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The revised lease accounting proposals: Aesop’s Fables revisited

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ABSTRACT

A close study of the newly proposed lease accounting changes from the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) brings to mind the lessons in many of Aesop’s best-known fables. While the FASB and IASB’s recently issued Revised Exposure Draft documents on lease accounting contain many significant changes from their original proposals in August 2010, these new proposals will require CRE executives and their counterparts in finance significantly to change the way in which they analyse, negotiate and structure leases going forward in order to avoid learning — or remembering — many of those lessons the hard way. For example, assuming two different leases with identical gross cash flows will have an identical impact on the tenant’s balance sheet and income statement may result in the tenant wishing it had looked before it leapt. Understanding the full financial statement impact from any lease helps illustrate how changes in the structure and negotiation of that lease may likewise change its financial statement impact, for better or for worse. Moreover, the subjective nature of many elements of these newest proposals increases the need for CRE and finance executives to be able to deal objectively and consistently with those elements in order to avoid unintended financial consequences. While the FASB and IASB have clearly attempted to assuage the concerns many raised about their original proposals from 2010, some criticisms of these revised lease accounting proposals remain, though a more thoughtful analysis shows that many of them appear exaggerated.

Those concerns notwithstanding, the combination of significant and varying financial statement impacts, numerous subjective issues and, in many cases, incomplete data on existing leases means the
The worlds of CRE and finance will need to begin working more closely together than they have in the past. In fact, many will find they should have already begun doing so in order to be prepared to transition to these new standards in time.

Keywords: lease accounting, FAS13, IAS17, revised exposure draft, lease accounting changes, LeaseCalcs

THERE ARE MANY MORALS TO THE REVISED LEASE ACCOUNTING STORY

In the nearly two years that have elapsed since the paper entitled ‘New lease accounting standards are evolving: Is there a scary monster under the bed and will it really affect lease versus buy or other CRE decisions?’ appeared in this publication, the Financial Accounting Standards Board and the International Accounting Standards Board (FASB and IASB, respectively, and collectively ‘the Boards’) have continued to deliberate and revise their initial lease accounting proposals, as set forth in their respective Exposure Draft documents issued in August 2010. It was these original proposals that caused so many to believe that the Boards had put a monster under the bed. Even as of two years ago, the Boards had begun to revise their initial proposals substantially, and during these intervening two years they have revised them further in many significant ways. On 16th May, 2013, the FASB issued its ‘Proposed Accounting Standards Update (Revised)’, and the IASB issued its ‘Exposure Draft ED/2013/6 — Leases’, which collectively and individually are widely referred to as the ‘Re-Exposure Draft’ (RED). The RED sets forth the Boards’ revised proposals for how all organisations that are required, or have elected, to adhere to US Generally Accepted Accounting Principles (GAAP) or International Financial Reporting Standards (IFRS), including organisations in countries that have recently adopted IFRS (such as in Canada where publicly accountable enterprises transitioned to IFRS in 2011), will account for their leases going forward.

Most of the contents of RED were foreseeable to those who have been closely watching the Boards’ re-deliberation process. Nonetheless, the corporate real estate (CRE) industry will be faced with significant and important changes not just in how they account for their real estate leases, but also in how they analyse, structure and negotiate those leases going forward. Most CRE and finance executives will still find there is something unpleasant under the bed when the new lease accounting standards are finalised later in 2013 or early 2014, and these new standards unquestionably will affect existing business practices. In looking back at where the process started, and looking forward to the impact these new standards will have on CRE and finance executives, many of Aesop’s more famous fables come to mind, as, for example, the new standards require you to look before you leap, you will see the Boards cannot please everyone, and it will be far better to do the hard work before it is too late.

THE FOX AND THE GOAT: LOOK BEFORE YOU LEAP

‘A Fox, having fallen into a well, could find no means of escape. A Goat, overcome with thirst, came to the well, and, seeing the Fox, inquired if the water was good. The Fox, concealing his sad plight under a merry guise, indulged in a lavish praise of the water, saying it was beyond measure excellent, and encouraged him to descend.

‘The Goat, mindful only of his thirst, thoughtlessly jumped down, when, just as he quenched his thirst, the Fox informed him of the difficulty they were both in, and suggested a scheme for their common escape. “If”, said he, “you will place your forefeet upon the wall, and bend your
head, I will run up your back and escape, and will help you out.” On the Goat readily assenting to this proposal, the Fox leaped upon his back, and steadying himself with the goat's horns, reached in safety the mouth of the well, and immediately made off as fast as he could.

When the Goat upbraided him with the breach of his bargain, he turned round and cried out: “You foolish fellow! If you had as many brains in your head as you have hairs in your beard, you would never have gone down before you had inspected the way up, nor have exposed yourself to dangers from which you had determined upon no means of escape.”

One of the few relative constants between the Boards' original proposals from August 2010 and RED is that all leases with the potential to have a term greater than 12 months will be capitalised and placed onto the tenant's balance sheet. Although there have been many other significant changes in the Boards' proposals over the past few years, the Boards have not wavered in this regard. This represents the single greatest change from the accounting standards of the past 35 years. Conversely, one of the more interesting proposals included in RED, which marks a significant change from the Boards' original proposals in August 2010, revolves around the income statement treatment for real estate leases (and a tiny minority of equipment leases). The original proposals would have required every lease to flow through the income statement in the same manner as today's ‘capital’ leases (ie via a combination of straight-line amortisation of the right of use asset and an interest expense charge based on the effective interest method of drawing down the lease liability), thereby front loading the impact on a tenant's income statement related to any lease. RED, however, has included an additional income statement treatment that will apply to the majority of real estate leases, whereby tenants will recognise 'rent' expense on a straight-line basis, as opposed to the front-loaded amortisation and interest expense method. Although this additional income statement treatment effectively has the same look and result of the current FAS13/ASC840 and/or IAS17 operating lease treatment, the mechanics of how a tenant derives the results are significantly more complicated and cannot be dismissed as the underlying components of RED's straight-line expense calculations are required to be disclosed by tenants in their financials. RED distinguishes between the two lease classifications by labelling those leases utilising the interest and amortisation approach as 'Type A' leases, and those using the straight-line expense model as 'Type B' leases. (At the risk of oversimplifying the discussion it may be easier to think of Type A leases as being largely equivalent to today's capital leases and Type B leases as something of a capitalised version of today's operating lease.) The important thing for CRE and finance executives — and their advisors — to understand is it is possible for a real estate lease to be classified as one or the other (much like under the existing accounting standards but using subjective criteria instead of FAS13/ASC840’s ‘bright line’ tests of 75 per cent of useful life and 90 per cent of fair market value), and thus it will be critically important to know which model will apply to any existing or contemplated lease, as the resulting impacts on the tenant's income statement are quite different. In determining which model to apply, a more subjective test is proposed under RED, which for real estate leases requires the lease term to be a ‘major’ part of the remaining asset’s useful life or for the present value of the lease payments to be ‘substantially all’ of the fair value of the leased asset in order for the lease to be classified as a Type A lease.

Under the existing standards the overwhelming majority of real estate leases have been classified as ‘operating leases’ and are therefore ‘off balance sheet’ transactions with no associated assets and liabilities placed on the tenant’s balance sheet. Since today's operating
leases are recorded on the income statement using a straight-line approach (ie a three-year lease with base rent equal to US$40, US$45 and US$50 per ft² would be treated as though each year’s rent was equal to US$45 per ft²), very little scrutiny typically is given to the income statement impact of any contemplated lease. This is, in large part, a by-product of the fact that operating lease payments do not get recorded on the balance sheet and thus there has been no requirement or motivation for tenants to bifurcate their base rent charges into ‘rent’ components and ‘service charge’ components. In other words, under the existing standards, two leases with the same average gross base rental rates, but which have different average net base rental rates (ie gross rental rates less any embedded charges for things like property taxes, outgoings, estate charges, service charges and/or operating expenses, collectively hereinafter referred to as ‘service charges’), can be — and largely have been — recorded in the tenant’s accounting using the average gross values as there would be no difference in the impact on the tenant’s income statement compared with using the net average values plus the cost of the various embedded service charges. Hence, when evaluating the economic pros and cons of any operating lease transaction before it was signed, CRE and finance executives typically have not calculated the full financial statement impact of any lease or competing lease proposals. Rather, most have largely relied on a discounted cash flow analysis and a simple calculation of straight-line rent expense as there was no asset and liability recorded on a tenant’s balance sheet resulting from an operating lease. It should be noted that, under the current FAS13/ASC840 and IAS17, to the extent the subject operating lease includes increases in its rents over the term of the lease, free rent at the beginning of the term or other allowances or incentives provided by the landlord, the ‘straight line’ or average rent expense recorded in the tenant’s income statement for any year will not equal its cash rent payments. The difference between those values serves to create a ‘deferred rent credit’ that is recorded on the tenant’s balance sheet, and typically, as the term of the lease progresses the balance of the deferred rent credit increases until, somewhere usually around the mid-point of the lease term, it begins to draw back down to eventually reach a zero balance at the end of the lease term. Put another way, to the extent cash rent payments are less than the calculated straight-line rent, a deferred rent credit balance will increase and when, in the latter portion of the term, cash payments begin to exceed the straight-line rent value, the deferred rent credit draws down, eventually to zero. Continuing on that course in light of the newly proposed standards, however, is akin to the goat leaping headlong into the well. There are significant balance sheet and income statement implications for tenants to consider when evaluating new (or amending existing) lease transactions. To help put these implications into perspective, consider the following three scenarios:

- **Scenario 1**: The different impacts on the balance sheet from two leases having identical cash flows, but where their respective ‘net’ base rents are different.
- **Scenario 2**: The different impacts on the income statement from the same leases in Scenario 1 above, first assuming both leases qualify as Type B leases and, secondly, that both qualify as Type A leases.
- **Scenario 3**: The impact on the income statement resulting from a lease being classified as a Type A lease as opposed to a Type B lease.

For the purposes of these scenarios, assume the following:

A tenant is presented with two competing lease proposals, each covering 260,000 ft² for a ten-year term (the tenant’s incremental borrowing rate is 8 per cent). Lease Alternative 1 requires the tenant to pay base rents of US$27/ft²/year, increasing by
US$1.00/ft² each year during the term, and then also to pay for the building’s service charges. The service charges at the commencement of the lease are US$13/ft²/year, and assume 3 per cent annual increases in those expenses. Lease Alternative 2 requires the tenant to pay base rents of US$30/ft²/year at the commencement of the lease with annual increases, and also to pay service charges equal to US$10 with a projected annual increase of 3 per cent. Assume further the gross rent obligations for Lease Alternative 2 are identical, both in timing and the aggregate, to Lease Alternative 1. Notably, Lease Alternative 1 has lower ‘net’ base rent charges.

Figures 1 and 2 show how two leases with identical cash flows can have very different impacts on the tenant’s balance sheet, even when both leases are classified as Type B leases, as has been assumed in these illustrations. Tenants, particularly those concerned about debt ratios and/or those in financially regulated industries such as banking, insurance etc., quickly will realise that, while cash flow analyses will remain important, failing to consider the balance sheet impact from two competing leases, even those with equal gross cash flows, can yield unpleasant results.

Utilising the same assumptions from Scenario 1, Scenario 2 illustrates the differing income statement impacts from Lease
Figure 4  Differing income statement impacts from Lease Alternative 1 and Lease Alternative 2, with both classified as Type A leases
Source: LeaseCalcs

Scenario 3 serves to highlight an important by-product of the Boards’ decision (notably not on the basis of a unanimous vote of their respective members) to include the two lease models in RED. Under RED’s proposed standards, tenants still will be required to determine whether they have a capital/Type A lease or a capitalised operating/Type B lease, and those determinations will have materially different results on their income statements. Moreover, one of the primary differences between Type A and Type B leases is the way in which the right of use asset is amortised over the term of the lease. Type A leases use a straight-line amortisation method.
while Type B leases use a newly created way of amortising a financial asset that is, in truth, nothing more than a ‘plug’ to allow the straight-lining of rent expense on the income statement to work. Consequently, a lease classified as Type A will see its right of use asset balance being amortised at a different rate over the lease term compared to the very same lease classified as Type B. But, since the lease liability balances during the term of the lease are calculated in the same way under both Type A and Type B lease models, the different approach to the amortisation of the right of use asset means Type A and Type B leases actually affect shareholders’ equity differently over the course of the lease term.

As Figures 5 and 6 illustrate, there is a stark difference in income statement treatment and the effect on shareholder equity between the Type A and Type B models included in RED. Since it is conceivable that one lease could be classified as a Type A lease by one party and a Type B lease by another, it is critically important for CRE or finance executives to look before they leap in negotiating and signing any lease that will be subject to the new standards;

![Figure 5](Image)

**Figure 5**  Showing income statement impact from Lease Alternative 1 classified as a Type A lease and, alternatively, as a Type B lease

*Source: LeaseCalcs*

![Figure 6](Image)

**Figure 6**  Showing yearly ending balances of the right of use asset and lease liability for Lease Alternative 1 classified as a Type A lease and, alternatively, as a Type B lease. Note the larger the difference between the annual asset balance and the annual liability balance in each Type A column as compared to the same year’s Type B column represents a greater negative impact on shareholder equity (all else being equal)

*Source: LeaseCalcs*
otherwise, they may find themselves much like Aesop’s goat: stuck in a bad situation with no way out.

Notably, the very presence of these two lease models in RED adds a level of complexity to the proposed lease accounting standards that was not part of the Boards’ original proposals. This added complexity, especially in light of the relatively subjective manner in which tenants will need to establish which model is the proper one to use for each lease, contributed to three of the seven Board members of the FASB voting against moving forward with RED in the form in which it was issued. Additionally, when the two model approach is coupled with the several other very subjective issues contained in RED’s proposed standards, it arguably gives rise to the possibility of tenants trying to manage the financial implications of any lease by evaluating and characterising the subject lease in a way that best suits their economic interests rather than in an objectively determined manner.

THE LION AND THE STATUE: WE CAN REPRESENT THINGS AS WE WISH THEM TO BE

‘A Man and a Lion were discussing the relative strength of men and lions in general. The Man contended that he and his fellows were stronger than lions by reason of their greater intelligence. “Come now with me”, he cried, “and I will soon prove that I am right.” So he took him into the public gardens and showed him a statue of Hercules overcoming the Lion and tearing his mouth in two. “That is all very well”, said the Lion, “but proves nothing, for it was a man who made the statue.”’

Over the course of the past two years, the Boards heard many criticisms of their original proposals and the new proposals included in the Boards’ RED have attempted to address these complaints. Notwithstanding the significant changes from the original proposals, one of the broadest criticisms of RED’s updated proposals is their reliance upon several subjective issues or questions in order for a tenant to be able to properly establish accurate accounting for any lease. Some of these subjective issues will be somewhat familiar to tenants, while others will be new issues for tenants to consider when evaluating and accounting for their lease obligations. Given the way in which these subjective issues impact the actual accounting treatment, there is certainly the risk that some tenants might wish to characterise what should properly be a Type A lease as a Type B lease, or vice-versa. That said, ultimately tenants will need — if not be compelled — to demonstrate the veracity and consistency of their application of the new standards, and thus will need to have an objectively determined and auditable process related to how they apply these important but subjective issues in their accounting. Some of the most important or larger subjective issues included in the Boards’ newest proposals include the following, and each of these issues applies to both Type A and Type B leases, and also has the ability to affect whether a lease ends up being classified as a Type A or Type B lease:

- incremental borrowing rate (or ‘risk-free rate’ for non-public entities);
- remaining economic life of building/leased asset;
- fair market value of building/leased asset;
- presence and amount of ‘disguised minimum rents’; and
- significant economic incentives to exercise renewal or termination options.

It should be noted that slightly different versions of certain of these issues are presently included in the current FAS13/ASC840 and/or IAS17 accounting standards. For example, the second and third items in this list are slight variations of IAS17’s test for determining

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whether a lease is a capital or operating lease, and they are related to FAS13/ASC840’s capital versus operating lease but without the ‘bright lines’ of 75 per cent of useful life and 90 per cent of fair market value, respectively, in the existing standard; however, the subjective nature of each of these items has drawn increased attention in light of the impact each can have on the tenant’s balance sheet and income statement. Aside from the reintroduction of the economic life and fair market value determinations vis-à-vis RED’s dual lease models, the one item on the above list that continues to draw the greatest attention is determining whether or not a tenant has a ‘significant economic incentive’ to exercise a renewal or termination option included in its lease. Largely this attention is due to the way in which the presence or absence of ‘significant economic incentives’ can greatly alter the balance sheet and income statement impacts from any lease.

**Significant economic incentives**

Over the course of the past two years, the Boards made their proposals regarding the treatment of term-related options much more palatable to almost everyone involved in leasing transactions. While the new ‘significant economic incentive’ (SEI) criteria included in RED’s proposals are certainly less onerous than the ‘more likely than not’ standard of the Boards’ original proposals, determining whether a tenant has an SEI has many elements, each of which is also fairly subjective in nature. In both the Boards’ re-deliberations over the past two years and RED itself, the determination of whether a tenant has an SEI to exercise its renewal or termination option(s) is to include the following considerations:

- **Discounts:** Does the option include a discount or economic incentive for the tenant to exercise the option?
- **Penalties:** Does the option include an economic penalty to the tenant if it does not exercise the option?
- **Business entity considerations/strategic value:** Are there business entity-related issues that indicate the tenant would exercise its option, such as a location having important strategic value to a tenant’s business?
- **Improvements/restoration:** Are improvements installed in the leased premises expected to have remaining useful life and/or value at the end of the initial term of the lease and would need to be replicated if the tenant were to relocate, or are there restoration obligations the tenant would need to pay for if it were to move out of the leased premises at the expiration of the term?

To help put each of these considerations into perspective, it helps to put them into the context of either a renewal or termination option. What follows describes the ‘calculus’ tenants will need to consider for each of these elements when faced with a lease that includes a renewal option. (Note, this is not intended to be an exhaustive or all-inclusive list of considerations, but rather addresses the issues and considerations CRE and finance executives will most commonly face.)

**Discounts**

Many renewal options entitle the tenant to renew its lease at a to-be-determined rental rate based upon ‘fair market value’ at the time the option is exercised and/or the lease is renewed. While standard fair market value provisions are unlikely to cause a tenant to conclude it possesses an SEI to renew its lease, variations of fair market value may result in a tenant possessing an SEI to renew. For example, many highly negotiated fair market value renewal provisions are unlikely to cause a tenant to conclude it possesses an SEI to renew its lease, variations of fair market value may result in a tenant possessing an SEI to renew. For example, many highly negotiated fair market value renewal provisions are structured in such a way that they are not truly fair market value provisions but actually represent a discount to fair market value by virtue of removing, for example, the cost of tenant improvement allowances that will not need to be provided by the existing landlord in a renewal but would need to be provided by a competing building if the tenant were to move. For
example, if the competing building offered a base rental rate equal to €50 per ft² per year, of which €5 was attributed to the cost of constructing tenant improvements, the rental rate for the existing lease’s fair market value renewal option could be considered to be €45 instead of €50. Similarly, many renewal options stipulate the tenant is entitled to renew its lease for 90 per cent or 95 per cent of fair market value. This is a more obvious discount to fair market value. Similarly, renewal options with stipulated rental rates for the renewal term will need to be judged, at the commencement of the lease and upon any required reassessments (due to contractual changes in the lease or other business considerations), based upon whether the tenant believes those stipulated rates represent a discount against the rental rate it would otherwise expect to pay during the renewal period. In any of these cases, tenants would need to evaluate whether the associated discount to fair market value was significant to their business. The subjective nature of this question also indicates that two different tenants faced with exactly the same renewal provision and scenario could end up with different conclusions. Therefore, it should occur to CRE and finance executives that they will need to have a consistent yard (or metre) stick for the purposes of establishing the significance of any discount embedded in their renewal options, and do so in a consistent manner across their lease portfolio. With respect to establishing this measurement standard and being able to apply it objectively, tenants should establish internal controls and policies that indicate when these significant discounts exist. These measurement standards are likely to need to include multiple facets so that, for example, the discount is evaluated on the basis of whether it is:

- equal to or greater than X per cent of fair market value;
- equal to or greater than £Y per m² per year; or

In utilising such a structured analysis, CRE and finance executives should be able to avoid debating the relative strength of their conclusions with the king of their accounting jungle — their auditors.

**Penalties**

It is likely the Boards’ inclusion of penalty considerations in establishing the presence of an SEI is geared more towards the equipment leasing industry, as a real estate lease with an explicit financial penalty to be paid by the tenant if it did not renew its lease is an exceedingly rare phenomenon. That said, the same considerations as utilised in establishing the significance of a discount likewise could be adopted in establishing the significance of a penalty for non-renewal.

**Business entity/strategic considerations**

This, perhaps, is the most subjective of the components in establishing the existence of an SEI. The Boards have made it clear that these considerations are not based upon a pattern of the tenant’s past decisions (ie no consideration is given as to whether the tenant has previously renewed the subject lease or other leases like the one under consideration), but rather on what the tenant anticipates it will do based upon factors of significant importance to its business operations. For example, the Boards have given examples of a tenant establishing it has an SEI to renew its headquarters’ lease because that facility is located, say, across the street from the manufacturing facility it owns, and the tenant therefore concludes there is a significant strategic value in maintaining its headquarters in its current location. Another fairly common example is the case of a tenant leasing a facility in very close (if not adjacent) proximity to one of its larger or more important customers or suppliers, where the tenant will conclude it will continue to renew that lease as long as it
retains that key business relationship. Due to the strategic importance of the location, the tenant may conclude — or its auditor might do so on its behalf — the renewal option includes an SEI for it to exercise that option. As with the question of the significance of discounts and penalties, under the newly proposed accounting standards, tenants will need to establish a framework in which these business entity/strategic value questions can be evaluated in an objective manner. For example, CRE directors will find themselves needing to answer questions, such as:

- Does the location have strategic value to other locations owned or leased by the company?
- Is the location related to a relationship the company has with a key customer or supplier?
- Is the location one of the company’s top-performing stores?

These criteria arguably will differ by company and industry, but in each case will need to be able to withstand an auditor’s scrutiny.

**Improvements/restoration**

At the expiration of any lease, part of the decision-making process any tenant undertakes includes an evaluation of the remaining value and usefulness of the improvements previously installed in the leased premises and what, if any, restoration obligations would it face if it were to relocate (or close) that facility upon expiration. As part of establishing the presence of an SEI, however, tenants will need to consider these factors not just upon the expiration date or the date by which it is required to exercise its option, but also upon the commencement of the lease and upon any reassessment resulting from contractual changes to the lease or other business considerations.

By way of example, consider the case of a pharmaceutical company that executes a seven-year lease including a five-year renewal option. Assume the tenant constructed and/or installed specialised improvements in the leased premises at a cost of US$5m and those improvements had a useful life of ten years. At the end of its seven-year lease term the improvements would still have remaining life and value, and would need to be replicated at additional cost to the tenant if it were to relocate. Consequently, at the commencement of the lease the tenant would be required to evaluate whether the remaining useful life and value of those in-place improvements represent an SEI that would result in it exercising its option. If it were to conclude an SEI existed, its financials would be based upon it having a lease for a period covering twelve years (ie seven-year initial term plus five-year renewal term), wherein it would estimate what its rental charges would be (if not explicitly stipulated in the renewal option), during the five-year renewal term, and incorporate those rents into the calculation of its right of use asset and lease liability. In order for tenants to be able to legitimately avoid having a spirited debate with their auditors about whether or not their improvements, installations and/or restoration obligations resulted in their renewal option being deemed to include an SEI for them to exercise said renewal, going forward tenants will need to document several data points in a consistent and auditable manner. By way of example, in order to turn this subjective issue into one with an objectively determinable answer, tenants first will need to establish what constitutes an SEI with respect to these improvement and restoration-related issues. This probably will need to include documenting, at the commencement of the lease:

- the useful life of the improvements and installations, which needs to be done anyway for the purposes of amortising the tenant improvement assets related to the lease;
• estimating what the value of those improvements will be at the end of the initial lease term; and
• estimating the cost the tenant expects to incur in connection with its lease-imposed restoration obligations, which is also something that needs to be done under existing standards for asset retirement obligations or dilapidations.

Additionally, each of the above would need to be updated upon any reassessment resulting from a contractual change in the terms of the lease (ie an amendment), or upon some other business-driven event that necessitates a reassessment (ie if, at the end of year seven of a ten-year lease, the tenant installs new, additional tenant improvements or refurbishes the existing improvements or installations).

Next, the tenant also will need to have established what would amount to a materiality threshold, much as discussed in the paragraphs above concerning discounts incorporated into the renewal provision. In other words, the tenant would need to have established a yardstick, much as it did for discounts, whereby it would evaluate whether the economic cost of any of the improvement/restoration-related issues met or exceeded certain economic thresholds such as costs per ft² or costs in the aggregate exceeding certain values utilised consistently across its portfolio. For those who believe that sounds like too much effort, they might first try having a debate with a lion to see which is preferable.

**Why all the fuss about SEIs?**

Admittedly, this all does sound like a fair amount of effort to be able to establish whether or not the renewal or termination option(s) contained in a lease include an SEI. But, given the magnitude of the impact on a tenant’s financials that can result from a renewal option (or termination option) either being included or eliminated from the tenant’s lease accounting, these are not simply trivial matters. To help put this in perspective, consider the following example: a tenant with an incremental borrowing rate of 8 per cent leases 130,000 ft² of office space for a term of ten years, and the lease includes one, five-year renewal option. The base rent starts at US$27 per ft² per year and increases by US$1 per ft² per year. Additionally, the tenant pays service charges and, at the commencement of the lease, those costs are equal to US$13 per ft² and expected to increase by 3 per cent per year. Assume further that the lease would be classified as a Type B lease (ie a capitalised operating lease) under the new standards and the renewal provision in the lease entitled the tenant to renew for 95 per cent of fair market value rents at the time of exercising the option, which the tenant projects will be equal to the last rental rate paid under the initial term, or US$36 per ft² per year. For the sake of illustration, assume the tenant presumed its 5 per cent discount to fair market value would not constitute an SEI for it to renew and therefore did not include the renewal term in its lease accounting. In such an instance, this lease would have the profile on the tenant’s balance sheet and income statement as illustrated in Figures 7 and 8.

Now, consider the alternative case where the tenant (or its auditors) has established criteria by which to objectively quantify SEIs across the tenant’s lease portfolio. If those objectively defined criteria stated that, for discounts to be deemed *significant*, they would need to (x) exceed 10 per cent of the otherwise available rental rate in the market, (y) exceed US$2 per ft² or (z) exceed US$1,000,000 in the aggregate over the renewal term, in this particular example the tenant would have ‘missed’ the first two criteria (ie 95 per cent of fair market value is not sufficient for the first criteria and the 5 per cent discount on anticipated rents of US$36 only equates to US$1.80), but would have triggered the third criteria, as saving US$1.80 per ft² on 130,000 ft² over five years exceeds US$1m (US$1.80 x 130,000 x 5 years = US$1.17m). Hence, under these objectively determined
criteria, the tenant would be deemed to have an SEI to renew its lease and therefore be required to include the renewal term in its lease accounting. As such, the impact of including the renewal term on the tenant’s balance sheet and income statement is shown in Figures 9 and 10, respectively. It should be noted that, even though the tenant has not actually exercised its renewal option, its balance sheet and income statement are affected as though it had actually done so. Moreover, even considering the fact in this example that the lease was classified as a Type B lease, the impact on both the balance sheet and income statement is not limited to the renewal term years, but actually serves to inflate the impact during the initial term of the lease as well. For example, by virtue of including the renewal term rates in the calculation of the average straight-line rent calculations, it serves to inflate the straight-line rents for all years during the term.

Finally, consider what these figures would be if, by virtue of including the renewal term in the accounting-based term of the lease, the tenant now concluded that the accounting-based term of the lease represented the ‘major part’ of the remaining economic life of the property.5 In such an instance, the tenant would no longer classify the lease as a Type B lease, but instead would need to classify it as a Type A lease (ie a capital lease). Upon viewing the difference in the balance sheet and income statement results from the lease without an SEI and the lease with an SEI that also becomes a Type A lease, tenants clearly will find spending the time and effort to establish an objective framework for defining SEIs across their lease portfolios to be a prudent decision (see Figures 11 and 12). Tenants also

![Figure 7](image7.png) **Figure 7** Balance sheet impact from ten-year, Type B lease with no renewal option  
*Source: LeaseCalcs*

![Figure 8](image8.png) **Figure 8** Income statement impact from ten-year, Type B lease with no renewal option  
*Source: LeaseCalcs*
would be well advised to consider and quantify these potential outcomes before signing any new lease as it may alter the way in which they choose to negotiate the terms and conditions of the lease and its renewal options. In thinking back to Aesop’s fable of the Lion and the Statue, it is true that one can characterise things in the manner one prefers to perceive them, and this is certainly the case with many of these subjective issues contained in RED’s proposals. But, any tenant also familiar with Aesop’s tale about the Honest Woodsman (also known as ‘Mercury and the Woodman’), will relate that ‘honesty is the best policy’, and this no doubt will be the standard upon which all companies will operate lest they meet their lion on less-friendly terms.

**THE ANTS AND THE GRASSHOPPER: IDLENESS BRINGS WANT**

‘The Ants were employing a fine winter’s day in drying grain collected in the summer time. A Grasshopper, perishing with famine, passed by and earnestly begged for a little food. The Ants inquired of him: “Why did you not treasure up food during the summer?” He replied: “I had not leisure; I passed the days in singing.” They then said: “If you were foolish enough to sing all the summer, you must dance supperless to bed in the winter.”’

As shown in the discussion above concerning the need to establish a portfolio-wide
framework for dealing with issues such as SEIs, there is no doubt or debate that accurately transitioning to the new accounting standards will include a rather significant amount of effort and diligence. For example, after the original Exposure Draft was issued in August 2010, a survey conducted by Deloitte in 2011 reported that 93 per cent of the companies surveyed did not believe they would be prepared to make the transition to those new standards, more than half of them believing it would take more than one year to make the transition and roughly two-thirds believing their current IT and software systems would be insufficient to deal with the new standards. Moreover, many companies expect the cost of the transition alone to be millions of dollars, as evidenced by comment letters submitted to the Boards during the comment period for the original Exposure Draft, whereby companies such as Intel, URS and Chevron stated their expected transition costs would be US$6m, US$10m and US$50m, respectively. Admittedly, these projections ultimately should prove to be worst-case scenarios, particularly in light of the advancements in lease accounting and analysis.

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Figure 11  Balance sheet results for Type B lease without significant economic incentive (SEI), and the same lease with SEI classified as a Type A lease
Source: LeaseCalcs

Figure 12  Income statement results for Type B lease without significant economic incentive (SEI), and the same lease with SEI classified as a Type A lease
Source: LeaseCalcs
software applications over just the course of the past 18 months. Nonetheless, these values speak of the magnitude of the effort that will be required for companies to make the transition.

While there is also no doubt that the Boards have significantly ‘softened’ the proposals since the issuance of the original Exposure Draft, they also have increased the complexity of the proposals if only by virtue of issuing RED with two lease models instead of one for all leases. In terms of positive changes (at least from the tenant’s perspective), however, RED has:

- changed the threshold of when options must be included in the accounting from ‘more likely than not’ to be exercised to requiring the presence of an SEI (much as discussed above);
- eliminated the requirement for continual reassessments of prior decisions or determinations absent changes in relevant or contractual changes; and
- concluded that rent payments based upon output or sales, such as percentage rent payments for retailers, will not be capitalised as part of the right of use asset and lease liability but rather expensed as incurred.

It is worth noting that this last point regarding percentage rent payments seemingly will need to be balanced against the requirement in RED for ‘disguised minimum rent’ payments to be capitalised, as, for example, a tenant who will only pay percentage rent charges might legitimately have to conclude at least some portion of their percentage rent charges represents ‘disguised minimum rent’. (This wrinkle is expected to receive more attention during the comment period and subsequent deliberations.)

The improvements and added complexities of RED notwithstanding, the fact remains that tenants will be faced with a wide-reaching project to make transition occur accurately and in a timely and cost-effective manner; however, this begs the question of ‘when?’ When does the process of transition need to begin and when does a tenant need to be able to operate under the new standards? The answer somewhat depends upon the individual company given how many leases they may have in their portfolio and the underlying complexities of those leases; however, it is far more useful to think of timing in terms of a common tenant profile and to use the new standards’ widely expected effective date of 1st January, 2017.

Therefore, assuming the effective date of the new standards is established as 1st January, 2017, many privately held companies may feel as though they have ample time to make the transition, particularly if they have fewer than 100 leases in their portfolio; however, an important issue that has been glossed over or missed by many tenants and observers is the concept and impact of ‘comparative financials’. More specifically, if a tenant is required to provide comparative financials in its audited financial statements, that tenant does not just have an ‘effective date’ to contend with, but also has a ‘date of initial application’ (DIA), ie the date on which its first comparative financial period commences. In other words, if a tenant is required to provide two years of comparative financial statement information (as is required from every US public company, for example), its DIA would be 1st January, 2015, a mere 19 months from the date of this paper. Considering more than half of the companies in Deloitte’s survey expected it would take them more than one year to make the transition, those firms are arguably the ‘grasshopper’ of Aesop’s story if they are not actively and deeply engaged in transition efforts already.

To be clear, the DIA is not the date upon which companies begin reporting based upon the new standards. Rather, it marks the beginning of the period during which a tenant will effectively need to maintain two sets of lease accounting books. It will continue to report its financial results utilising the existing
standards between the DIA and the effective date; however, on the effective date it will issue its financials utilising the new standards, and incorporate the new standards' version of its lease accounting into its comparative financials for the prior periods. So, why can a tenant not just use the effective date as its target in its transition efforts? The answer is largely due to the risk that the comparative periods' financials will be 'apples' to the post-effective date's 'oranges' if the tenant were to fail to capture every one of its leases in effect during the period between its DIA and the effective date. In other words, if the tenant plays the role of the grasshopper and waits until winter to make the transition it runs the real risk of mistating its financial results, and that risk is greater for tenants with larger and more complex lease portfolios.

As a compelling example of why tenants will regret being idle on this issue in the time between now and when their own DIA occurs, consider the simple fact that the overwhelming majority of operating leases under today’s accounting standards have been captured, recorded and entered in tenants’ systems (whether they are lease management, enterprise resource planning (ERP) or simple Excel worksheet ‘systems’) in such a way that the data cannot be utilised in the most important of the new lease accounting calculations: determining the right of use asset and lease liability. The right of use asset and lease liability are both to be calculated using the tenant’s ‘net’ base rent, ie after deducting the value of any services provided by the landlord that have been embedded in the gross rental rate such as base year or expense stop costs, or the value of services being provided by the landlord as part of the terms and conditions of the lease. (There are certainly many other components that are factored into the determination of right of use asset and lease liability, but, for the purposes of this example, they are assumed not to affect the example lease in question.) In calculating the straight-line rents under FAS13 or IAS17, however, the vast majority of tenants, as evidenced by leases and their associated accounting reviewed by the author’s firm, have utilised the respective lease’s gross base rent values for the purposes of establishing straight-line rent expenses. Arguably, the expenses and rent should be bifurcated for the purposes of establishing straight-line rent, but since both components end up ‘above the line’ in terms of earnings before interest, taxes, depreciation and amortisation (EBITDA) calculations and the sum of the bifurcated amounts in today’s operating lease is equal to the gross, there is really no consequence for the tenant’s financials as a result of this common shortcut. So, while the shortcut is not necessarily incorrect in terms of current accounting standards, it presents a clear problem in terms of implementation of the new standards.

If a tenant were to attempt to transition to the new standards utilising its existing, recorded data for straight-line rent expense for any given lease such that it did not have either the data or the ability to bifurcate the gross base rents into net base rent and service charge components, that tenant would end up with an erroneous and overstated right of use asset and lease liability on its balance sheet both at transition and throughout the remaining term of its lease. By way of illustration, consider the following hypothetical example of a common gross lease structure in the USA. A tenant leases 100,000 ft² for a term of ten years, the tenant’s incremental borrowing rate is 8 per cent and the lease is structured as a ‘base year’ lease wherein the base year service charges of US$14 per ft² are embedded in the tenant’s base rental rates of US$50 per ft² at lease commencement, and base rental rates increase by US$2 per ft² every two years throughout the term. As shown in Figure 13, in this scenario, while the tenant’s cash flows and income statement impacts would be really no different whether it did or did not bifurcate the gross rental charges into net rents and service charges, the impact on the tenant’s balance
sheet would be wholly material, even for just one lease calculated incorrectly. Moreover, if this hypothetical lease actually was to be treated as a Type A lease instead of, as in the illustration above, a Type B lease, then the impact also would be felt on the tenant’s income statement, as illustrated in Figure 14.

Considering the attention the new accounting standards have garnered with respect to complaints about their resulting impact on a company’s financial ratios, debt covenants and the like, tenants will need to ensure they allow themselves ample time ahead of their DIA to get all of their lease documents, data and systems aligned to accommodate the new standards so they do not find themselves wanting more time or more accurate results.

THE FATHER AND HIS TWO DAUGHTERS: YOU CANNOT PLEASE EVERYONE

‘A man had two daughters, the one married to a gardener, and the other to a tile-maker. After a time he went to the
daughter who had married the gardener, and inquired how she was, and how all things went with her. She said: “All things are prospering with me, and I have only one wish, that there may be a heavy fall of rain, in order that the plants may be well watered.” Not long after, he went to the daughter who had married the tile-maker, and likewise inquired of her how she fared; she replied: “I want for nothing, and have only one wish, that the dry weather may continue, and the sun shine hot and bright, so that the bricks might be dried.” He said to her: “If your sister wishes for rain, and you for dry weather, with which of the two am I to join my wishes?”

As anyone who has followed the Boards’ efforts over the past several years knows, there have been a great many complaints and criticisms lodged at the original Exposure Draft’s proposals, which, truth be told, is the reason RED was released. The Boards have made many significant modifications to their original proposals in an attempt to assuage some of the more vocal concerns, and yet it seems some complaints will continue to be voiced during RED’s ‘comment period’ that runs through 13th September, 2013, and perhaps even beyond. If anything can be learned from observing the Boards’ efforts these past several years it is that it is often impossible to make every constituent happy, particularly when there are significant changes afoot. The likelihood for continuing complaints aside, there should be no doubt in CRE or finance executives’ minds that their lease obligations will be appearing on their balance sheets in the very near future. On this one overriding point the Boards have not wavered in the slightest over the past several years. As RED’s proposals move forward though it may be helpful to CRE executives and their counterparts in finance to understand, and perhaps be able to temper, some of the expected complaints from various parties. For example, consider the following three themes that have seemed to repeat since the issuance of the Exposure Draft and throughout the Boards’ redeliberation process.

**Dual lease model (ie Type A and Type B)**

RED includes a dual model approach due, in large part, to the complaints associated with the ‘front-loaded’ income statement impact of the Type A model when it was the only model in the original Exposure Draft. Anticipated complaints about the dual model, and their most likely or largest sources, include:

**Type A**
- **Issue:** The subjective nature of determining the correct lease classification.
- **Source:** Real estate lessees adhering to US GAAP are accustomed to the ‘bright line’ tests of existing FAS13/ASC840 for the purposes of classification, but companies following IFRS today do not have bright lines for classification.
- **Consideration:** In light of the fact that adherents to IFRS apparently have not had tremendous difficulty in implementing the current dual model approach, one should not expect GAAP-based entities to encounter tremendous difficulty in doing so either.

**Type B**
- **Issue:** The straight-line approach in the Type B model is flawed due to its reliance on a ‘plug’ for amortising the right of use asset, thereby complicating the accounting and making it less useful at the same time.
- **Source:** Three of the seven FASB members voted against the dual model approach and thereby voted against issuing RED in a form that included the dual model approach. These three Board members’ alternative views are contained in RED.
- **Consideration:** The single versus dual model issue with the Boards has been akin to watching a US presidential campaign: replete with ‘flip-flops’. First, the Exposure Draft proposed one standard, then the
Boards, in the course of redeliberations, tentatively agreed to a dual model approach (although one slightly different than that contained in RED), then the Boards reversed that tentative decision and reverted to a single model approach using the Type A lease model for all leases, and, finally, issued RED with a dual model approach, notwithstanding the objection of several Board members. Ultimately, tenants should be aware of this flip-flopping behaviour and the underlying basis for it — ie the invented amortisation method and the associated lack of transparency in reporting and disclosures — as it would not be shocking to see the Boards revert, yet again, to a single model approach (using the Type A model), before this project is finalised.

Front-loaded expense profile for Type A leases

As shown in the various analyses elsewhere in this paper, the profile of how a lease affects a lessee’s income statement under a Type A lease is such that the expense is higher in the earlier years of the lease term than it is in the latter years. Many observers complained that this profile was not reflective of the underlying lease transaction and thus they lobbied for a straight-line model, such as that included in RED. Anticipated complaints about the front-loaded expense profile of Type A leases, and their most likely or largest sources, include:

- **Issue:** With the issuance of RED, the Boards have managed to assuage the concerns of at least the majority of real estate lessees as far as the ‘front loading’ of the expense profile complaints were concerned by virtue of the Type B model being included in RED; however, for equipment lessees with existing operating leases that will be treated as Type A leases, and the equipment leasing industry in general, their complaints remain as before. More specifically, the complaints will be that the front-loaded expense profile on the income statement does not match the pattern of contractual lease payments or the consumption of the underlying asset.

  - **Source:** Equipment lessees and the equipment leasing industry in general.
  - **Consideration:** Perhaps the greatest misnomer — or missing point — in complaints about the front loading of the expense profile under Type A leases is that those complaints always seem to ignore or overlook the ‘back end lightening’ of the expense profile during the term when using the Type A model approach. In other words, it would seem as though, for those complaints about the front loading to have credence, they would need to acknowledge and give balance to the relief lessees will receive in the latter half of their lease terms. After all, when the lease is executed it is expected that the lessee will remain obligated to make all of its lease payments, and continue to account for them, throughout the term of the entire lease, not just in the first few years where these complaints have been largely focused.

CRE executives and their counterparts in finance no doubt will recognise the fact that even the straight-line expense approach under both existing accounting standards and RED’s Type B model represents a ‘front loading’ of rent expense as compared to the actual cash payments being made under the lease. In other words, since the vast majority of all real estate leases have some amount of increase in their rents over their term, utilising the ‘average’ of those rents on the income statement is just another type of front loading.

Reduction in shareholder’s equity from leases being placed on the balance sheet

To the extent a lease liability balance is greater than its associated right of use asset, a
tenant’s calculation of its shareholder’s equity, or net worth, would be negatively affected.

• **Issue:** In calculating the right of use asset and lease liability under both the Type A and Type B models, it is anticipated, and in many instances actually assured, that the amount of lease liability will exceed the amount of the right of use asset from most real estate leases. This is a by-product of the differences in how each of those values are calculated and also a function of the difference in how each is drawn down on the balance sheet over the term of the lease. Suffice it to say that, all else being equal, placing a £5m right of use asset and a £6m lease liability on a tenant’s balance sheet would serve to reduce its shareholder’s equity by £1m.

• **Source:** Multiple constituents have raised this issue over the past several years as a purported example of how the new standards might damage company valuations.

• **Considerations:** This line of complaint, perhaps, seems to have the most in common with the literary theme of this paper, i.e. a fable. The reasons why these complaints do not stand up to scrutiny include the following:

  – Existing capital leases cannot have such an impact as they are already on the balance sheet, and thus there will be no net change in a tenant’s shareholder’s equity position due to the new standards as far as existing capital leases are concerned. Thus, if anything, this complaint should be focused on existing operating leases.

  – Operating leases which (a) have level rents over their respective lease terms, as is the case with the majority of equipment leases, and (b) did not include meaningful upfront incentives from the lessor or initial direct costs paid by the lessee, should have a right of use asset and lease liability balance at the commencement of the lease (or upon transition to the new standards) equal to one another. Hence, there would be no impact on equity. It also should be noted that the leases described here would not generate a deferred rent credit balance under existing standards, and where deferred rent credits, in fact, are recorded on a tenant’s balance sheet there is also no impact on a tenant’s equity from the leases described in this section under existing standards.

  – Operating leases which (a) have increasing rents over their respective lease terms, as is the case with the majority of real estate leases, and/or (b) did have meaningful upfront incentives or allowances from the landlord, would have unequal asset and liability balances over the lease term. But, under existing lease accounting standards these leases also would generate a deferred rent credit balance to be recorded on the tenant’s balance sheet and that balance, as is typically the case with an operating lease with increasing rents over a lease term, would grow and then subsequently be drawn down to zero by the end of the lease term. The more interesting point here is that today’s deferred rent credit balances are tomorrow’s difference between the asset and liability balances on the balance sheet. In other words, a tenant with 100 operating leases today, each of which records its own deferred rent credit balance, will find each of those deferred rent credit balances will be equal to the difference of the corresponding lease’s asset and liability balances. Consequently, these complaints about the impact on a tenant’s equity or net worth are unfounded.

**SLOW AND STEADY WINS THE RACE**

The changes in the lease accounting standards no doubt will continue to generate a
lot of discussion and thought among CRE leaders and their peers in finance and accounting. Although quite some time has elapsed since the original Exposure Draft was issued, the Boards clearly seem to have found their momentum again and one should expect to see a steady push to the finish line. Much as with the benefit of hindsight, a final nod to Aesop seems in order as it can be said that the Boards’ strategy to reach their finish line has been one of ‘slow and steady wins the race’, just as in Aesop’s ‘The Tortoise and the Hare’. The CRE community would be wise to follow these examples, as the transition to the new standards already should be underway for most if they are to reach the finish line successfully.

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REFERENCES
(3) See, for example, Paragraph 840-10-25-1 of the FASB Accounting Standards Codification, which address the 75 per cent of economic life and 90 per cent of fair market value tests to determine whether a lease is a capital lease or an operating lease under existing FAS13/ASC840 standards.
(5) See Paragraphs 842-10-25-5 through to 842-10-25-7 of FASB’s RED for details on lease classification considerations and criteria.
(11) Aesop’s Fables.