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FASB ISSUES NEW LEASE ACCOUNTING STANDARDS

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Introduction

On February 25, 2016, the Financial Accounting Standards Board ("FASB") issued its final Accounting Standard Update No. 2016-02, Leases (Topic 842) (the "ASU") for lease accounting under U.S. Generally Accepted Accounting Principles ("GAAP"). The new standards, which were developed in coordination with new international accounting standards promulgated by the International Accounting Standards Board ("IASB"), are intended to eliminate off-balance-sheet recording of lease obligations in an effort to cause financial statements to more accurately reflect a company's leasing activities. Generally, the new standards require tenants to report nearly all leases on their balance sheet by recognizing a liability for future lease payments and an asset for the "right-of-use" of the premises. Public companies will have to transition to the new standards for fiscal years beginning after December 15, 2018, while private companies must transition one year later, for fiscal years beginning after December 15, 2019. Comparative periods presented in financial statements must be entered using the same standards, as if the new ASU was in effect for such prior years.

Changes under the New ASU

Under the current standards, companies must disclose capital leases (those whose economics are more akin to financing transactions) on their balance sheet, while other leases, termed "operating leases," require no balance sheet disclosure, but do include certain footnote disclosure in the financial statements. The new standards reflect a dual approach to lease accounting, for all types of assets (not limited to real property). Under the ASU, leases will be classified from a tenant's perspective as either "finance leases" or "operating leases." "Finance leases" are those which meet one or more of the criteria in FASB Accounting Standards Codification Paragraph 842-10-25-2, which is similar to how capital leases are classified today. All other leases are classified as "operating leases". This client alert addresses only operating leases.

The accounting for tenants with operating leases represents a significant change from current lease accounting requirements. Under the new ASU, a tenant would recognize the present value of all lease payments as a liability and an asset representing the "right-of-use" of the asset for the term of the lease, measured by the lease liability adjusted for prepaid or accrued lease payments, lease incentives and initial direct leasing costs. As such, many companies will see a substantial increase in assets and liabilities since almost all leases will move to the balance sheet. The landlord's treatment of an operating lease is less of a departure from current standards and is very similar to the current treatment of an operating lease. The landlord will continue to recognize the asset on its balance sheet

and will recognize lease income on a straight-line basis over the lease term, or other appropriate systematic and rational basis. Note, with respect to operating leases, both the tenant and the landlord will recognize the same asset (or a portion thereof) on their balance sheets.

Leases that have a maximum possible length of 12 months or less (including all renewal options that a tenant will likely exercise) may continue to utilize off-balance-sheet treatment at the company's election.

The Potential Impact of the Rule Changes

Companies with substantial lease obligations as tenants should begin to prepare for these changes proactively since the changes will likely have a significant impact on the company's financial statements. Certain key financial ratios will change significantly: for example, the debt-to-equity ratio will increase as the amount of debt increases due to the reporting of the present value of lease obligations. These changes in accounting principles may lead to violations of covenants in transaction documents that depend on metrics that will be affected by such changes. Accordingly, companies may need to negotiate amendments to their loan documents, bond indentures, leases and other transaction documents to avoid default solely because of the change in accounting principles.

Commentators expect that compliance costs will likely rise because companies will need to acquire the requisite technology and internal controls to account for leases properly under the new ASU. Further, some tenants, in certain situations, may seek short-term leases to receive off-balance-sheet treatment. As such, transaction costs may rise since lease negotiations will occur on a more frequent basis, and landlords may face a greater demand for short-term leases or potential increases in vacancies if tenants are reluctant to enter into longer term leases.

Next Steps

Although the rules do not take effect for a few years, companies must present prior periods on their financial statements and will need to adjust balance sheets retroactively for a period of two years before the effective date. As a result, companies should look for ways to make the transition less significant or burdensome by implementing new strategic changes in the next few years instead of waiting until the rule changes take effect.

We encourage our clients to contact their accounting professionals with respect to these changes to their lease accounting procedures, and to call us to discuss potential impacts on loan, lease and transaction documents, or if they have any questions regarding the matters discussed herein.

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If you have any questions concerning these developing issues, please do not hesitate to contact any of the following Paul Hastings Chicago lawyers:

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