BENNETT VALLEY LAW
www.bennettvalleylaw.com

REAL ESTATE TOPICS

OCTOBER 15, 2009

ACCOUNTING CHANGES TO AFFECT TENANTS

Under proposed changes to accounting standards, today's operating leases may be deemed capital leases and included on tenants' balance sheets. These changes would have an unfavorable and unanticipated impact on tenants' financial statements. Even though the underlying lease transactions will not change, tenants may find themselves in breach of financial covenants due solely to how leases are reported.

The proposed changes will affect current leases, not just future transactions. So it's important for real estate professionals to be aware of these proposed changes now.

Current reporting standards: Today, leases are classified by tenants as either capital leases or operating leases. Office, retail and R&D leases are typically classified as operating leases.

Under current accounting practices, an operating lease is not reported as either an asset or a liability on the tenant's balance sheet. Rather the tenant reports the lease payments on its income statement as an expense, typically on a straight-line basis over the life of the lease. Whether the transaction relates to a small office or multi-building campus, most operating leases are "off-balance sheet" transactions.

In recent years, the accounting treatment of operating leases has been criticized because it permits billions of dollars of liabilities to remain "off-balance sheet." The SEC has called for enhanced disclosure of lease transactions.

Proposed Changes: On March 19, 2009, the FASB issued Discussion Paper 1680-100, and it accepted public comments through July 17, 2009. The Discussion Paper and comments are available at www.fasb.org/leases.shtml#due_process.

If the changes move forward, then further drafts will be issued over the next year or so, and formalized standards could appear as early as 2012.

Under the proposed changes, all leases would be considered capital leases and reported as both an asset (a right-to-use) and a liability (payment obligation) on the tenant's balance sheet. The lease would be valued as the present value of the lease payments discounted at the tenant's incremental borrowing rate.

Helen Sedwick, Attorney at Law
Bennett Valley Law
707.546.4628

On the tenant's income statement, the rental expense would be treated as depreciation and an interest payment, similar to a purchase loan obligation. The interest component would be higher in earlier years, particularly for long-term leases. While the overall expense deduction (depreciation and interest) will be the same over the life of the lease, under the capital lease treatment, higher expenses will be recognized in the early years of the lease term.

As between the landlord and tenant, the proposed accounting changes do not affect their respective obligations toward each other. However, because they will affect the tenant's balance sheet and income statement, the tenant may find itself in breach of financial covenants in its financing or other agreements. Further, because the accounting changes will affect income statements, they may trigger changes in bonuses and earn-outs, again not because the underlying transaction has changed, but due to how the transaction is being reported for accounting purposes.

The Discussion Paper does not address whether there will be a transition period from the old standards to the new, whether there will be an exception for small leases, and how the changes will affect landlords and sublandlords (when a party is both a tenant and a landlord).

For now, real estate professionals should advise tenants to evaluate their leases as both capital leases and operating leases from an accounting perspective. In negotiating any financing or other documents with financial covenants and ratios, the parties should provide that so long as the covenants are satisfied under current standards, they will not be deemed breached by a change in accounting standards.

Some professionals feel these accounting changes may tip the balance towards owning real property instead of leasing, particularly for significant, stand-alone facilities.

This article is not intended to be a technical analysis of the proposed changes and their effects, but is an alert that these changes may be on their way.

The article above was prepared by Helen Sedwick of Bennett Valley Law. After more than 20 years of practicing law with major firms in San Francisco, Helen Sedwick founded her own firm, Bennett Valley Law, in 2007. She continues to specialize in commercial real estate transactions, primarily sales and acquisitions, leasing, entity formation, financing and management. Clients include developers, investors, start up companies, bio-tech companies, solar technology companies, wineries, restaurant franchisees and owners, and individuals. For more information, please visit www.bennettvalleylaw.com.

The information in this article is solely for informational purposes and is not, nor is it intended to be, legal, tax or other advice or to be a substitute for advice from qualified counsel. Because the information is general in nature, it may not pertain to your specific circumstances. You should consult an attorney and other professional advisors for individual advice.

Helen Sedwick is licensed to practice law in the State of California only. This article in not to be deemed a solicitation to provide legal services in any other jurisdiction.

Helen Sedwick, Attorney at Law
Bennett Valley Law
707.546.4628