



## ACCOUNTING ALERT

2010-02

September 9, 2010

### Proposed Changes to Lease Accounting

#### Background

On August 17, 2010, the FASB and IASB issued an exposure draft of a proposed accounting standards update which, if confirmed, will significantly change how we account for leases. Current practice allows two different methods of accounting depending on the results of a bright-line test to determine whether the lease is a capital lease or an operating lease. Operating leases are recognized in operations over the lease term as payments are made and are generally not reflected on the balance sheet. Capital leases on the other hand are currently

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*The FASB and IASB are proposing significant changes to lease accounting which will eliminate off-balance sheet accounting for most leases and require companies to record an asset and liability for their leases.*

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reflected on the balance sheet. The proposed standard would require most leases to be recorded on the balance sheet as financing transactions and essentially eliminate the current off-balance sheet accounting for operating leases.

The proposed standard will require that lessees and lessors apply a right-of-use model in accounting for all leases other than the leases of biological and intangible assets and leases to explore or use natural resources.

Under a right-of-use model a lessee would record an asset representing its right to use the leased asset and a corresponding liability to make lease payments. Similarly, a lessor would recognize an asset representing its right to receive lease payments and, depending on its exposure to risks or benefits associated with the leased asset, would either recognize a lease liability (a performance obligation approach) or derecognize its

rights in the leased asset that are transferred to the lessee and continue to recognize a residual asset (a derecognition approach).

Existing leases are not expected to be grandfathered which means that both existing and new leases will be impacted. The proposed standard is currently being exposed by the FASB for comments through December 15, 2010, and a final accounting standards update is expected to be issued in the first half of 2011. The proposed standard does not specify an effective date.

*Reznick Group Note: Although the proposed lease standard does not specify an effective date, we anticipate that it will not be effective until 2013.*

#### Key Provisions for Lessees

Lessees will record both a right-of-use asset and a lease liability at inception of the lease which will be based on the present value of its expected liability to make lease payments plus any initial direct costs. The present



value of the lease liability will be discounted using the lessee's incremental borrowing rate<sup>1</sup>. In leases that have contingent payments (such as contingent rentals, residual value guarantees and payments due under option penalties) the lessee will estimate rental payments based on the expected outcome using probability-weighted averages. The lease term will be the longest possible lease term that is more likely than not to occur (the cumulative probability greater than 50% of occurring).

After commencement of the lease, a lessee will measure the lease liability using the interest method and will amortize the right-of-use asset over the lease term or the useful life of the underlying asset if shorter.

If facts or circumstances indicate that there would be a significant change in the lease liability, the lessee will be required to reassess the carrying amount of the liability. To the extent that the length of the lease term is modified a corresponding change will be made to the right-of-use asset. However, changes to expected

rental payments related to contingent rentals, expected payments under option penalties and residual value guarantees will be charged to income to the extent that the changes relate to current or prior periods. Only changes that relate to future periods will be recorded as adjustments to the right-of-use asset.

***Reznick Group Note:** Under the interest method the lease liability will be amortized similar to a mortgage where payments will reduce the liability and also pay interest expense. Use of the interest method will also front load interest costs during the lease term.*

The balance sheet will reflect the right-of-use asset and the liability to make lease payments. Operations will reflect interest expense resulting from the lease obligation and amortization expense arising from the right-of-use asset as well as any impairment of the right-of-use asset that occurs.

***Reznick Group Note:** Both interest expense and amortization expenses are excluded from the determination of EBITDA thus potentially increasing EBITDA when compared to the current treatment of lease expense.*

## Key Provisions for Lessors

Similar to lessees, a lessor will record an asset representing its right to receive lease payments equal to the present value of the lease payments discounted using the rate the lessor charges the lessee plus any initial direct costs incurred by the lessor. Different from lessees, lessors are required to determine at inception of the lease whether the lease should be accounted under the performance obligation approach or the derecognition approach depending on the lessor's exposure to risks or benefits associated with the leased asset during and after the lease term. If a lessor retains exposure to significant risks or benefits associated with the leased asset, a lessor shall apply the performance obligation approach to the lease. If a lessor does not retain exposure to significant risks or benefits associated with a leased asset, a lessor shall apply the derecognition approach to the lease. Whichever approach is selected cannot be changed after inception of the lease.

Performance obligation approach – Under the performance obligation approach the lessor continues to account for the leased asset and records a performance obligation liability to reflect its obligation to allow the lessee to use the asset during the lease term. The amount of the performance obligation liability at inception of the lease is equal to the present value of the lease payments expected to be received. In leases that have contingent payments such as contingent rentals, residual value guarantees and payments due under option penalties the lessee will estimate rents expected to be received and that can be reliably measured based on the expected outcome using probability-weighted averages. Similar to lessees, the lease term will be the

<sup>1</sup> The rate the lessor used in the lease can be used if it can be determined.



longest possible lease term that is more likely than not to occur (the cumulative probability greater than 50% of occurring).

If facts or circumstances indicate that there would be a significant change in the amount of lease payments to be received, the lessor will be required to reassess the carrying amount of the right to receive lease payments asset. To the extent that the length of the lease term is modified a corresponding adjustment will be made to the performance obligation liability. However, changes to expected rental payments related to contingent rentals, expected payments under option penalties and residual value guarantees will be recognized as income based on whether or not the performance obligation has been satisfied. Changes that have not been satisfied will be recorded as adjustments to the lease liability.

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***Under the performance obligation approach the leased asset, the right to receive lease payments and the lease liability are presented together in the balance sheet as a net lease asset or net lease liability.***

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After commencement of the lease, a lessor will account for the right to receive lease payments using the interest method. The right to receive lease payments asset will be assessed for collectability and any impairment recorded. Income under the lease will be recognized as the lease liability is satisfied. It is not a foregone conclusion that revenue from the satisfaction of the liability will be measured on a straight-line basis.

Under the performance obligation approach the leased asset, the right to receive lease payments and the lease liability are presented together in the balance sheet as a net lease asset or net lease liability. The lessor would include interest income on the right to receive lease payments, lease income from satisfaction of the lease liability and depreciation expense on the leased asset together as net lease income or net lease expense.

Derecognition approach – Under the derecognition approach the lessor derecognizes the portion of the carrying amount of the underlying leased asset that represents the lessee's right to use the asset and recognizes a gain or loss based on the amount of the asset recorded for the right to receive lease payments.

In leases that have contingent payments (such as contingent rentals, residual value guarantees and payments due under option penalties) the lessee will estimate rents expected to be received and that can be reliably measured based on the expected outcome using probability-weighted averages. Similar to lessees, the lease term will be the longest possible lease term that is more likely than not to occur.

If facts or circumstances indicate that there would be a significant change in the amount of lease payments to be received, the lessor will be required to reassess the carrying amount of the right to receive lease payments. Any changes in the amount of the lease payments will be recognized in income. However, to the extent that the length of the lease term is modified a corresponding adjustment will be made to the gain or loss resulting from derecognition of the asset and the residual value of the asset.

***Reznick Group Note:*** *Under derecognition the lessor is required to determine the fair value of the leased asset in making the allocation of cost between the residual asset and amount allocated to the lease.*



After commencement of the lease, a lessor will account for the right to receive lease payments using the interest method. The right to receive lease payment asset will be assessed for collectability and any impairment recorded.

Under the derecognition approach the residual asset and the right to receive lease payments would be presented separately in the balance sheet. Lease income and expense would be either presented separately or as a net number depending on whether the derecognized assets would otherwise be sold.

## Subleases

Subleases will be subject to the proposed guidance. The original lease and the sublease will be treated as separate leases and the lessor will apply the performance obligation approach. However, the presentation of subleases in the balance sheet will be a net presentation whereby the right-of-use asset under the head lease is presented together with the right to receive lease payments under the sublease less the lease liability in order to derive a net lease asset or a net lease liability.

## Short-term Leases

A concession was made in connection with short-term leases, which are defined as leases with a maximum lease term, including options to renew or extend, of 12 months or less.

- Lessees may elect to account for short-term leases on a lease-by-lease basis without discounting the obligation to make lease payments.
- Lessors may elect to account for short-term leases on a lease-by-lease basis without recording an asset for the right to receive lease payments or a lease liability, similar to operating leases under current accounting.

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*The lease term will be the longest possible lease term that is more likely than not to occur.*

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## Sale and Leaseback Transactions

For transactions that qualify as sales and leasebacks, the seller/lessee will account for the transfer as a sale and the subsequent leaseback will be accounted for as a lease under the proposed guidance. If the transaction does not qualify as a sale then the transferor will account for it as a financing transaction.

For transactions that qualify as sales and leasebacks, the buyer/lessor will account for the transfer as a purchase and the lease will be accounted for using the performance obligation approach. If the transaction does not qualify as a sale then the transferee will not record the asset as a purchase and will account for the monies advanced to the transferor as a receivable.

## Leases with Service Components

For leases with service components the lease payments will be allocated between the lease and the service components in situations where the service component is considered distinct and separable from the lease. If the service component is not considered distinct, then the entire contract will be accounted for as a lease. To



be distinct, the entity should sell identical or similar services separately or could sell the service separately because it is a distinct function and has a distinct profit margin.

## Disclosures

Significant new disclosures will be required concerning all aspects of an entity's leasing operations. The increased disclosures will focus on qualitative and quantitative information including disclosure of the significant judgments and components of its decisions and assumptions surrounding its lease term determination, contingent rentals, options and residual value guarantees. In addition, both lessees and lessors will be required to reconcile changes in the significant components of each item included in the balance sheet.

***Reznick Group Note:** The new required disclosures and accounting will increase the systems and documentation requirements related to leases.*

## Selected Real Estate Industry and General Implications

- **Leases of Office Space and Equipment** – Many companies lease office space and equipment, or both. As a lessee of either office space or equipment, entities will need to record a right-of-use asset and a corresponding lease liability representing its obligation to make lease payments regardless of the lease term.
- **Owners of Multi-Family Residential Rental Properties** – We anticipate that most residential rental real estate entities will be able to take advantage of the short-term lease provisions as a lessor in connection with their tenant leases and continue to account for these leases as operating leases. Some leases with longer lease terms may not meet the short-term lease criteria, which would require implementation of the proposed lease guidance.
- **Owners of Office and Industrial Properties** – Owners of office buildings and industrial property will likely retain significant risks or benefits associated with the leased real estate and will be required to apply the performance obligation approach to account for their leases. These lessors will spend significant effort on determining lease terms since many office and industrial leases contain renewal options. Tenants will have to address subleases when they occur.
- **Owners of Retail Properties** – The entities that own and rent retail space will likely have lease terms with contingent rent provisions that will need to be estimated. The contingent rent features will likely result in use of the performance obligation approach. Ongoing reassessments will also need to be prepared with any changes allocated between current and future periods.
- **Taxable Entities** – The proposed guidance will create additional temporary book-to-tax differences for income tax reporting.



- **Lease Term Considerations** – Many entities may be inclined to negotiate shorter initial lease terms with multiple future renewal options in order to reduce the impact of the proposed lease accounting on their balance sheets. However, the proposed guidance makes it difficult to arbitrarily choose and justify a shorter lease term when extension and renewal options exist. Entities must disclose how they determined the lease term and must reconcile subsequent changes in the right-of-use asset and the lease liability which will highlight the reasons for any changes that occur.
- **Systems and Reporting** – Accounting software for leases will need to be significantly modified to ensure it is capable of handling the complex and multifaceted nature of this proposed standard.

Prepared by:

**Michael Beck – Principal**  
National Audit and Assurance  
[Michael.Beck@reznickgroup.com](mailto:Michael.Beck@reznickgroup.com)

**Corbin Adams – Senior Manager**  
National Audit and Assurance  
[Corbin.Adams@reznickgroup.com](mailto:Corbin.Adams@reznickgroup.com)

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