

FASB Lease Accounting

An exclusive article series designed to keep you informed.



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Principles-Based Accounting for Leases

As we mentioned in our first article, “Operating Leases Move to the Balance Sheet,” 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.

The objective of the Discussion Paper is to simplify lease accounting by adopting a principle of recognizing all lease obligations that create a liability and a corresponding “right of use” asset. The amount of the asset is determined by the amount of the obligation. The issues raised in the Discussion Paper, however, show that it may not be that simple. This article, the second in a series of articles written by Grant Thornton LLP and UGL Equis, discusses a few of the proposed principles, and suggests some questions that remain unanswered by the Discussion Paper.

Issues Discussed

This paper covers three important issues:

- What is a lease?
- What is the term of a lease?
- When is a lease payment a present liability?

Issue 1: What is a lease?

The amount to be recorded on the balance sheet in the new model will be limited to amounts for future payments for the right to use property, plant, and equipment (PPE). The new model would not capitalize payments for the following:

- Use of an intangible asset.
- Services such as maintenance or security.
- Executory costs such as taxes and insurance.
- Leases for minerals.

Deciding which costs would be capitalized and which would not could increase the complexity of lease accounting. It is not always easy to distinguish between a lease and a contract for services, and the proposed accounting could provide an incentive to blur the distinction. Even if the distinction

is clear, rent payments would need to be allocated between those amounts that will be included on the balance sheet and those that will not. Is the principle in the proposal practicable?

Issue 2: What is the term of a lease?

The intended principle for recognizing an asset and a liability is clear: recognize an obligation for the lease payments over the entire lease term and a corresponding right of use asset. But what if the lease includes optional renewal periods? Should rents during those optional periods be included in the recorded asset and liability?

For the time being, the FASB has decided to measure the lease liability using the “most likely lease term”, including optional renewal periods. The assessment of likelihood would be performed every reporting period, and the asset and liability would be adjusted accordingly. The lease term will be determined based on contractual and non-contractual factors. The lessee’s intentions and past practice would not be considered.

This accounting is somewhat unusual. Because an option represents a right but not an obligation, an option does not meet the accepted definition of a liability. Recognizing a liability and a corresponding right of use asset for payments during an optional renew period, therefore, would not be consistent with a principle of recognizing rent payments that meet the definition of a liability.

Issue 3: When is a lease payment a present liability?

Many leases include contingent rent payments, meaning payments whose amounts are not fixed at the beginning of the lease. These may be due to estimated future inflation, variations in the amount of use (miles driven in a car lease), or variations based on future sales. At the current time, those costs are not included in the calculation of lease payments, but rather recognized as rent expense when due.

The new accounting model would recognize contingent rents as an asset and liability based on an estimate of the most likely amount that will be paid in the future. Like the lease term, the amount of contingent rents must be re-evaluated each reporting period.

The proposed accounting model assumes that all future contingent rents meet the definition of a present liability. However, some contingent payments may be based on future optional use of the leased asset. Contingent rents would also need to be evaluated to determine if future payments are for the use of property, plant and equipment or for other elements of the contract such as services or the use of intangible assets. Although it may be simpler to capitalize an estimate of all contingent payments, should simplification come at the price of conceptual consistency?


Summary

This is not an exhaustive list of issues but includes some of the issues likely to have the most impact on the balance sheet in the future:

Issue	Proposal	Comment
What is a lease?	Capitalize payments for the right to use property, plant, equipment; do not capitalize payments for the use of intangible assets, services, and executory costs.	Current practice accounts for all rent payments in the same way in operating leases.

Issue	Proposal	Comment
What is the term of the lease?	Recognize an asset and liability based on the most likely lease term including optional renewal periods.	Options are generally considered to create a right but not an obligation to renew. The proposal could overstate the underlying asset and liability.
When is a lease payment a present liability?	Recognize an asset and liability based on the most likely estimated rent payments, including contingent amounts.	The term “contingent rents” includes different types of payments that differ in economic substance. Some may be similar to options; others may be payment for future executory costs.

What’s Next

As mentioned in our first article, 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 3 coming soon to your inbox so stay tuned for more insight!**

For a copy of our first issue, [click here](#).

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”](#)