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NEW ACCOUNTING RULES TO REQUIRE TENANTS TO REFLECT OPERATING LEASES ON BALANCE SHEET

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After several months of speculation, the consensus among real estate and accounting professionals is that tenants will be required to report operating leases on their balance sheets in coming years. This major change in treatment will be prompted by changes anticipated to be made to the rules of the Financial Accounting Standards Board (FASB) (the governing body in the United States) and the International Accounting Standards Board (IASB) (the governing body for G20 companies and U.S. companies whose financial statements are being used outside of the U.S.). The purpose of this change in treatment is to provide users of financial statements a better picture of a tenant's actual lease liabilities, which are not required to be shown for operating leases under current rules.

Although we still await issuance of the final revised rules from the FASB and IASB (which are expected later this year), the respective boards have come to several "tentative" decisions since they published an exposure draft outlining proposed rule changes for comment on August 17, 2010.

Importantly, the boards have settled on their original August 2010 proposal of a single approach to characterizing leases (i.e., instead of distinguishing between "operating" and "capital" leases as further described below), after flirting for several months with a kinder two-category approach. Rule changes for landlord accounting are anticipated also. However, the boards continue to defer their determinations on that issue, focusing instead on shoring up the rules for tenants.

Effect on Balance Sheet Treatment

Under current FASB rules, a tenant may treat rent obligations associated with "operating" leases as off-balance-sheet operating expenses. Keeping such assets off the balance sheet can enhance the company's return on assets. In addition, by leasing, rather than owning, its less profitable assets under an "operating" lease, a company essentially can finance certain assets without reflecting the associated debt on its balance sheet. Under current rules, a lease is classified as an operating lease if the lease term is significantly less than the useful life of the asset in question, and the landlord retains ownership rights and risks. Current rules require "capital" leases to be treated like owned assets, and such asset and the associated "debt" (a component of the lease payments) are included in the company's financial statement. A lease is considered to be a "capital" lease if (i) the ownership of the asset is transferred to the tenant during the term, (ii) the tenant can buy the asset at a nominal price at the end of the term, (iii) the asset will be leased for at least 75 percent of its economic life, or (iv) the present value of the lease payments equal at least 90 percent of the value of the asset.

The proposed new rules would remove the operating lease/capital lease distinction, treating all leases with terms of more than a year the same, and require all such leases to be reported on tenant financial statements. Under the proposed new guidelines, a tenant will be required to recognize both an asset — the tenant's right to use the property conveyed by the lease — and a corresponding liability — the tenant's obligation to make lease payments.

The "right of use asset" will be valued initially at the discounted net present value of the aggregate lease payments over the term of the lease.

The corresponding lease liability will equal the net present value of the lease payments at the interest rate in the lease. If the lease does not include an interest rate (which most do not), the tenant will use its incremental borrowing rate, the rate of return on the property included in the lease, or the implicit rate in the lease. If more than one of these is determinable, the implicit rate will be used. The interest expense on the rent liability will be calculated as it would be on any loan, and amortized accordingly. Contingent rent and other variable lease payments will be included with the lease liability only if they are tied to an index or rate, such as CPI or LIBOR. True contingent rent, such as percentage rent based on sales, will not be included.

While seemingly straightforward, the analysis is complicated by the fact that renewal, termination and purchase options will be evaluated to determine the "most likely" scenario to occur. The new rules will require tenants to include extension terms where

the tenant has a significant economic incentive to exercise the applicable renewal option (i.e., bargain rate rent). Similarly, a termination option will deemed to be exercised (and the corresponding lease term shortened) unless there is a significant economic incentive not to do so (i.e., material termination fee). Additionally, any purchase options contained within the lease will be deemed to be exercised, and therefore included in the calculation of lease payment liability and added to the asset determination, if there is a material incentive for the tenant to exercise such right.

The Securities and Exchange Commission predicts a recharacterization of over $1 trillion worth of operating leases, and commentators and experts have pointed out many potential adverse effects. In the first instance, the rule change will likely create an administrative burden on tenants attempting to true up their accounting. The recharacterization will also likely impact a company's compliance with debt coverage and similar loan covenant requirements.

Effects on Income Statements

The new rules will effectively decrease company earnings for the first half of the lease term, and increase earnings for the second half of the lease term, when the calculation is compared to recognizing a straight operating expense equal to lease payments required by current rules. The example at the bottom of this page reflects this front-loaded effect on earnings compared to current requirements. In this example, the tenant has a five-year triple-net lease with a $1 million per annum rent obligation. The lease does not state an interest rate, and the landlord has not disclosed a rate of return for the property. As a result, the tenant uses its incremental borrowing rate of five percent. This effect is analogous to purchasing the right of use asset at lease commencement for a net present value of $4,415,892.19 and paying the purchase price in installments of $883,178.44 over five years together with annual interest payments starting at $202,687.45 and declining thereafter.

Because the front-loaded interest expense will be determined based on the duration of the underlying lease term, this methodology may create incentives for tenants to pursue shorter leases and/or leases without renewal terms to avoid the potential of such renewal terms being included with the base term, as described above.

As we await the final adopted rules, the potential impact on the real estate industry remains unclear, but it is certainly an issue to be aware of while evaluating leasing decisions in the future. Also, depending upon the transition rules, tenants under current substantial operating leases might well reevaluate their initial decisions to be tenants as opposed to property owners.

Attorneys in Cozen O'Connor's real estate practice group are monitoring the developments in this changing environment. Please feel free to contact us before you commit to entering into a sale and lease-back transaction or a substantial operating lease.

Example Showing Front-Loaded Effect on Earnings

Year	Current Standard: Annual Rent Expense	Proposed New Standard: Depreciation	Proposed New Standard: Interest	Proposed New Standard: Total Expense
1	$1,000,000.00	$883,178.44	$202,687.45	$1,085,865.89
2	$1,000,000.00	$883,178.44	$161,895.46	$1,045,073.90
3	$1,000,000.00	$883,178.44	$119,016.41	$1,002,194.85
4	$1,000,000.00	$883,178.44	$73,943.65	$957,122.09
5	$1,000,000.00	$883,178.44	$26,564.85	$909,743.29
Total:	**$5,000,000.00**	**$4,415,892.19**	**584,107.82**	**5,000,000.01**

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