neutralize the effects of the proposed accounting changes, so as to help ensure that they remain in compliance once the new standards take effect.

Review their leases for problematic provisions.

Tenants should review their leases for provisions which would exacerbate the negative effects of the proposed new accounting treatment. Among other things, tenants should review their leases for provisions such as: (i) "gross" or "modified gross" rental provisions, which effectively increase the financial impact of the new standards by folding all or portions of expenses which might otherwise qualify as charges for "distinct service components," into rental obligations, thus effectively requiring capitalization of such expense obligations; and (ii) provisions which require the tenants to provide periodic financial statements to their landlords.

Contact their landlords to renegotiate problematic lease provisions.

Tenants whose leases contain problematic provisions under the new standards should consider contacting their landlords and requesting modifications to their leases so as to remove or neutralize any problematic provisions.

Review their future space plans and consult their real estate advisors.

Tenants should review their future space plans, and consult their real estate advisors, to determine whether or not those plans need to be modified in light of the proposed accounting changes, including whether or not the new standards make it more desirable for them to buy, rather than lease, space.

Review their software needs.

Tenants should review the adequacy of

their financial reporting software in regards to the additional burdens which would be imposed by the proposed new standards, and discuss possible enhancements to their software with their software providers, accountants and real estate advisors.

Recommended Practical Steps for Landlords

What practical steps should landlords take now, in anticipation of the upcoming changes? Landlords should do the following, in addition to reviewing the final FASB rule changes once they are announced.

Review the impact of the proposed standards on their financial statements.

Landlords should carefully evaluate their leases under the proposed new standards, and analyze the likely impact of those standards, assuming that the new standards are adopted in substantially the same form as the Exposure Draft, on their GAAP financial performance.

Review their credit agreements.

Landlords should review their credit agreements as to: (i) their financial covenants, if any; (ii) the likely impact of the changes on compliance with those covenants; and (iii) whether or not such covenants are already subject to a provision for automatic adjustment of those covenants based upon changes in GAAP standards. Covenants likely to be impacted by the changes would include net income tests, EBITDA tests and debt (leverage) ratios.

Contact their lenders, if appropriate, to renegotiate financial covenants.

Once landlords understand the impact of the proposed changes on their financial condition, they should consider contacting their lenders to request modifications of their financial covenants to neutralize the effects of the proposed accounting changes, so as to help ensure that they remain in compliance once the new standards take effect.

Review their form leases for problematic provisions.

Landlords should anticipate that tenants will request landlords to remove from their leases, or at least modify, potentially problematic provisions which would exacerbate the negative effects of the new accounting treatment on tenants. Such provisions include: (i) "gross" and "modified gross" rental obligations, which effectively increase the financial impact of the new standards on tenants by folding expenses which might otherwise qualify as charges for "distinct service components" into rental obligations (thus effectively requiring capitalization of such expense obligations, as well as base rentals); and (ii) any provisions which require tenants to provide periodic financial statements to their landlords.

Modify their form documents to remove problematic provisions.

In anticipation of tenant requests to remove problematic provisions, landlords should consider: (i) modifying their lease forms to remove provisions which can be problematic under the new standards; and (ii) preparing form lease amendments which can be used to accomplish the same goals as to existing leases.

Review their real estate investment portfolios and acquisition/disposition plans and financing arrangements, in light of the possible effects of the new standards.

While it is not yet possible to determine the full effects of the new standards on tenants' future demand for leased space, or on landlords' ability to finance property, the possibility that some tenants may elect to purchase rather than lease space, or may elect to lease space for shorter terms, due to the effects of the new standards should at least be taken into account by landlords as a risk factor.

Review their software needs.

Landlords should review the adequacy of their financial reporting software in regards to the additional burdens which would be imposed by the proposed new standards, and discuss possible enhancements to their software with their software providers, accountants and real estate advisors.

Conclusion

The FASB and IASB Exposure Draft outlining proposed major changes to Generally Accepted Accounting Principles ("GAAP") for leases, if adopted, will modify GAAP accounting standards to require the capitalization of most leases now treated as operating leases. Landlords and tenants should prepare for these changes.