Below Market Lease
Acquired in a Business Combination

**Disclaimer – The exposure draft received nearly 700 letters of comment through the comment period ended December 15, 2010. There is some expectation that key features of the standard will be modified as a result of constituent response. As a result, these illustrative examples will not likely be accurate or appropriate to rely upon after issuance of the final standard. We have provided these as an educational tool only and do not represent these examples to be accurate under current or future final standards. Any templates used in the examples below are for internal use only and are not available for distribution.

Leasing Example – **Below Market Lease Acquired in a Business Combination**

Summary:

Evaluation of leases and intangible assets associated with leases assumed or entered into in connection with business combinations will be changed by the proposed Accounting Standards Update from the existing guidance under ASC Topic 805.

Background:

ASC paragraphs **805-20-25-12** and **-13** state:

" Regardless of whether the acquiree is the lessee or the lessor, the acquirer shall determine whether the terms of each of an acquiree's operating leases are favorable or unfavorable compared with the market terms of leases of the same or similar items at the acquisition date. The acquirer shall recognize an intangible asset if the terms of an operating lease are favorable relative to market terms and a liability if the terms are unfavorable relative to market terms.

An identifiable intangible asset may be associated with an operating lease, which may be evidenced by market participants' willingness to pay a price for the lease even if it is at market terms. For example, a lease of gates at an airport or of retail space in a prime shopping area might provide entry into a market or other future economic benefits that qualify as identifiable intangible assets, such as a customer relationship. In that situation, the acquirer shall recognize the associated identifiable intangible asset(s) in accordance with paragraph 805-20-25-10."

Analysis:

Under the proposed ASU a right-of-use asset is initially recorded at "cost" measured as the amount of the liability to make lease payments plus any initial direct costs incurred by the lessee and the liability is recognized at the present value of expected future lease payments. The rules contained within the exposure draft will end "operating lease" treatment for leases.

ASC Topic 805 requires assets acquired and liabilities assumed to be recognized at fair value as of the acquisition date. This evaluation includes the "right to use" asset and the related liability to make lease payments. Therefore, the valuation guidance found in ASC section 820 (formerly FAS 157) applies to the valuation of these items. This will likely eliminate the current requirement for an acquiring entity to evaluate whether the terms of a lease agreement assumed or entered into in connection with a business combination constitute an identifiable intangible asset or a liability that should be recognized separately in accounting for the business combination..

Under the current rules, the acquirer determines whether the terms of an acquiree's leases are favorable or unfavorable by comparison with the market terms of leases of the same or similar items at the acquisition date. The acquirer recognizes an intangible asset (liability) when lease terms are favorable (unfavorable) relative to market terms. This analysis applies regardless of whether the acquiree was the lessee or the lessor.

Under the proposed guidance, such characteristics would instead be considered in determining the fair value of the "right to use" asset. In some instances, the determined fair value will be different than the amortized carrying value on the transferor's books.

Example:

In connection with a business combination, ABC Corporation has acquired an existingreal estate lease with a lessor owned by the sole shareholder of the acquiree.

Details:

<u>The lease terms are as follows:</u>

Tenant:	ABC Corporation (ABC) ***(Acquirer)***
Lessor:	General Properties, LLC (GP, LLC) ***(Selling shareholder)***
Premises:	Suite 100 of the 9999 Building, totaling 20,000 square feet
Term:	10 years
Lease Date	January 1, 2010 ***(Acquisition date)***
Commencement Date:	January 1, 2010
Base Rental:	$22 per square foot for 2010 with a 5% increase annually on January 1
Initial Direct Costs	ABC Corporation paid an attorney $9,000 in general fees and $1,000 for document preparation in conjunction with the lease process
Commissions	Commissions on the lease of $50,000 are paid directly by the lessor
Security Deposit:	$25,000
Free Rent Period:	No rent shall be due for January 1, 2010 through March 31, 2010
Option to Extend:	Lease may be extended for one (1) additional term of five (5) years with a significant term penalty if not extended
% share Operating Costs:	Certain operating costs of the building will be allocated at $25,000 annually for CAM
Subletting:	Not permitted
Build Out Allowance:	None at inception, $50,000 build out allowance provided at the beginning of year 6 of the lease and at renewal, if extended
Residual Value Guarantees:	None
Purchase Option	None, but failure to renew does trigger a significant penalty in the contract

<u>Other relevant assumptions:</u>

Market rate comparison:	**Market rates for similar space in the immediate area range from $40 to $48 per square foot. 5% annual increases are considered market-rate terms.**

Result:

The acquirer will apply the fair value considerations of ASC Topic 820 to consider (among other things) the difference in cash flows between the terms of this lease and the cash flows that would be required under market terms for this lease in order to determine the fair value of the right-of-use asset. It will also determine the fair value of the liability for future lease payments using the provisions of ASC Topic 820. The right-to-use asset and the lease payments liability will each be recorded at their determined fair values as part of the initial recognition of the business combination using the acquisition method. Note that the fair value of the asset is determined independent of the fair value of the liability. They likely will not be exactly the same amount, although a wide variation between the amounts would be unusual.