New England Real Estate Journal

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THE LARGEST COMMERCIAL/INVESTMENT REAL ESTATE NEWSPAPER IN THE WORLD

Reprint | nerej.com | Friday, July 29, 2016

How the new FASB Accounting Standards Update may affect the decision to lease rather than buy

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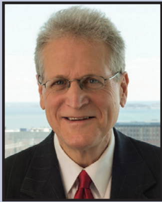

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It is too early to predict whether any standard conventions will develop in the loan and investment communities to address the ASU. One possible approach would be to amend existing loan/investment documents which currently extend beyond the effective date of the ASU, to provide that all covenants will be measured by the standards in effect at the time the loan was entered into.

On February 25, 2016, the Financial Accounting Standards Board (FASB) issued an Accounting Standards Update (ASU) significantly impacting the financial reporting for many types of leases, including most real estate leases. From the perspective of the FASB and close watchers of the FASB, the ASU was the culmination of a 10-year joint study by the FASB and the International Accounting Standards Board, following a 2005 recommendation by the Securities and Exchange Commission for more transparency in lease accounting. From the perspective of many of us who are not close watchers of the FASB, the ASU arrived somewhat out of the blue.

As an oversimplification, the ASU requires, effective for all non-public companies, including nonprofits, as of fiscal years beginning after December 15, 2019, that leases with a term exceeding twelve (12) months (and in some cases even leases of less than a year if they include an option to purchase) be recognized as both an asset and a liability on the company's balance sheet. Under present standards, an operating lease (i.e., the typical real estate lease) does not need to be recognized on a company's balance sheet; only capital leases need to be recognized.

For some well-capitalized companies which can easily afford to own the real estate from which they operate, leasing, even as the sole user of the property, has been preferred over owning precisely because of the off-balance sheet treatment of the lease. Now a company will need to consider the effect of the ASU on its financial presentation, and perhaps on its future ability to comply with certain covenants with lenders and/or investors, such as debt service coverage ratios and restrictions on additional liabilities, depending on the definitional terms used in the financing documents.

Companies should accordingly take very seriously the balance sheet effect of the ASU, but they should not ignore the "traditional" issues in deciding whether to lease or own, such as:

• Will the space be needed for an indefinite period or for a finite period (such as the length of an existing contract requiring a presence by the company in a particular location)?

• Do real estate market trends indicate that if the property needs to be sold on short notice, the company would be able to recoup all or most of the purchase price?

• Is the company only occupying a portion of the property, and, if so, what is its appetite for being a landlord?

• Does the company anticipate outgrowing the space?

• Is the company willing to pay the costs and fees associated with financing a purchase, and will personal guarantees or collateral other than the property itself be required for the financing?

• Will the property require the expenditure of significant sums for repairs, renovations or capital improvements?

• Does the property contain hazardous waste? There are protections available for some types of tenants which are not available for owners, who by definition are in the "chain of title".

It is too early to predict whether any standard conventions will develop in the loan and investment communities to address the ASU. One possible approach would be to amend existing loan/investment documents which currently extend beyond the effective date of the ASU, to provide that all covenants will be measured by the standards in effect at the time the loan was entered into. This may have its own complications, however, such as the need to prepare two sets of financial statements after the effective date of the ASU, one in compliance with GAAP, and one based on the pre-ASU standards, both of which would presumably be provided to the lendor/investor. It may be the case that a lender/investor would be more open to amending the covenants in documents that were entered into before the effective date than of the ASU than using non-GAAP definitions in documents entered into after the effective date of the ASU.

In any event, companies with real estate leases should review their existing loan and/or investment documents which extend beyond the effective date of the ASU, and should be proactive in reaching out to their lenders/investors if changes are needed to the existing documents.

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