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# Do Not Let ASC 840 Catch You Off Guard: Prepare Yourself for the New Lease Accounting Standards



On August 17, 2010, the Financial Accounting Standards Board ("FASB") issued exposure draft ASC 840 which is anticipated to become the replacement to the current lease accounting standards, known as FAS 13. Under existing FAS 13 standards, leases are classified as either capital leases or, more commonly, as operating leases. The basic meaning behind this differentiation is that capital leases impact the balance sheet of an organization while operating leases do not. The proposal currently under consideration would essentially 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 and income statements.

Though ASC 840 is merely a proposal, the final standards are expected to be issued in the second quarter of this year. The major change for corporate lessees will be that their lease obligations will now impact their balance sheets, income statements and EBITDA calculations.

In addition, there are other important changes specified in ASC 840 which tenants should not ignore. Most leases separately identify base rent from services a landlord provides. These services, often classified as "additional rent," include, among other things, property taxes, insurance costs and common area maintenance fees. Under the new ASC 840 guidelines, tenants will be required to capitalize rent payments but will be allowed to exclude those amounts which represent reimbursements to the landlord for distinct services provided by the landlord. At first glance this seems simple enough, but FASB has stated in no uncertain terms that it does not view all additional rent as being distinct service components. Specifically, the board has concluded that property taxes and insurance are in fact, "not distinct from the lease," but are a natural consequence of landlord's ownership of the building. Accordingly, as ASC 840 stands today, tenants will have to capitalize all lease payments related to taxes and insurance.

Moreover, tenants will be required to: (i) adjust said capitalized amounts each year based on forecasts of future fluctuations in said costs, and, (ii) in the case of leases requiring percentage rent, make adjustments for expected changes in yearly revenue.

The implication is those tenants with any income statement sensitivity will need to prepare for the forthcoming changes. The changes have not been finalized, and revisions to ASC 840 are probable. However, based on the initial exposure draft, real estate professionals are beginning to take proactive steps to address what may be in store. The following are some ideas that may prove helpful to tenants wishing to protect themselves.

In order to address the change in which components of additional rent are to be capitalized, tenants should begin the process of understanding how rent payment mechanisms in their leases are structured and how base rent and additional rent are bifurcated. Tenants with a large number of leases will need ample time to research this issue for all of their leases, and determine the potential income statement impact.

Tenants with modified gross leases utilizing a base year structure will want to be certain they have thoroughly audited their base year expenses. The importance of base year expense accuracy will be augmented by the proposed revisions. In addition to reducing the amount of operating expenses passed through to tenants, higher base-year expenses will result in a lower amount of capitalized rent hitting the tenant's balance sheet.

Tenants should ensure their lease documents include a detailed listing of services the landlord will provide in order to exclude as much of their operating expense-related obligations from capitalization as possible. Landlords are often reluctant to provide a detailed listing of services for fear of creating an opportunity for dispute over the landlord's required services. However, given the potential impact on a tenant's balance sheet from failing to have services separately identified in the lease, tenants will want landlords to be more accommodating going forward. Current leases lacking sufficient detail may need to be amended.

In connection with the preceding consideration, for tenants negotiating new leases, or lease extensions, greater consideration should be given to drafting robust tenant audit rights. The ability to discern between distinct and non-distinct service components (taxes and insurance costs) will be critical in minimizing income sheet impacts.

Proposition 13 protection takes on even greater importance. Under the new lease accounting standards, an increase in real property taxes resulting from the sale of the premises will also have an impact on the tenant's balance sheet. Prop 13 protection not only ensures that said cost increases aren't passed on to tenants, but also nullifies the corresponding impact to the tenant's balance sheet.

Tenants ignoring ASC 840's proposal, or procrastinating the implementation of steps to address it, do so at the risk of being caught off guard. The proposed changes will move an estimated trillion dollars onto companies' financial statements.

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