

Lease Accounting





Applicable Literature (pre-Codification)

- FAS 13
- FAS 66
- FAS 98
- FAS 141
- FAS 143
- EITF 97-1
- EITF 97-10
- EITF 98-9
- EITF 04-1
- FIN 21
- FIN 47
- FSP 13-1
- FTB 88-1

Post-Codification

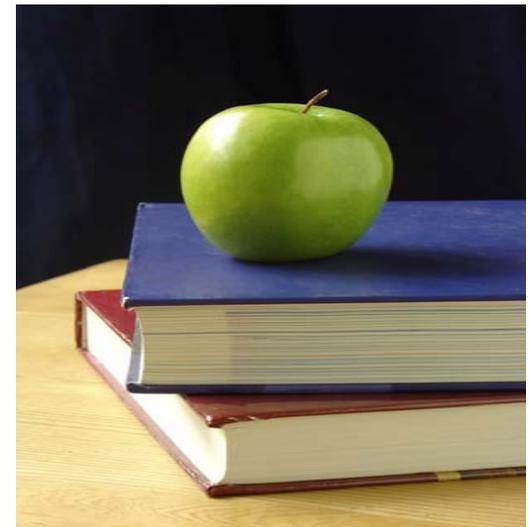
www.fasb.org; effective as of September 15, 2009

- 840 – Leases
 - o 840-10 – Overall
 - o 840-20 – Operating
 - o 840-30 – Capital
 - o 840-40 – Sale Leaseback Transactions

Codification does not change GAAP, merely changes referencing.

Other Resources

- Ernst & Young Financial Reporting Developments, *Leasing, A Summary*
- CCH, *Accounting for Leases*



FAS 13 – a great starting point

- Issued in November 1976
- The primary guidance in accounting for leases
- Classifies leases into “operating” or “capital”
- Defines important terms such as “incremental borrowing rate” (IBR)
- Deals with leases from perspective of both lessee and lessor; also discusses subleasing and leveraged leases.

Lessor, Lessee, Subleasing?

We will discuss primarily from the lessee (“expense side”) perspective, and more from a real estate than equipment leasing perspective.

Lessor, Lessee, Subleasing? (continued)

But let's take a quick look at acting a lessor, and then subleasing.

In the real estate world, acting as a lessor (“income side lease”) usually results in an operating lease. Direct financing leases are rare, and result primarily from a landlord/lessor building a unit to rent immediately to the lessee. See FAS 13.6(b)(ii) – cost or net book value MUST equal FMV of the property on the date of lease inception for the lease to be Direct Financing. Title must transfer to be sales-type. See also table on following slide.

The following slide (adapted from CCH “Accounting for Leases”) is a table of income lease accounting of real estate from a prime lessor perspective only (not as a sublessor).

1. Leased Property is land only.

Fair Value = Cost at Lease Inception	Title Transfers	Bargain Purchase Option	Fair Value of Land \geq 25% of Property's Fair Value	Lease term within last 25% of life	75% test or 90% test met?	Appropriate Lease Classification
No	Yes	N/A	N/A	N/A	N/A	Sales-type lease
No	No	N/A	N/A	N/A	N/A	Operating lease
Yes	Yes	N/A	N/A	N/A	N/A	Direct financing or leveraged lease
Yes	No	Yes	N/A	N/A	N/A	Direct financing or leveraged lease

2. Leased Property is land and building, and the fair value of the land is greater than 25% of the total FMV. The land component is always an operating lease unless there is a title transfer or a bargain purchase option.

Fair Value = Cost at Lease Inception	Title Transfers	Bargain Purchase Option	Fair Value of Land \geq 25% of Property's Fair Value	Lease term within last 25% of life	75% test or 90% test met?	Appropriate Lease Classification
Yes	No	No	Yes	No	Yes	Direct financing or leveraged lease
Yes	No	No	Yes	Yes	N/A	Operating lease
Yes	No	No	Yes	No	No	Operating lease
No	No	No	Yes	N/A	N/A	Operating lease

3. Leased Property is land and building, and is treated as one because (a) FMV of land is less than 25% of total FMV, or (b) bargain purchase option/title transfer is present in the lease.

Fair Value = Cost at Lease Inception	Title Transfers	Bargain Purchase Option	Fair Value of Land \geq 25% of Property's Fair Value	Lease term within last 25% of life	75% test or 90% test met?	Appropriate Lease Classification
No	Yes	N/A	N/A	N/A	N/A	Sales-type lease
No	No	N/A	No	N/A	N/A	Operating lease
Yes	No	No	No	No	No	Operating lease
Yes	No	No	No	Yes	N/A	Operating lease
Yes	Yes	N/A	N/A	N/A	N/A	Direct financing or leveraged lease
Yes	No	Yes	N/A	N/A	N/A	Direct financing or leveraged lease
Yes	No	No	No	No	Yes	Direct financing or leveraged lease

Subleasing

Subleasing generally always results in an operating lease – acting as sublessor means your income side treatment follows your expense side treatment; but if the expense side is capital, only FAS 13.7(c) applies to the income lease.

(The lessee does their own FAS 13.7 test independently – for them, it's just a lease).

FAS 13 – Land Only Leases

- Paragraph 25
- **Land only leases are always operating**
 - Unless title transfers, or bargain purchase option (“BPO”) exists
 - BPO is typically a nominal amount, such as \$1 or \$10
- Land leases are often used when the lessee is building a free-standing retail unit at its cost – title reverts to lessor at end of lease

FAS 13 – “Part of a building” leases

- Paragraph 28
- Typically operating leases - cost/fair value often are not objectively determinable; useful life of building is generally significant
- Examples: office space leases, mall unit leases



FAS 13 – Land and Building Leases

Paragraph 26 (“go to paragraph 7”)

- 7(a) – title transfer
- 7(b) – BPO
- 7(c) – 75% test
- 7(d) – 90% test



The 75% test in action...

Land and Building Allocation (Value per Third-Party Appraisal)

Land Value	900,000	64%
Building Value (Includes Site Improvements)	500,000	36%
Total Land and Building Value	1,400,000	100%

FAS 13, Section 7(c) test

Is Land > 25%	Yes	64%
Remaining Life per Third-Party Valuation	20.00	Years
Economic Life per Marshall Valuation Guide	30.00	Years
New Lease Term (includes stub period)	15.75	Years (options taken plus stub period)
Is lease term > = 75% of REL	Yes	79%
Is lease term in last 25 % of EL	No	33%
Pass 75% Lease Test	No	
Capital Lease based on 75 % test	Yes	

The 90% test in action...

- First, determine payments allocable to the land compared to building:

Land and Building Allocation (Value per Third-Party Appraisal)			
Land Value	900,000	64%	
Building Value (Includes Site Improvements)	500,000	36%	
Total Land and Building Value	1,400,000	100%	
Rent Allocation	Yearly	Monthly	
Land Value	900,000.00		
Incremental Borrowing Rate (IBR)	8.0%		
Land Allocation	72,000.00	6,000.00	
Rent payments	Total Rent	Land	Existing Building
Stub period of modification	6,000.00	6,000.00	-
Option period 1	6,600.00	6,000.00	600.00
Option period 2	7,260.00	6,000.00	1,260.00
Option period 3	7,986.00	6,000.00	1,986.00
Option period 4	8,784.60	6,000.00	2,784.60

A quick note about airport leases or leases from a governmental or port authority...

- They are always operating, per FAS 13.28; see also FIN 23
- Rationale:
 - No title transfer or BPO
 - Indeterminate useful life as the governmental body may be able to force the lessee to abandon the property or otherwise control the lessee's continued use of the property
 - Neither the leased property nor its equivalent are effectively ever offered for sale (no market exists), therefore making fair value indeterminable.

So...how is IBR determined?

- As you can see, IBR is crucial
- IBR is often not readily available – there is debate about whether WACC is a good measure of IBR
- Independent third party valuation specialist can help
- IBR is often reassessed quarterly; sometimes annually, depending upon the stability of the credit markets and financial condition changes of the company

FAS 13 paragraph 7 not applicable to all leases – Build to Suit != 75% and 90% tests

- A build-to-suit deal requires a different accounting evaluation – the lease is not a capital lease, nor will it be subject to the capital lease tests. We call these “Financing Obligations”.
- The first step in a build-to-suit lease evaluation is determining if we are considered the deemed owner of the leased property under **EITF 97-10** during the construction period. In the majority of instances the contracts with the landlords related to BTS and building remodels contain construction caps. Therefore, a company would generally be considered the deemed owner during the construction period. The deemed owned “project” is typically the new or renovated building; land is not typically considered part of the project as the construction risk relates only to the building not the land.

During the construction period

- During the construction period, we record construction project costs as incurred and landlord reimbursements as financing obligations (“FO”). Lease payments are split between land rent and building rent; the land rent is recorded as an operating lease in accordance with **FAS 13** (also see “*Recording and Amortization of FO’s*” below).
- Land rent expense is recognized once we have access to the land, regardless of when such rent is paid. None of the rent during the construction period is capitalized, in accordance with **FSP FAS13-1**.
- The next step is to determine if the lease qualifies for SLB accounting under **FAS 98** once construction is complete. If the company has “continuing involvement” in the property, SLB accounting is not permitted. “Continuing involvement” can be due one or a combination of the following reasons - 1) the lease is a perpetual lease, meaning the lease term including renewal options are greater than 90% of the economic life of the property, 2) we are not reimbursed for 100% of the project costs, or 3) the lease contains environmental indemnifications.
- As a failed SLB, the company should record the assets and liabilities on its books as a Financing Obligation (“FO lease”).

Recording and amortization of the FO

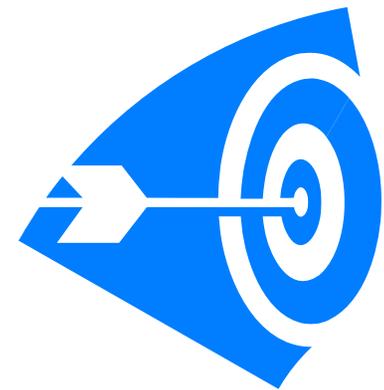
- Lease payments are typically allocated between land and building based on FAS 13 methodology (ground rent = IBR multiplied by FMV of land), unless the payments for land and/or building are specifically noted in the lease (they often are) or another methodology is considered more appropriate given the facts and circumstances.
- Ground rent is recorded as an operating lease in accordance with FAS 13. The FO liability is recorded once the funding is received from the landlord and amortized as lease payments are made over the term of the lease. This obligation is amortized to zero over the life of the lease, which sometimes results in negative amortization in the early years of the lease and/or an interest rate that is lower than the company's IBR.
- The related FO building asset is recorded as the actual cost incurred to construct the building (which is generally equal to or greater than the reimbursement received from the landlord) and depreciated over the lesser of the economic useful life or the lease term. The FO asset is depreciated beginning when the property is put in service (i.e. when a retail unit or restaurant begins operations), while interest is recognized on the FO liability immediately after it is recorded.

FO Example

Rent Payment Information							
			Construction funding rent and cap rate stated in lease				
			Initial ground rent separately stated in the lease				
Begin SL Rent	4/1/2009	See SLR Workbook; rent below is cash beginning at estimated Commencement Date					
Cap Rate	9.00%						
Total Funding	890,459.00	ESTIMATED AT TIME OF EXECUTION-WILL BE REVISED UPON FINAL FUNDING RECONCILIATION					
Escalation rate (land rent):	10.00%	every 5 years					
Escalation rate (building rent):	5.00%	every 5 years					
Years	Annual rent	Monthly Land Rent	Monthly Building Rent	Monthly Rent Total	Yearly Land Rent	Yearly Building Rent	Yearly Total Rent
					Estimated based on Commencement Date per Article 2		
1	8/1/2009	3,932.70	6,678.44	10,611.14	47,192.40	80,141.31	127,333.71
2	8/1/2010	3,932.70	6,678.44	10,611.14	47,192.40	80,141.31	127,333.71
3	8/1/2011	3,932.70	6,678.44	10,611.14	47,192.40	80,141.31	127,333.71
4	8/1/2012	3,932.70	6,678.44	10,611.14	47,192.40	80,141.31	127,333.71
5	8/1/2013	3,932.70	6,678.44	10,611.14	47,192.40	80,141.31	127,333.71
6	8/1/2014	4,325.97	7,012.36	11,338.33	51,911.64	84,148.38	136,060.02
7	8/1/2015	4,325.97	7,012.36	11,338.33	51,911.64	84,148.38	136,060.02
8	8/1/2016	4,325.97	7,012.36	11,338.33	51,911.64	84,148.38	136,060.02
9	8/1/2017	4,325.97	7,012.36	11,338.33	51,911.64	84,148.38	136,060.02
10	8/1/2018	4,325.97	7,012.36	11,338.33	51,911.64	84,148.38	136,060.02
11	8/1/2019	4,758.57	7,362.98	12,121.55	57,102.80	88,355.79	145,458.60
12	8/1/2020	4,758.57	7,362.98	12,121.55	57,102.80	88,355.79	145,458.60
13	8/1/2021	4,758.57	7,362.98	12,121.55	57,102.80	88,355.79	145,458.60
14	8/1/2022	4,758.57	7,362.98	12,121.55	57,102.80	88,355.79	145,458.60
15	8/1/2023	4,758.57	7,362.98	12,121.55	57,102.80	88,355.79	145,458.60
16	8/1/2024	5,234.42	7,731.13	12,965.56	62,813.08	92,773.58	155,586.67
17	8/1/2025	5,234.42	7,731.13	12,965.56	62,813.08	92,773.58	155,586.67
18	8/1/2026	5,234.42	7,731.13	12,965.56	62,813.08	92,773.58	155,586.67
19	8/1/2027	5,234.42	7,731.13	12,965.56	62,813.08	92,773.58	155,586.67
20	8/1/2028	5,234.42	7,731.13	12,965.56	62,813.08	92,773.58	155,586.67

FIN 21 – “Accounting for Leases in a Business Combination”

- The acquiring company (new lessee) must assume the leases at the acquired company’s (old lessee’s) classification...
- ...if the acquired company’s original classification was correct.



...but what if it wasn't correct, or the lease may or may not have been tested??

...if lease(s) were acquired from small private companies or individuals, it is often unable to be determined that the prior classification was appropriate.

In those cases, current management must estimate values at original lease inception (often with assistance from third party valuation expert) and re-determine what the classification should have been at lease inception.

Then, record the lease using that classification as of the acquisition date at the proper value as assigned in purchase accounting.

- Obligation balance will be at current obligation balance (per amort table) as of acquisition date; asset balance will be at FMV as of acquisition date. Difference is booked to goodwill.

EITF 04-01

- **Creates favorable/unfavorable leases**
 - These are an intangible asset/liability
 - Only applies to leases assumed during an acquisition
 - Example: acquiring a franchisee and assuming his/her leases, or acquiring a competitor and assuming all of its leases
 - Usually assessed by a third-party valuation firm, who compare market rents with rent per the lease
 - *Favorable = we are paying rent below market*
 - *Unfavorable = we are paying above-market rent*

How it works...

- Amortize over the life of the lease estimated in force at acquisition...modification of the lease may change this.
- Favorable leases are a normal debit, and amortize to expense – these work how one would expect an asset to work.
- Unfavorable leases are a normal credit, and accumulated depreciation is a debit.
 - (meaning that this amortization creates non-cash “income”)

How long of an initial life?

- Unfavorable leases typically valued only over current remaining term (assumed that unfavorability will create reason to let lease lapse)
- Favorable leases are often valued over all remaining option periods (assumed that favorability will create a reason to keep the lease in force)...unless we know that the life will be shorter.

What about at modification?

- Must be re-assessed at modification, along with lease life
- Will be impaired (written down) or written off if lease life re-evaluated to less than estimated at acquisition
- Favorable/Unfavorable leases follow the remaining lease life if shortened...but not extended

Same principle as recognizing impairments immediately but not writing an asset back up if the decline is reversed.

So, let's talk about modifications

- Modifications may create a new lease – or they may change an existing lease, sometimes to a new classification.
- Test 1
 - Does the modification extend the term of the lease?
- Test 2
 - Does the modification change other terms of the lease, such as rent?

Modification of a lease currently classified as operating

1. Has the lease term been extended?

- o Any action that extends a lease beyond the expiration of the existing lease term (see FAS 13, paragraph 5(f)) is a new agreement that should be classified using the **revised terms and new assumptions** as of the modification date.
 - o “Terms” refers to “life of the lease” and “payments”, and “assumptions” indicates remaining useful life, IBR, and valuation of land and building.
- o This modification may have one of two results, depending upon testing:
 1. **Continued operating lease** – the lease agreement is still an operating lease. Rent expense should be recognized on a straight-line basis over the new lease term.
 2. **Capital lease** – The lease becomes a capital lease immediately; obligation should be recorded at the lower of the NPV of the minimum lease payments or the FMV of the asset.

2. (Continued – operating lease) Has a provision *other than lease term* been changed?

- o If the provisions of an operating lease are changed (i.e., by adjusting the minimum lease payments) in a manner that would have resulted in the operating lease being an capital lease at its inception, using the **revised terms and original assumptions**, the modified agreement is a new lease that should be classified using the criteria of paragraph 7 as of the modification date(i,.e., becomes capital on the modification date and going forward, but capitalized using IBR at inception date, not modification date).
- o If the provisions of an operating lease other than lease term are changed but result in a continued operating lease, make adjustments (example: SLR) going forward.
- o An example of such a change in provision would be where a land and building lease currently classified as an operating lease is modified to delete percentage rent and increase base rent for the remainder of the term.

Modification of a lease currently classified as capital (FAS 13.14)

1. Has the lease term been extended?

- o Any action that extends a lease beyond the expiration of the existing lease term (see FAS 13, paragraph 5(f)) is a new agreement that should be classified using the **revised terms and new assumptions** as of the modification date.
- o “Terms” refers to “life of the lease” and “payments”, and “assumptions” indicates remaining useful life, IBR, and valuation of land and building.
- o This modification may have one of two results, depending upon testing:
 1. **New operating lease** – the existing capital lease should be allowed to run its course and amortize naturally over the original term of the lease. The renewal/extension period will be accounted for as operating.
 2. **Capital lease** – The lease is still a capital lease. In computing the PV of the FMLP under the modified agreement, use the same IBR as initially used to record the obligation. The current balances of the asset and obligation should be adjusted by an amount equal to the difference between the PV of the FMLP under the modified agreement and the present balance of the **obligation**, with no gain or loss being recognized (do not exceed the new FMV assumption).

2. (Continued) Has a provision *other than lease term* been changed?

- o If the provisions of a CL are changed (i.e., by adjusting the minimum lease payments) in a manner that would have resulted in the CL being an operating lease at its inception, using the **revised terms and original assumptions**, the modified agreement is a new lease that should be classified using the criteria of paragraph 7 as of the modification date.
 - o **This may create a new CL** (in which case, the existing CL would be written up or down depending upon the test)...(see previous paragraph on this – same operation)
 - o **...or it could create an operating lease**, in which case, the current CL is written off – gain is deferred, loss is recognized immediately.
 - o If the asset has already been written off due to impairment, the CL write-off will be an entirely deferred gain.
 - o Gain is deferred until the lease is terminated.

Modification of a current Financing Obligation-type lease

- In the current economic environment, many lessors are willing to reduce rent over the current lease term. An amendment is signed, reducing rent...but what, then, for an FO?
- An FO is still an FO. The construction funding (original obligation) received from the landlord at the beginning of the lease cannot change – it was in the past.
- But as payments have indeed changed, this means that the interest rate changes on the debt. Re-run the amortization table with the new payment stream and original obligation to solve for the new interest rate.

Modification of a fully amortized Financing Obligation-type lease

- Let's assume that the lease was originally a Build-to-Suit (FO), but the initial term has run out. A modification has been signed to extend the term of the lease and add additional option periods.
- The amortization of both the asset and liability are, at this point, down to zero.
- Re-test the lease as a Land and Building lease (i.e., the 75% and 90% tests of FAS 13).
- The lease may be capital or operating, going forward, depending upon how it tests out.

What about modifying a lease to add a major remodel funded by the landlord?

Or, how about a brand-new lease of an existing land and building, that you need to significantly remodel for it to be suitable...with the remodel funded by the landlord?

Major remodel defined

- Example would be turning a former Hardees into an Arby's (with LL funding).
- Generally, only the building slab and frame of the former footprint remain
- A major remodel *is* expected to be repaid/recovered through rent, unlike a LL Incentive, which is a small amount (furniture allowance, landscaping allowance), which is not expected to be substantially repaid, and is accounted for under FTB 88-1.

...We call it a “Hybrid FO”

- Step 1 – third party valuation of land and building is needed
- Step 2 – Figure out the split in lease payments between land, existing building, and construction rent.
 - Construction rent is often stated in the lease
 - Third-party valuation will help you figure out the split between land rent and building rent

Hybrid FOs – continued...

- The portion of rent attributable to the construction cost is treated as an FO.
- The portion of rent attributable to the existing building is capitalized.
- Land rent (unless 25% or less of total FV of land and building) is always operating.

If you fund the remodel, not the landlord, this is not an issue.

(Then, the improvements are just leasehold improvements
- fixed assets - amortized over the shorter of the life of the
lease or the life of the assets)

FTB 88-1 – “Landlord Incentives”

- Leasehold improvements made by a lessee that are funded by LL incentives or allowances under an operating lease should be recorded by the lessee as leasehold improvement assets and amortized over the shorter of the life of the lease or the lives of the assets (debit side)
- The incentives should be recorded as deferred rent and amortized as reductions to lease expense over the term (FAS 13.15 and FTB 88-1) (credit side)

LL incentives was one subjects of an SEC Staff Letter to the AICPA during the 2005 lease accounting restatements affecting a number of public companies (Target, Wendy's, Cheesecake Factory)

Other Lease Accounting Items of Note

Rent Holidays, Commencement Date

- **Rent holidays are a part of SLR**
- The beginning of a lease may be from a feasibility waive date, not a lease execution date.
- Feasibility waive (possession) is common in retail leases where there is construction. **SLR starts at feasibility waive**, NOT lease execution (earlier than FW) or commencement date (which is usually unit opening date, and is later than FW).
- For office leases, commencement date (possession) is usually closer to the execution date. Commencement/effective date = SLR date for a typical office lease.

Rent holidays were also a topic discussed in the aforementioned 2005 SEC Staff Letter to the AICPA.

Contingent Rent

Many retail leases contain provisions which require the lessee to pay rent in addition to minimum base rent (“contingent rent”).

The amount of contingent rent payable is often calculated as a percentage of gross sales above a set minimum. It may also be an increase in rent during option periods indexed to a current unknown, such as CPI.

Contingent rent is not included in minimum lease payments for purposes of recording FO’s, CL’s or operating leases; or for recording SLR, consistent with the guidance in FAS 13.

Key Money

There are circumstances in which cash is paid to or on behalf of a lessor to assume a lease (for example: Hardees' lease goes until 2012 and we want to pay them to terminate early so that Arby's can lease the unit.

This payment ("key money") is included as minimum rent (on the 90% test) and recorded as prepaid rent and amortized over the lease term as a reduction of rent expense.





Be aware of AROs

- Lease agreements should be reviewed for provisions that would indicate the potential for asset retirement obligations (ARO's) as defined by SFAS 143 or FIN 47.
 - This is usually indicated by a clause stating that the lessee must put back the site in its original condition; for example, scrape (demolish) and re-grade a retail unit site.
 - **Not** indicated by a clause indicating that the lessee must return a retail unit in “broom clean” condition, or with wear and tear/ordinary obsolescence accepted.
 - **Not** indicated by the acceptance of the lessor *allowing* the lessee to remove items of personal property from the site.

IFRS and Proposed Changes

- Changes to lease accounting will be dramatic
- Lease accounting as currently on the table under IFRS will look very different:
 - Moving to recognition of “right of use” as an asset
 - All leases will be essentially treated much as how capital leases are now recorded
 - Contingent rents will be taken into account, by “robust evaluation of probability”
 - FASB has not yet considered subleasing arrangements, although this would probably be covered in the May 18 meeting re lessor accounting
 - Impact on short term/low value leases not yet final

Shortcomings of IFRS Proposed Changes

- Contingent rents are just that – contingent. Also, adding in CAM payments and other executory costs to base rent does not reflect the true nature of the payments.
- What about build-to-suit type leases and ground leases?
- Essentially ripe for cooking the books (or at least, allegations of such) due to the “judgment” factor

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