OFF BALANCE SHEET FINANCING, VIA REAL ESTATE "OPERATING" LEASES – SOON TO BE A THING OF THE PAST?

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On August 17, 2010, the Financial Accounting Standards Board ("FASB") released for public comment proposed changes to the generally accepted accounting practices ("GAAP") accounting standards for leases. Among other things, FASB decides various issues that determine the GAAP standards. The proposed new rules recognize that many leases are but alternative forms of financing. If and when adopted, the revisions to Accounting Standards Codification "Topic 840" will dramatically alter the balance sheet treatment of lease transactions.

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This article will first review the currently effective FASB standards concerning leasehold interests, particularly with regard to real estate leases. Next, the article will briefly recount certain criticisms of the present treatment, and the ten-year process towards establishing a "new" standard. Then, some of the computational aspects of the proposed changes will be examined. We will follow that with a short review of the public commentary received by FASB to date on the "Exposure Draft" proposed by the FASB and the International Accounting Standards Board ("IASB"). Finally, we will address certain loan covenants and certain other details that will need to be addressed in connection with the proposed change in lease accounting rules. Whether public comments result in revisions to the draft or not, the classical "off balance sheet" leasing transactions likely will soon be largely a thing of the past.

1. Current FASB Leasing Rules

Effective in November 1976, FASB issued Financial Accounting Standard 13 covering lease accounting. FAS13 has been amended at least 7 times. Numerous interpretative and technical bulletins have provided additional guidance. However, the general authority has remained in effect throughout 35 years. The latest version of the lease accounting rules and guidelines is codified in Accounting Standards Codification Topic 840 ("ASC 840").

Most real estate lawyers, when pressed, can tell you that a lease is a "capital" lease if any of the following are true: (1) ownership is conveyed to the lessee at the end of the term; (2) the lessee has a "bargain" option to acquire the property; (3) the lease term equals or exceeds 75% of the property's useful life; or (4) the present value of rents, using a discount factor of the lessee's incremental borrowing rate, is 90% or more of the property's fair market value at inception of

the term. If a given lease is not a "capital" lease under any 1 or more of these 4 measures, then the lease is an "operating" lease.

A capital lease under ASC 840 generally is treated as if the lessee financed the purchase the leased property. In this instance, the lessee's balance sheet will include the property as an asset. However denominated, the "rental" payments' present value will treated as a liability. The payments on a capital lease are then allocated between the reduction of the liability and an interest expense component.

Unlike capital leases, an operating lease under current ASC 840 typically has no effect on the lessee's balance sheet. The lessee records the lease payments, as they accrue, as rental expense.

2. Reasoning and Motivation For Change

With the basic rules currently under ASC 840, legal and accounting personnel were given a great deal of flexibility to structure any number of economic arrangements as operating leases. Under these guidelines, the applicable lease term is defined to include only the fixed non-cancelable term, together with certain renewal options, (such as "bargain" renewal options) which are "reasonably assured". In addition, only the scheduled minimum rental payments over the lease term are considered (including fixed rental increases or decreases). Thus, the 75% and 90% tests of the capital lease standard were easily avoided and could be designed around.

In 1996 and 2000, reports from the accounting standards boards of the US, the UK, Canada, Australia, New Zealand and IASB outlined a "new approach" to lease accounting that their staffs were recommending. Then, in 2002, the Sarbanes-Oxley Act was passed, signaling a

call for transparency in corporate affairs and more meaningful financial disclosure. Later in 2002, FASB and IASB entered into a Memorandum of Understanding to converge their rules to comparability and consistency. There is a self-imposed deadline of June 2011 to complete various projects under the Memorandum of Understanding.

On July 19, 2006, FASB and IASB announced a joint project to reconsider standards for lease accounting. The chairman of the IASB, Scotland's Sir David Tweedie, expressed the view that the current rules are "fundamentally broken". Tweedie is also credited with the thought that, during his life, he would hope to fly in an airplane that is shown on the balance sheet of the carrier flying him!

The recent release of the "Exposure Draft" in effect proposes an "update" to ASC 840. A public comment period is open through December 15, 2010. The Introduction and Invitation to Comment section notes that the capital/operating models have been criticized for failing to provide "faithful" representations of leasing transactions. The new approach is said to be one that "would ensure that assets and liabilities arising under the leases are recognized in the statement of financial position."

Under the proposed version of ASC 840 virtually every lease will be reflected on both the balance sheet of the landlord and the balance sheet of the tenant. Three additional measures will also have a significant effect, if the lease accounting standard as suggested is adopted. First, the lease term would be measured by the longest possible lease term that is "more likely than not" to occur, taking into account options to extend or to terminate. Second, an "expected outcome technique" will be used to determine variations in rent, including contingent rental based on consumer price indices and sales volume. Finally, measurements will be revised when changes

in facts and circumstances indicate a significant change in assets or liabilities since the previous reporting period.

A June 22, 2010 *New York Times* article reported that the revised lease accounting standards would require public companies to move approximately $1.3 trillion of off-balance sheet items onto their balance sheets. When private companies using GAAP accounting are also considered, the total balance sheet effect of the change could be closer to $2 trillion.

The proposed rules would be effective with annual financial statements for periods beginning on or after a fixed date determined when the rule is implemented. There will not be a grandfather provision for existing "operating" leases.

3. Tenant Accounting Under The Proposed Standards

The proposed standards eliminate the distinction between capital leases and operating leases for tenants and replace it with a "right to use" method that is similar to current accounting for capital leases. Under the proposed standards, on the commencement date of a lease, the tenant's balance sheet includes the right to use the underlying asset for the lease term as a right-to-use asset and the obligation to make lease payments as a liability. The value of the right-to-use asset equals the tenant's liability to make lease payments, reduced by the tenant's direct costs of acquiring or originating the lease (such as commissions, legal fees, and negotiating, preparing, and closing the lease).

The liability recorded to reflect the tenant's obligation to make lease payments is the present value of the lease payments over the lease term, determined on the basis of "expected outcome" as described below. The lease term represents the longest possible term that the tenant

determines is more likely than not to occur after estimating the probability of each possible term and taking into account any options to extend or rights to terminate the lease.

The process for estimating the lease term can be illustrated with the following example, which is a paraphrase of Paragraph B17 of the Exposure Draft:

1. An entity enters into a lease that has a non-cancellable 10-year term, an option to renew for 5 years at the end of 10 years and an option to renew for an additional 5 years at the end of 15 years. The entity determines the probability for each term as follows:

   (a) 40% probability of 10-year term

   (b) 30% probability of 15-year term

   (c) 30% probability of 20-year term.

   The term will be at least 10 years, there is a 60% chance that the term will be at least 15 years (a 30% chance of a 15-year term and a 30% chance of a 20-year term), but only a 30% chance that the term will be 20 years. The lease term is 15 years, which is the longest possible term more likely than not to occur.

The "expected outcome" represents the present value of the lease payments over the lease term, which the tenant calculates using all relevant information as follows:

1. Identify each reasonably possible outcome under the lease, which could include extensions or terminations of the lease, changes in contingent rent, and payments under a residual value guarantee (a contract term requiring the tenant to pay the

landlord the difference between the anticipated residual value of the leased asset and the actual residual value of the leased asset at the end of the term);

2. Estimate the amount and timing of the cash flows for each reasonably possible outcome (including estimates of contingent rent payable, amounts payable under residual value guarantees, and expected term option penalties, but <u>not</u> including the exercise price of a purchase option under the lease);

3. Determine the present values of the cash flows for each reasonably possible outcome using the tenant's incremental borrowing rate (the rate the tenant would have to pay to borrow, over a similar term and with similar security, the funds necessary to purchase a similar asset), or the rate charged by the landlord if it can be readily determined of those cash flows; and

4. Estimate the probability of each outcome and calculate a weighted average present value of the cash flows under a reasonable number of outcomes based on the probability that each outcome will occur.

The tenant's income statement will reflect interest expense on the liability to make lease payments, amortization of the right-to-use asset, any changes in the liability to make lease payments resulting from reassessment of the expected amount of contingent rentals and expected payments under term option penalties and residual value guarantees, and any impairment losses on a right-to-use asset.

The proposed standards provide that the tenant must amortize the right-to-use asset over the shorter of the lease term or the useful life of the underlying asset. The tenant's liability to

make lease payments is amortized using the effective-interest method. Neither the liability to make lease payments nor the right-to-use asset will be reassessed unless the value is impaired or there is a significant change in the liability to make lease payments.

4. Landlord Accounting Under the Proposed Standards

The proposed standards create two separate approaches to lease accounting by landlords: the "performance obligation approach" and the "derecognition approach." The landlord determines which approach it must use at the date of inception of the lease. Once an approach is applied to a lease, it cannot be changed.

The landlord must use the performance obligation approach if, on the date of inception of the lease, the landlord retains exposure to significant rights and benefits associated with the underlying asset either (1) during the expected term of the lease or (2) after the expected term of the lease by having the expectation or ability to generate significant returns by re-leasing or selling the underlying asset. The landlord must use the derecognition approach if the landlord does not retain exposure to significant rights and benefits associated with the underlying asset.

Exposure to Significant Rights and Benefits Associated with the Underlying Asset

Under the proposed standards, a landlord must consider the following factors when assessing whether it retains exposure to significant risks or benefits associated with the underlying asset during or after the expected term of the current lease:

1. During the expected term of the lease:[†]

[†] Exposure Draft, Exhibit B, ¶ B22.

(a) significant contingent rentals during the lease term that are based on the use or performance of the underlying asset;

(b) options to extend or terminate the lease; and

(c) material non-distinct services provided under the current lease.

2. After the expected term of the lease:[‡]

(a) whether the duration of the lease term is not significant in relation to the remaining useful life of the underlying asset; and

(b) whether a significant change in the value of the underlying asset at the end of the lease term is expected. In making that assessment, the lessor shall consider:

(i) the present value of the underlying asset at the end of the lease term, and

(ii) the effect that any residual value guarantees (including those provided by an unrelated third party) may have on the lessor's exposure to risks or benefits.

Performance Obligation Approach

The landlord is required to use the performance obligation approach, which is similar to the current method of accounting for an operating lease, if the landlord retains exposure to

[‡] Exposure Draft, Exhibit B, ¶ B24.

significant rights and benefits associated with the underlying asset. With this approach, the landlord continues to carry and depreciate the leased asset on its balance sheet. On the date the lease commences, the landlord's balance sheet includes the right to receive lease payments as an asset and the landlord's obligation to allow the tenant to use the underlying asset for the lease term as a lease liability.

The value of the right to receive lease payments is determined using the present value of the lease payments over the lease term (the "expected outcome" determined in the same way as it is for tenants), reduced by the landlord's direct costs of acquiring or originating the lease (such as commissions, legal fees, evaluating the tenant's financial condition, securing the lease, and negotiating, preparing, and closing the lease). The lease term is determined in the same way for landlords as it is for tenants, and represents the longest possible term that the landlord determines is more likely than not to occur after estimating the probability of each possible term and taking into account any options to extend or rights to terminate the lease.

Under the performance obligation approach, the landlord's income statement will reflect interest income on the right to receive lease payments, lease income as the lease liability is satisfied, and any changes in the lease liability resulting from reassessment of the expected amount of contingent rentals and expected payments under term option penalties and residual value guarantees when the lessor satisfies that liability, and any impairment losses on the right to receive lease payments.

Neither the right to receive lease payments nor the lease liability will be reassessed unless the value is impaired or there is a significant change in the right to receive lease payments.

Derecognition Approach

The landlord is required to use the derecognition approach, which is similar to the current method of accounting for a capital lease, if the landlord does not retain exposure to significant rights and benefits associated with the underlying asset. Under the derecognition approach, the landlord is deemed to have transferred to the tenant, at the commencement of the lease, a portion of the economic benefits associated with the tenant's rights to the underlying leased asset. When this occurs, the landlord derecognizes the portion of the asset transferred to the tenant (meaning that the carrying value of the asset on the landlord's balance sheet is reduced), recognizes the present value of the right to receive lease payments from the tenant (the "expected outcome" determined in the same way as it is for tenants), which creates a lease receivable, and recognizes revenue and cost of sales. The amount derecognized by the landlord is equal to the carrying value of the underlying asset (the leased property) multiplied by the fair value of the right to receive lease payments divided by the fair value of the underlying asset. The remaining carrying value of the leased asset is allocated to a residual asset.

> For example, Landlord enters into a 10-year lease with Tenant for a building, and Landlord determines that it does not retain exposure to significant rights and benefits associated with the building. Landlord carries the building at a value of $85,000 on its books, the building's fair market value is $100,000, and the present value of Tenant's lease payments over the lease term is $92,661.
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> On the date the lease commences, Landlord will derecognize $78,762 of the building's value ($85,000 carrying value x $92,661 present value of lease payments ÷ $100,000 fair value) and will have cost of sales of the same amount.

Landlord's balance sheet will include a lease receivable of $92,661 and a residual asset of $6,238 ($85,000 - $78,762). Landlord will have revenue of $92,661 and cost of sales of $78,762, so it will recognize profit of $13,899 ($92,661 revenue - $78,762 cost of sales) upon the commencement of the lease.

The right to receive lease payments is measured at amortized cost over the life of the lease using the interest method. Neither the right to receive lease payments nor the residual asset value will be reassessed unless the value is impaired or there is a significant change in the right to receive lease payments.

5. Early Feedback Based On Public Commentary

The August 17, 2010 Exposure Draft provides for public commentary through December 15, 2010. Apart from feedback made through correspondence to the FASB, there is also a protocol for e-mail suggestions and criticism, with postings to a website maintained by the International Financial Reporting Standards ("IFRS") Foundation.

As of October 12, 2010, there are 16 comment letters shown on the IFRS Foundation site, dated from August 19, 2010 through October 7, 2010. It can take up to 10 days for a comment letter to appear "live" on the website. Some common themes from the early commentary follow.

1. The treatment of short-term leases (defined as having a maximum possible term, inclusive of renewals or extensions, of 12 months or less) still can involve "bright line" determinations. As an extreme example, consider the use of an oil well drilling platform, at a cost of $500,000 a day. If the term is 1 year plus 1 day, the proposal would require capitalizing

the present value of the $180,500,000 in payments. If the term were 364 days, no capitalization would be mandated.

2. Several of the comments expressed that renewal options are not a guaranty of future expense, for the tenant, or income, from the landlord. It is a recurring theme that the parties to a lease usually cannot predict with any accuracy future renewals 15 or 20 years out.

3. Some parties are concerned that updated ASC 840 would make necessary the calculation of future rental factors such as forecasted CPI or sales results. One writer says that this exercise would be “at best, a wild guess”.

4. It is said that the new provisions for altering “carrying amounts” of lease liabilities may promote widespread inconsistency in application, as well as exposure to significant penalties for “guessing wrong” during previous reporting periods.

5. In the case of routine equipment rentals and other transactions which are not material to the financial statement as a whole, questions have been raised about “phantom” liabilities and assets resulting in “ballooned” balance sheets.

6. In a number of cases, a company may find that it is mathematically in violation of loan covenants due to a change in accounting principles, without any change in true economic financial position. For loan agreements that have and will be in effect for a number of years, it is perceived that difficulty may be encountered in today’s environment to negotiate corrective amendments, without acceding to some countervailing requests from the lender.

7. Certain of the parties providing public comment to date report that they serve clienteles consisting of principally small to medium sized companies. The general comment

from these practitioners is that the benefits from the new standard will likely outweigh the administrative and other costs. Some have suggested that revised ASC 840 deal with publicly traded companies differently from private businesses.

8. For mall landlords with multiple tenants, the proposed lessor accounting rules are said to be unnecessarily complex. For instance, in calculating lease receivables at any time, difficulties might be anticipated with such matters as co-tenancy provisions and "kick-out" clauses.

6. Some Potential Effects of The Proposed Changes

Several effects that may come out of the proposed changes are: (1) tenants may be inclined to negotiate shorter leases; (2) renewal and extension options may become less likely as a matter of course, as they make accounting more complicated and will require analysis of the effects that accounting for such options could have on the parties' financial statements; and (3) retail and office users who intend to occupy property for long periods of time may find it more favorable to own than to rent properties.

Users who borrow from financial institutions may feel a perceived impact on loan covenants concerning financial ratios and the like. The impact should be less significant when dealing with most sophisticated lenders, which already take into account the footnotes to financial statement and other information regarding current and future lease obligations, but it may take longer for the expectations of others to adjust to the new accounting regime. One significant result of the proposed changes is the likely increase in tenants' earnings before interest, taxes, depreciation, and amortization (EBITDA), as rent expense that is currently included when calculating EBITDA will be replaced with interest and amortization expenses that

are not. The accounting changes would likely increase the administrative burden for public companies and privately held companies that report using GAAP as well.