

FASB Lease Accounting

An exclusive article series designed to keep you informed.



Grant Thornton



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“Operating” Leases Moving to the Balance Sheet

Welcome to Our Series

The Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) are discussing changes to lease accounting. In a Discussion Paper titled *Leases: Preliminary Views*, the FASB has agreed to eliminate off-balance sheet accounting for operating leases. If finalized, all current and future leases will be recorded on the balance sheet as assets and liabilities.

This article is the first of a series of three articles that will discuss some of the issues raised by the proposed changes. Grant Thornton and UGL Equis have joined forces to help CFO's sort through the accounting issues and determine how these changes will affect your business. The second article will discuss some of the more complex aspects of the new accounting. The third article will include suggestions on how to plan ahead.

And, planning ahead will be a necessity – if the proposal ultimately becomes generally accepted accounting principles (GAAP), there will be major changes to the accounting for operating leases.

The Particulars

Executing any lease agreement will create a liability and a corresponding asset on the balance sheet. How will this be done? The proposed accounting will measure the obligation first. Using the lessee's incremental borrowing rate as a discount rate, the lessee will discount the most likely rental payments for the leased asset over the most likely lease term.

The most likely rental payments will include all required lease payments, any purchase options likely to be exercised, and an estimate of future “contingent” rents such as future increases for inflation and rents determined as a percentage of future sales or other future usage.


The most likely lease term will include periods covered by renewal options that are likely to be exercised. If there is a purchase option, the most likely lease term may be the useful life of the asset. The resulting figure will then be recorded on the balance sheet as both an asset and a liability.

The *Leases: Preliminary Views* document only discusses a simple leasing model and does not discuss the accounting for a typical real estate lease that may include executory costs such as taxes and insurance, and services such as security, common area maintenance or other features. Recent discussions at the FASB indicate that the payments for services and other executory costs would not be included in the recognized asset and liability.

Table 1 summarizes the key changes proposed by the Boards for operating leases:

Topic	Existing U.S. GAAP	Proposed Model	Expected Impact
Overall recognition	Operating leases are “off-balance sheet”.	Record an asset and liability for all leases based on the most likely payments and lease term.	Increased assets and liabilities on the balance sheet
Payments for services and executory costs	Also “off balance sheet.”	Remains “off balance sheet”.	Must distinguish payments for “rent” from payments for services and executory costs.
Lease term	Include option periods with bargain renewals or periods prior to a bargain purchase option in the lease term.	Include option periods when determining the most likely lease term and in the recognized asset and liability.	Need to assess most likely term each reporting period and adjust financial statements if needed.
Purchase options	Capitalize bargain purchase options.	Capitalize all purchase options likely to be exercised.	Need to assess likelihood of exercise each reporting period.
Contingent rents	Generally recognized in the periods incurred.	Estimate future payments and include in recorded asset and liability.	Need to estimate and capitalize likely future payments.
Income statement presentation	Record rent expense on a straight line basis in the income statement.	Recognize interest expense on the obligation and depreciation expense on the asset in the income statement.	Increases in EBITDA, depreciation expense and interest expense.

What’s Next

The FASB and the IASB are analyzing the comments received on the preliminary views. They expect to issue a second and more refined proposal (exposure draft), during the second half of 2010 and a final standard in 2011. You will have an opportunity to comment on the exposure draft when it is issued. The Discussion Paper and Comment letters on the Discussion Paper can be found on the FASB website.  :: **Article 2 coming soon to your inbox so stay tuned for more insight!**

Resources:

www.fasb.org

www.iasb.org

[AICPA: FASB/IASB - Leases FAQs](#)

[Grant Thornton: New Developments Summary, “FASB and IASB express views on accounting by lessees”](#)