

Proposed Changes to

Lease Accounting Rules (FAS 13)

A REAL ESTATE Perspective — July 2011

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Overview

The Financial Accounting Standards Board (FASB) as well as the International Accounting Standards Board (IASB) have issued proposals on how leases are to be accounted for by entities reporting under United States generally accepted accounting principles (GAAP) and International Financial Reporting Standards (IFRS).

If adopted in its current form tenants will have to record lease obligations on their balance sheets and landlords would have to reclassify balance sheet reporting.

Financial Accounting Standards Statement No. 13 (FAS 13) changes will have a material impact on both balance sheet and income statements of tenants and landlords and could lead to a significant change in leasing structures with accounting standards potentially driving business decisions.

Under the proposed standards, a **tenant** would likely see the following:

- Interest and amortization expense instead of rent expense on income statement.
- Higher expenses incurred during the first half of lease with lower expenses in the second half due to declining nature of interest.
- “Right of use” asset and rent liability obligation recorded on balance sheet.
- Impact on financial ratios, debt covenants and company value.
- Complex and subjective accounting analysis and administration costs (systems, staffing, audit and legal fees) to manage reporting requirements.
- Significantly more attention being paid to lease structuring.
- Elimination of most operating leases for entities reporting on a GAAP basis.
- Significant increase in the number of entities negotiating with lenders and investors to report on other comprehensive bases of accounting (e.g. income tax basis).

Overview

Under the proposed standards, a **landlord** would likely see one of two prescribed approaches:

Method One (most likely in real estate)

- The lease creates a new right and obligation.
- The ongoing right of the tenant to use the leased asset is now viewed as a service provided by the landlord.
- The performance obligation would be reduced as the landlord satisfies its service obligation and landlord would record rental income and interest income over the term of the lease.

Method Two

- The lease agreement transfers a portion of leased asset to tenant.
- A residual interest in investment property and lease receivable will be recorded to the balance sheet.
- Interest income and change in fair value of investment property instead of rental income on landlord income statement.

*** It is important to note that, if the proposed standards are finalized as currently written, ALL existing leases will be treated as NEW leases. ***

Proposed Lease Accounting Rules Update

In our September 2010 'Advice From the Pros' article 'New Leasing Standards Proposal – Could This Impact Your Company' we outlined significant changes being proposed to the way leases will be accounted for under U.S. GAAP. The proposed changes would significantly modify FAS 13. Currently, under FAS 13, leases are classified as either capital leases or operating leases. Simply stated, capital leases impact the balance sheet of an entity while operating leases do not (often referred to as "off-balance sheet" liabilities). Under proposed revisions to FAS 13, operating lease treatment would be eliminated and all leases with a maximum term greater than one year would be classified as capital leases, resulting in a material impact on balance sheets and financial metrics across many businesses.

In March 2011, the Financial Accounting Standards Board (FASB) released a summary of comments received from the public. FASB is currently evaluating what changes, if any, should be made to the proposed new FAS 13.

Based on comments released in March, there are currently three major areas being considered for revision at this time.

Proposed Lease Accounting Rules Update

Impact on Earnings:

Because the proposed FAS 13 would require tenants to record a “right of use” asset and corresponding liability, with related interest and amortization charges (as opposed to rent expense currently), earnings will generally be lowered in the early part of the lease term. FASB is considering creating two categories of leases: “finance leases” and “other than finance leases.” A lease classified as a finance lease would require interest and amortization expense as outlined in the proposed new FAS 13 while a lease classified as an other than finance lease would require straight line expense to be recorded on the income statement consistent with current lease accounting rules. Real estate and other business organizations have lobbied strongly that real estate leases should be categorized as other than finance leases, an outcome that appears highly unlikely.

Impact on Service Contracts:

Because of the broad definition of leases under the proposed revisions to FAS 13, it is believe the definition would include many service related agreements. FASB is considering a more precise definition of a lease to avoid requiring the capitalization of assets that are incidental to services being provided.

Measurement Uncertainty:

Because the proposed FAS 13 requires tenants to project lease terms, renewal options, contingent rents and residual value guarantees tenants would be required to record a liability that will only crystallize when the event actually occurs in the future. In case of contingency renewals and residual value guarantees, the revised FAS 13 as currently proposed, would bring much volatility to reported earnings. FASB is considering introducing a higher threshold for including lease renewal options in calculating lease terms. To address this issue, FASB is also considering eliminating requirements to include contingent rents and residual value guarantees projections from the standard.

While the proposed standard is not yet finalized, the revised FAS 13 will bring significant changes to both tenants and landlords with respect to how leases will be accounted for in the future. At the time of writing this article FASB and IASB announced they would expose the proposed lease standards for a second time because of significant changes made to the original model proposed last year. It is unclear when the new standard is expected to be finalized.

Proposed Lease Accounting Rules Update

To keep you up-to-date and well positioned to negotiate leases in the period leading up to adoption of new FAS 13, the following is a broad outline of the current proposed standard.

Tenant Accounting

Tenants will recognize an asset representing the right-to-use the leased asset for the lease term and a liability for the obligation to pay rent. The amount to be recorded, representing the right-to-use asset, is the net present value of the **expected lease payments** to be made over the **estimated lease term** at an interest rate equal to the tenant's incremental cost of borrowing.

Estimated Lease Payments

Lease payments include fixed rental payments, plus payments subject to uncertainty including contingent rentals (e.g. percentage rent), residual value guarantees and termination penalties. Lease payments exclude lease payments that represent a payment or reimbursement to the landlord for the distinct services provided by the landlord under terms of the lease agreement. (Examples of distinct services include utilities and common area maintenance charges but exclude real estate taxes and property insurance.)

Expected Lease Term

The lease term is the longest possible lease term that is more than likely not to occur ("more than likely" being where the probability of occurrence is greater than 50%).

Factors that the tenant would need to consider would include:

- Contractual factors including contingent rentals, termination penalties, and residual value guarantees
- Non-contractual factors including extent of tenant improvements, local regulations, and tax consequences
- Business factors including the location of the property, nature of the property, and its importance to entity.
- Tenants stated intentions and historic practices.

Proposed Lease Accounting Rules Update

Example:

A tenant executes a five-year lease with two five-year renewal options. The base rent is fixed at \$240,000 per annum. The tenant's incremental borrowing rate is five percent. The tenant believes it has a fifty percent chance of exercising the first renewal option and twenty percent chance of exercising the second renewal option.

Table 1	Annual Adjustments							
	Inception		Year 1		Year 2		Year 3	
Balance Sheet	DR	CR	DR	CR	DR	CR	DR	CR
Cash				240,000		240,000		240,000
Right-of-Use Asset	1,886,000			188,600		188,600		188,600
Lease Obligation		1,886,000	149,105		156,733		164,752	
Income Statement								
Amortisation Expense			188,600		188,600		188,600	
Interest Expense			90,895		83,267		75,248	

Proposed Lease Accounting Rules Update

Example (cont.):

Assume at the beginning of year three, the landlord believes there is a better than fifty percent likelihood that the second five year renewal option will be executed. The tenant would have to record the additional right-of-use asset and rental obligation. The adjustment in year three would change as follows:

	Annual Adjustments							
	Inception		Year 1		Year 2		Year 3	
Balance Sheet	DR	CR	DR	CR	DR	CR	DR	CR
Cash				240,000		240,000		240,000
Right-of-Use Asset	1,886,000			188,600		188,600	781,994	176,215
Lease Obligation		1,886,000	149,105		156,733		128,376	781,984
Income Statement								
Amortisation Expense			188,600		188,600		176,215	
Interest Expense			90,895		83,267		111,624	

Proposed Lease Accounting Rules Update

Landlord Accounting

Landlords will be required to apply one of two methods of accounting for leases – the Performance Obligation Model and the Derecognition Model. The method to be used depends on whether the landlord retains significant rights and benefits associated with the underlying asset. (1) During the expected lease term, or (2) after the expected lease term with the ability to re-lease or sell the underlying asset.

If the landlord retains significant risks or benefits associated with ownership of the asset, the landlord must apply the Performance Obligation Model to the lease. If the landlord does not retain significant risk or benefits, the landlord must apply the Derecognition Method. Since most lease terms are substantially less than the economic life of real estate, the Performance Obligation Model will generally apply.

Performance Obligation Model

The landlord will record a lease receivable (right to receive lease payments) based on the lease payments expected over the term of the lease plus any direct costs incurred by the landlord. Lease payments include fixed lease payments plus contingent lease payments, residual value guarantees, and termination penalties. The lease receivable is the net present value of expected lease payments to be made over the estimated lease term discounted at an interest rate equal to “the rate the landlord is charging the tenant.”

The proposed standard suggests “the rate the landlord is charging the tenant” could be, for example, the landlords incremental borrowing rate, the rate implicit in the lease (i.e. the rate that causes the sum of the present value of cash flows and the present value of the residual value of the underlying real estate at the end of the lease to equal the fair value of the underlying property) or, the yield on the property.

The lessor will record a corresponding lease liability. The real estate remains on the books of the landlord.

Proposed Lease Accounting Rules Update

Example:

A landlord executes a five-year lease with two five-year renewal options. The base rent is fixed at \$240,000 per annum. The landlord will charge the tenant the tenant interest at 10% per annum. Landlord estimates the lease term will be ten years.

Table 3		Annual Adjustments							
		Inception		Year 1		Year 2		Year 3	
Balance Sheet		DR	CR	DR	CR	DR	CR	DR	CR
Cash				240,000		240,000		240,000	
Lease Receivable	1,886,000				149,105		156,733		164,752
Lease Obligation		1,886,000		149,105		156,733		164,752	
Income Statement									
Lease income					149,105		156,733		164,752
Interest income					90,895		83,267		75,248

Important to note that there would be no adjustment required to carrying value of real estate and to annual depreciation expense.

Proposed Lease Accounting Rules Update

Derecognition Model

Where all significant risks and benefits of ownership of real estate have been transferred to tenant, the landlord will derecognize an amount of the real estate’s carrying value that represents the tenants’ right-to-use the asset. The remaining carrying value will be treated as a residual asset. The derecognized component of the asset as determined by dividing the fair value of lease payments by the fair value of the real estate multiplied by the carrying value of the real estate.

Example:

A landlord executes a fifty-year non-cancellable lease with two fifty-year renewal options. The base rent is fixed at \$240,000 per annum. The landlord will charge tenant interest at 10% per annum.

Table 4	Calculation of Residual Asset
Carrying Value	2,666,667
Fair Value of Lease Payments	2,383,490
Fair Value of Asset	3,000,000
Derecognition Amount	* 2,118,658
Residual Asset	* 548,009

* Derecognition calculation
Fair Value of Lease Payment / Fair Value of Asset * Carrying Value
or $2,383,490 / 3,000,000 * 2,666,667 = 2,118,658$

** Residual Asset calculation
Carrying Value – Derecognition amount
or $2,666,667 - 2,118,658 = 548,009$

Proposed Lease Accounting Rules Update

Example (cont.):

Table 5	Annual Adjustments							
	Inception		Year 1		Year 2		Year 3	
Balance Sheet	DR	CR	DR	CR	DR	CR	DR	CR
Cash			240,000		240,000		240,000	
Lease Receivable	2,383,490			1,729		1,910		2,110
Real Estate		2,666,667						
Residual Asset	548,009							
Income Statement								
Interest Income				238,271		238,090		237,890
Lease Revenue		2,383,490						
Cost of Sales	2,118,658							

Summary of Impact

There has been much speculation about the impact of the proposed rules on both tenants and landlords. To focus attention on how you might be impacted and emphasize the importance of careful preparation for the adoption, we have compiled a list of how the proposed rules might impact you:

- Steep learning curve to get up to speed with the standards and their implications.
- No so called “grandfathered” leases. All leases in existence as of the effective date of the new standard will be subject to the new rules.
- The traditional “straight line” treatment of rent expense (for tenants) or rental income (for landlords) will generally shift to higher rent in early years and lower rent in later years.
- Increased complexity of lease arrangements to minimize the impact of the standards on company financials. For example, retail leases might be structured with less emphasis on percentage rent to mitigate the negative impact on retailer’s balance sheet.
- Incentive for tenants to sign shorter-term leases (making more difficult for landlords to negotiate long-term leases) and tenants may opt out of renewal options to avoid accounting exercise of estimating lease terms and rent payments.
- Diminished leasing premiums particularly for single-tenant buildings. While the timing of the final adoption of FAS 13 is still unclear, the impact of its implications has already been felt. In a July 21, 2010 Wall Street Journal article announcing the purchase by Northrop Grumman of a new headquarter building in Falls Church VA, they wrote that “Northrop also took into consideration the low cost of borrowing money and **proposed new accounting standards that could make it less advantageous to lease real estate**” [emphasis added].
- Characterization of expenses will become critical. Payments that represent distinct services provided by the landlord in accordance with leases are excluded from capitalization. FASB has stated that taxes and insurance are not distinct service components because they are a consequence of the landlords’ ownership. Consequently tenants will have to capitalize payments related to taxes and insurance. Tenants will want to negotiate for larger base year numbers to minimize the amount of additional capitalized rent affecting the balance sheet.

Summary of Impact

- Tenants will see significant front-end loading of expenses.
- Tenants will negotiate for detailed listing of services which landlord will provide to exclude as much as possible of their operating expenses related obligations from capitalization. Leases lacking sufficient detail may need to be amended.
- Leases structured with expense stop and stipulated base structures will become structures of the past with. Base year and triple net lease structures will prevail.
- More and more private companies will negotiate with their investors and lenders to opt out of preparing their financial statements on a GAAP basis. Instead, they will elect to use the method of accounting used to prepare their tax returns as permitted under Other Comprehensive Basis of Accounting (OCBOA) rules.

Action Items

Although there is time before the proposed standards are adopted, the complexity of the changes and their broad impact within the operations of landlords and tenants, change should begin now. To focus attention on items that will require attention, we have compiled a list of action items for consideration:

- Establish who will head up the change management process, including who will be responsible for making key decisions with regard to judgment calls implicit in applying the proposed rules, and what changes might be necessary to existing leases and templates for leases in future.
- Assess company personnel and identify key members in accounting and leasing (landlords) or facilities (tenants) to develop an understanding of the proposed rules and to implement an education plan for those responsible for assessing, measuring, and reporting on same. In addition, ensure that the key members assess lease deals and lease strategies going forward to ensure appropriate strategic action is taken that coincides with the company's long term business goals.
- Evaluate the effects of the proposed rules and their likely impact on company financial reporting, debt covenants and valuations and what action needs to be taken with company lenders and company investors. Consider the possibility of substituting GAAP based financial statements with OCBOA based financial statements.
- Plan for a review of processes, procedures and available lease data necessary to capture and calculate annual adjustments including lease terms, contingent rents, expense recoveries, options etc. It is important to bear in mind for those companies who are audited that information accumulated and estimate calculations made should be maintained in a format that can be easily audited.
- Develop the company's accounting group to manage the additional accounting burdens necessitated by the proposed new rules. It is important to remember where GAAP financials are required, to establish a system that will maintain the accounting records necessary to prepare tax returns (that will continue to be prepared under existing rules).