

New Lease Accounting Rules: Impact On Balance Sheet & Lease Structures

ALERT! – Taxes & Insurance To Be Capitalized

By: [Marc A. Maiona](#)

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In conjunction with the International Accounting Standards Board (“IASB”), the Financial Accounting Standards Board (“FASB”), which is the organization in the United States that establishes financial accounting and reporting standards, is developing a replacement of the current standard by which leases are to be accounted for, known as FAS 13. Under existing FAS 13 standards, leases are classified as either capital leases or operating leases. In a greatly simplified explanation, capital leases impact the balance sheet of an organization while operating leases do not. Historically most commercial tenants have favored operating lease treatment for purposes of their real estate commitments. However, the replacement of FAS 13 currently under consideration would eliminate the operating lease treatment and require all leases with a maximum term greater than one year to be classified as capital leases, resulting in a material impact on tenants’ balance sheets, financial metrics, etc.

With the August 17, 2010 issuance of both FASB’s and IASB’s respective Exposure Draft (“ED”) documents on the proposed new lease accounting standards, tenants were provided with a clearer picture of how the new accounting standards will likely apply.¹ The key word, however, is “likely” as the standards are not entirely finalized but are open for comment and potential revision. The final standards are expected to be issued in the second quarter of 2011. The major change for corporate lessees will be that their lease obligations (at least those with a maximum term greater than one year), will now impact their balance sheets, income statements and EBITDA calculations. However, there are other important provisions within the newly proposed ED which tenants should pay close attention to if their goal is to minimize the amount of the lease obligations which impact their financials.

Many have advised tenants their lease payments related to the landlord’s property tax and insurance costs would be treated as “executory costs” and thus not be capitalized. *FASB says otherwise.*

Under FAS 13 All Operating Expenses, Taxes, Etc. Are Excluded From Capitalization

Under the FAS 13 framework, tenants and their accountants and/or real estate advisors establish whether a lease is to be treated as an operating lease or a capital lease by, among other things, determining whether the present value of the minimum rent payments exceeds 90% of the fair market value of the subject property. In determining the rental amounts to be used for this calculation, so-called “executory costs”, including all amounts for taxes, insurance, operating expenses, etc., are excluded. Additionally, if any of those costs are imbedded in the base rent, they are to be removed (whether via estimated or actual cost data). In other words the base amount of operating expenses, taxes, etc. which are included in a tenant’s base rent under a modified gross lease structure are removed for purposes of running FAS 13’s capital lease tests to determine whether the lease is an operating lease or a capital lease.²

By way of example, assume a tenant was provided two options for its new lease: the first was a modified gross, base year structured deal with base rent of \$40 per square foot and the second option was a triple net lease carrying base rent of \$25 per square foot and anticipated triple net charges of \$15 per square foot, for a total of \$40 per square foot.³ Under FAS 13 the tenant would run its capital lease test utilizing \$25 per square foot for both leases. This is simple and straight forward.

¹ To find out more, visit the FASB website via www.fasb.org and the Leases section of the IASB website via <http://go.ifrs.org/leases>.

² Modified gross leases are referred to herein as leases where the base rent includes some base amount of operating expenses, taxes and/or utilities, above which the tenant is required to pay for its proportionate share. Modified gross leases include those leases which provide a tenant with either a “base year”, “expense stop” or “stipulated base amount” for purposes of determining their additional rent obligations.

³ Generally speaking, triple net leases take two forms: one where the tenant reimburses the landlord for its share of operating expenses, taxes and utilities without the benefit of any base offset and the other where the tenant separately contracts for all of the building’s services and insurance and pays taxes directly to taxing authorities.

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New Standard: Executory Costs Under FAS 13 Replaced By “Distinct Service Components”

The importance of the new ED in the context of operating expenses, taxes, utilities and/or common area maintenance charges has to do with the distinction between the payment of rent and the payment (or, more appropriately, the reimbursement), for services provided to a tenant under the terms of its lease. In their ED documents both the FASB and IASB have recognized many leases include service components, which are a type of “performance obligation”, and the service components can be distinct services with quantifiable costs. Ultimately, this boils down to payments of rent are to be capitalized while payments for distinct services tied to performance obligations are to be expensed as incurred. Critically, however, executory costs are not the same as distinct services. Instead, the devil is in the details with respect to what constitutes a “distinct service”.^{4, 5}

In accordance with the ED and the associated staff papers released by the accounting boards, “indicators that a good or service is distinct include:

- i. The good or service is identified separately in the contract.
- ii. The good or service has a distinct profit margin.
- iii. The good or service has a distinct function.”⁶

New Standard: Taxes and Insurance To Be Subject To Capitalization

Most leases separately identify the services a landlord (or, in the case of certain triple net leases, the tenant), is to provide to the tenant and/or building, and those services have distinct functions and profit margins. Therefore, the new guidelines will require tenants to capitalize rent payments but allow them to exclude those amounts which represent a payment or reimbursement to the landlord for distinct services provided by the landlord in connection with the requirements of the lease. At first blush this seems pretty innocuous as it would conceptually apply to all of the payments a tenant is required to make pursuant to the terms of its lease for operating expense, property tax, insurance, utility and common area maintenance charges, as well as to the portion of a tenant’s base rent, if any, which represents its base expense amount under a modified gross lease.

The old Boy Scout motto of “Be Prepared” comes to mind, as CFOs will find the impact on their balance sheet to be greater than expected – by as much as \$3 to \$10 per square foot per year over the term of each lease!

However, the new guidelines in the ED, including the background papers issued by FASB and IASB, do not make things quite so simple. **Importantly, the ED and associated staff papers do not view all operating expenses, taxes, utilities, etc. as being distinct service components.** Specifically, the boards have stated taxes and insurance are “not distinct from the lease,” because “they are a consequence of [a landlord’s] ownership of the building.”⁷ **Therefore, if the existing ED remains unchanged, tenants will have to capitalize the payments related to taxes and insurance. Additionally, they will also be required to adjust those capitalized amounts each year based on the expectation of future fluctuations in the taxes and insurance charges incurred by their landlord.** Under the hypothetical examples given above, assuming five dollars of the \$15 per square foot of expenses per year were related to taxes and insurance, the tenant would have to capitalize that \$5.00 per square foot charge over the term and would only be able to exclude the \$10 per square foot difference when calculating the capitalized costs which impact its balance sheet. Subsequently, if two years into the term of the lease the building is reassessed by the local taxing authorities, or if insurance premiums increase or decrease significantly due to insurers requiring higher or lower premiums to write, for example, windstorm or earthquake policies, the amounts the tenant originally calculated at lease inception and commencement as the corresponding asset and liability will have to be adjusted to reflect the changes in these contingent rentals.⁸ **In other words, the balance sheet impact from the new lease accounting rules is *not* limited to a tenant’s net base rent, and will require regular monitoring and revision.**

⁴ See FASB’s Exposure Draft, Leases (Topic 840), August 17, 2010, Section B7, page 43.

⁵ The ED cross-references to an Exposure Draft on Revenue Recognition issued by the boards for purposes of defining a “distinct performance obligation.” See FASB’s Exposure Draft, Revenue Recognition (Topic 605), dated June 24, 2010, p. 3 and 14-15.

⁶ Accounting for Arrangements with Service and Lease Components, IASB/FASB Joint Meeting Staff Papers, March 15, 2010, page 8.

⁷ *Ibid*, p. 18 (It should be noted the Staff Papers reflect the positions of FASB’s and IASB’s respective staff, while the ED reflects the boards’ official decision. On this particular topic, however, the Staff Papers and the ED are consistent.)

⁸ Unforeseen increases or decreases in tax or insurance costs chargeable to a tenant under the terms of its lease for prior or current periods (e.g., via a reconciliation statement issued by a landlord for the prior year’s actual expenses), would be expensed as incurred, resulting in an adjustment to the current period’s net income. Changes in these expenses which alter future expectations, however, will require an adjustment in the asset and liability over the remaining term of the subject lease.

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Important Considerations Going Forward:

1. Given the impact the tax and insurance components of a tenant's lease obligations will have on its balance sheet, tenants should begin the process of truly understanding how all of their leases are structured and how much they are paying via base rent and escalations in connection with these charges. Although the implementation of the new lease accounting rules is not expected to occur before 2012, tenants with a large number of leases will need ample time to research and quantify this issue for all of their leases, and corporate real estate directors will benefit from being proactive instead of reactive to their CFO and finance groups.
2. More than ever, tenants with base year structured leases will want to be certain they have audited their base year expenses. Currently, tenants with base year structured leases want to ensure their base year costs are as accurate and high as possible since higher base year expenses reduce their operating expense-related obligations through the term of the lease. However, now in addition to reducing their operating expense-related obligations, higher base year expenses result in a lesser amount of capitalized rent hitting the tenant's balance sheet.
3. It will be of greater importance for tenants to negotiate for protections against having to pay for increased property taxes which result from the sale of the building. Historically this has been important solely from the perspective of reducing a tenant's property tax-related obligations under its lease. Under the new lease accounting standards, however, an increase in property taxes resulting from a sale of the building will also have an impact on the tenant's balance sheet. For example, if a building sale results in a tax reassessment increasing the property taxes from \$3.00 per square foot to \$5.00 per square foot per year, the additional \$2.00 per square foot over the remaining term will be capitalized on the tenant's books. That an unrelated party selling its asset could impact another's balance sheet will be a very unwelcome realization for any tenant's CFO.
4. Tenants who lease an entire building will want to consider taking direct responsibility for insuring the building, with the landlord's consent and to a level accepted by the landlord's lender(s). In doing so it may be possible for a tenant to expense, rather than capitalize, its current period insurance expenses, thereby avoiding the associated impact on its balance sheet.
5. Tenants will be interested in ensuring their lease documents include a detailed listing of services which the landlord is to provide in order to be able to have the ability to exclude as much of their operating expense-related obligations from capitalization. Currently landlords are sometimes reluctant to provide too detailed of a listing for fear of creating an opportunity for dispute by a tenant over whether the landlord is doing what the tenant expected. Given the potential impact on a tenant's balance sheet from failing to have services separately identified in the lease, tenants will want their landlords to be more accommodating going forward.
6. Because the new rules for lease accounting will apply to existing leases when it goes into effect, tenants need to review existing leases to determine whether the services the landlord is to provide and obtain reimbursement for via operating expense escalations are adequately detailed in the document. Those leases lacking sufficient detail may need to be amended.
7. Greater transparency in the landlord's annual reconciliation of operating expenses, taxes, etc. will be necessary in order to allow tenants the ability to make the newly required adjustments to its financials in a timely and accurate manner. For example, it will not be enough for a landlord to simply issue a reconciliation statement without a detailed break down of the various components of those expenses. A tenant will need to be able to quickly and easily identify how much of its obligations were tied to the payment for "distinct service components" which can be expensed and how much were not.

Stakeholders Impacted:

- Corporate Real Estate
- CFOs / Finance Group
- Legal
- Private Equity Firms
- Analysts
- Investors
- Real Estate Brokers
- Landlords

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8. Tenants will be less likely to enter into a lease with an expense stop or stipulated base structure for purposes of determining their tax and operating expense obligations. With an expense stop or stipulated base lease structure, those amounts are arbitrarily negotiated and so who is to say, for example, how much of the tenant's \$10 per square foot expense stop is for taxes and insurance? Hence, base year (where the base amounts are at least verifiable) and triple net lease structures are likely to gain favor over expense stop and stipulated base structures for their ease of accounting treatment under the new lease accounting standards.
9. In order to be consistent with the balance of the ED, tenants with leases currently classified as capital leases under FAS 13 would have to restate the associated asset and liabilities in order to capture the property tax and insurance costs incorporated in the lease.⁹ While those costs were executory costs under FAS 13, based upon the current ED they will be subject to capitalization under the newly proposed standards.

Final Thoughts

Based upon direct discussions with FASB representatives following the issuance of the ED, the conclusion a tenant's lease obligations related to payments associated with a landlord's property taxes constitute a lease liability instead of a distinct service component or performance obligation is, in the author's opinion and experience, correct. The conclusion with respect to insurance expense related payments, however, seems at least somewhat debatable. For example, if a tenant leased an entire building and agreed to directly take responsibility for insuring the building, the associated cost would arguably be a period expense instead of a lease liability. On the other hand, if a tenant leased less than the entire building it would be either unwilling, unlikely or simply unable to insure the entire building itself, and therefore would be charged for its proportionate share of the landlord's insurance expenses. Those costs, pursuant to the ED, would be subject to capitalization. That one tenant would be able to expense insurance costs while another had to capitalize them simply due to the fact it leased less than the whole building certainly seems to defeat the consistency the accounting boards seek to achieve.

Additionally, based upon discussions with FASB's representatives the boards' decision that insurance costs are "not distinct from the lease," because "they are a consequence of [a landlord's] ownership of the building," was, at least in part, based on the belief a landlord's lender(s) would require insurance to be purchased, or that it would at least be prudent for a landlord to carry insurance, irrespective of lease requirements. If the decision on insurance ultimately hinges on lender requirements and prudence, would the absence of a lender (or a lender requirement) imply the tenant's payments related to its landlord's insurance costs could be expensed?¹⁰ So while the property tax aspect of the ED seems well established, it would not be surprising to see some clarification or change in guidance on the proper treatment of a tenant's payments related to its landlord's insurance costs when the final standards are released next year.

The Big Question: What Do I Do Now?

CyberLease, with twenty years of experience in auditing and negotiating commercial leases has formed the first lease accounting practice group to focus exclusively on providing stakeholders with the ability to obtain expert analysis of their lease obligations and the impact of the newly proposed lease accounting standards. Our systems, staff and technical knowledge allow for those impacted by the new standards to quantify the financial impact – *lease-by-lease and year-by-year* – and to plan for the implementation and on-going reporting the new standards will require. More information is available on our [website](#).

⁹ Paragraph 92 of the ED says the previously capitalized amounts for existing capital leases will be carried over under the newly proposed standards, but does not make explicit mention of the treatment of non-distinct services under those existing capital leases.

¹⁰ Arguably, a landlord lacking the purported prudence to insure its building would cause neither a lease liability nor a period expense for a tenant as there would be no insurance cost to consider.