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Extreme Makeover: Accounting for Leases Edition

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In 2002, the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) agreed to work together to converge U.S. generally accepted accounting principles (GAAP) and International Financial Reporting Standards (IFRS). The agreement is documented in a “Memorandum of Understanding” and identifies a number of standards and projects to be modified or converged. Today, there are a significant number of joint FASB/IASB projects in process. The goal of each project is to replace the existing FASB and IASB guidance on the topic with a common standard. One such project is the leases project. An exposure draft (the lease proposal) was issued in August 2010.

The goal of this joint project is to develop common lease accounting requirements to ensure that the assets and liabilities arising from lease contracts are recognized in the statement of financial position. Under the proposal, all leases within the scope would result in an asset and a liability being recognized in the balance sheet. Off-balance sheet accounting for leases would no longer exist.

Introduction and Background

On August 17, 2010, the Financial Accounting Standards Board (FASB) issued an exposure draft (the lease proposal) with major changes to lease accounting. The lease proposal would cause significant changes to the leasing model that exists in U.S. GAAP today. The FASB intends to issue a final standard on lease accounting during 2011.

For years, the current lease model has been subject to criticism for many reasons including:

- The nature of the model allows for structuring opportunities, such that arrangements with only minor differences are afforded significantly different accounting
- Leases that are accounted for as operating leases are not reflected on the balance sheets of the parties, even though the obligations and rights in a lease meet the conceptual definition of liabilities and assets
- In a world that is moving towards “principles-based” accounting standards, the accounting standards for leases are perceived to be very much “rules-based”
- Even though most companies liked the off-balance sheet answer of an operating lease, it is difficult to defend the concept and model for many leases

The model in the lease proposal would address these and other issues. Perhaps the most significant change in the lease proposal is that all leases within the scope would be reflected on the balance sheets of the involved parties, similar to a capital lease today.

In summary, lessees would record an asset for the right to use the leased asset and would record a corresponding liability to reflect the present value of the obligation to make rental payments. Accounting by lessors would depend on the extent to which the lessor retains exposure to the significant risks or benefits associated with the underlying asset during the expected term.

Many view the proposed model as similar to capital lease accounting, in that all leases within the scope will have some asset recorded on the balance sheet. However, under the proposal, the asset recorded by lessees is the right to use the asset, not the underlying asset itself. Even the accounting for leases that are accounted for as capital leases under existing literature will change, primarily reflecting the proposal's requirements related to determination of the lease term, the measurement of lease payments, and the reassessment requirements.

Scope

The lease proposal would be applicable to all leases, other than

- Leases of intangible assets
- Leases to explore for or use natural resources
- Leases of biological assets

Additionally, contracts that represent the purchase or sale of the underlying asset are scoped out of the lease proposal. A contract is considered a purchase or sale if, by the end of the contract, both (a) control of the underlying asset and (b) all but a trivial amount of the risks and benefits associated with the underlying asset are transferred.

One of my main goals in life is to one day fly on an airplane that appears on the balance sheet of an airline.

*Sir David Tweedie,
IASB Chair*

The lease proposal defines a lease in a manner similar to its current definition:

A contract in which the right to use a specified asset (the underlying asset) is conveyed, for a period of time, in exchange for consideration.

More arrangements may fall into the scope of the lease proposal than fall into the scope of the current guidance. This is due, in large part, to the framing of the scope. The current guidance limits its applicability to leases of property, plant and equipment. The lease proposal, in contrast, applies to all leases, with certain exceptions. As a result, arrangements that are structured as leases of items other than property, plant and equipment (for example, inventory) that would not fall within the scope of the current lease guidance, would indeed fall within the scope of the lease proposal.

The scope of the lease proposal does include short-term leases and leases embedded in other arrangements (such as service or supply contracts). With respect to short-term leases, the lease proposal proposes a “simplified” approach, under which short-term leases (defined as leases with a maximum possible lease term of no more than 12 months) are accounted for as follows:

- Lessees would measure the right-of-use asset and the liability to make lease payments at the undiscounted amount of the lease payments.
- Lessors would recognize lease payments as income over the lease term, and would not recognize lease assets or lease liabilities or derecognize any portion of the underlying leased asset.

The lease proposal also would potentially be applicable to the lease components of any arrangement that contains both a lease and a service component. An example of this type of arrangement might arise if, for instance, an entity enters into an agreement to provide services for a customer, and those services require the use of specified equipment. In such situations, the entity would be required to determine if the arrangement includes both services components and lease components. To do so, the entity would apply the concepts of the revenue recognition exposure draft. If the service component is “distinct” from the lease component, the two components would be accounted for separately, with the lease component falling within the scope of the lease proposal. The accounting for arrangements that contain both services and lease components is addressed later in this document.

Changes to Entities that Lease an Asset

The lease proposal puts forth a model that requires all leases to be recorded on the balance sheet of the lessee as of the commencement date of the lease. While this model may sound as if the lease proposal only impacts operating leases, those leases currently accounted for as capital leases would also be impacted, as the lease proposal would result in changes to the lease term, the measurement of lease payments, as well as other aspects of lease accounting.

Under the model in the lease proposal, a lessee would record an asset representing the right to use the underlying leased asset and would record a corresponding liability to make lease payments. In order to record these assets and liabilities, lessees will need to consider contractual terms, as well as other concepts such as expected lease term, lease payments and the appropriate discount rate.

Lease Term

Under the model in the lease proposal, the lease term is the longest possible term that is more likely than not to occur. Therefore, the lease proposal would require lessees to consider optional renewal periods (a marked contrast to current lease accounting rules, which generally only include non-cancellable periods as part of the lease term, unless penalties are involved).

In determining the lease term to be used for accounting purposes, the lessee would consider all possible lease terms, taking into account items that include, but are not limited to:

- Renewal and termination options
- Termination penalties that might exist
- Changes in level of lease payments (e.g., bargain renewal rates)
- The importance of the underlying leased asset to the operations of the lessee
- The significance of leasehold improvements that the lessee may have put in place

After considering the potential impacts of any explicit or implicit options in the contract, the lessee would identify each possible lease term and assess a probability of occurrence of each term. Then, starting with the longest possible lease term, the lessee would consider the *cumulative* probability of occurrence of all lease terms until it obtains a cumulative probability of 50%. The following example illustrates this concept:

Assume a lessee enters into a non-cancellable seven-year lease that includes two three-year renewal options. Such a lease has possible lease terms of 7, 10, or 13 years. The lessee has assessed the following probabilities:

Seven year term	40%
Ten year term	25%
Thirteen year term	35%

Under this scenario, there is a 35% probability of a thirteen-year term, a 60% probability of a term of at least ten years, and a 100% probability of a term of at least seven years. Therefore, the longest possible lease term that is more likely to occur is ten years. (Note that, as illustrated in this example, there will be situations in which the lease term used for accounting purposes is actually the lease term with the lowest probability of occurrence.)

Lease Payments

Once the lease term has been identified, the amount of lease payments must be determined. The lease proposal requires the use of an “expected outcomes” approach to determine the lease payments. Under this approach, the lessee must determine the present value of the probability-weighted average of the cash flows for a reasonable number of outcomes. In another significant departure from existing lease accounting, the lease proposal would require consideration of uncertain payments such as contingent rental payments, residual value guarantees, and term option penalties. (Note: the lease proposal does contain an exception for contingent payments that change in response to indices or rates, such as CPI or LIBOR. If forward rates or indices are not available, the lessee would use existing rates or indices.)

Discount Rate

The lessee generally would use its incremental borrowing rate to determine the present value of the lease payments. However, if the rate that the lessor is charging the lessee can be determined, that rate would be used.

Initial Measurement

Once the lease term, expected payments and discount rate have been determined, the lessee would have the components needed to calculate the initial carrying amount of the liability to be recognized. As stated previously, the model would require the lessee to record a liability for the obligation to make rental payments. That liability would be measured initially at the present value of the lease payments over the estimated lease term, discounted at the appropriate discount rate.

The lease proposal would also require that the lessee record a right-of-use asset. The asset would be measured initially at cost (that is, the initial recorded amount of the liability) plus any initial direct costs incurred by the lessee. Initial direct costs are those costs that are directly attributable to negotiating and arranging the lease, and that would not have been incurred if the lease had not been entered into.

Subsequent Measurement

After initially recording the right-of-use asset, the lessee would record amortization on a systematic basis (usually on a straight-line basis) over the shorter of the lease term or the useful life of the underlying asset. In addition to amortizing the asset, the lessee must reassess the carrying amount of the asset each reporting period if indicators of impairment exist. That reassessment will be done in compliance with ASC 350, *Intangible Assets—Goodwill and Other*.

The liability will be measured at amortized balance, with interest expense being recognized on the outstanding amount.

The change in character from “lease expense” to amortization and interest expense will potentially have a significant change on certain performance measures like earnings before interest, taxes, depreciation and amortization (EBITDA). However, while EBITDA and similar measures are likely to improve, interest coverage ratios are likely to suffer. Additionally, because interest expense is generally greater in the early years of an obligation than in later periods, expense recognition under the proposal will be correspondingly greater in the early period (resulting in the front-ending of expenses under the proposal).

Additionally, lessees are required to reassess the carrying amount of the liability if facts or circumstances indicate that a significant change in the liability would result from revisions to prior estimates. If that type of indication exists, the lessee would be required to reassess the length of the lease term and the expected amount of any contingent payments (contingent rents, termination penalties, residual value guarantees, etc).

Any changes in the lease term would result in an adjustment of the liability and the right-of-use asset. Any changes to contingent payments would be recorded in the income statement if the changes affect current or prior periods. Any other changes would be recorded as an adjustment to the liability and the right-of-use asset.

Lessor Accounting

As mentioned in the “Introduction and Background” section, accounting by lessors would depend on the extent to which the lessor retains exposure to the significant

risks or benefits associated with the underlying asset during the expected term. If the lessor does retain such exposure, it would use the “Performance Obligation Approach.” If the lessor does *not* retain such exposure, it would use the “Derecognition Approach.”

Performance Obligation Approach

Under the performance obligation approach, the lessor would recognize an asset (representing its right to receive rental payments, plus initial direct costs) and a liability (representing the obligation to allow the lessee to use the underlying asset).

Initial measurement of the asset and liability is determined in a manner similar (but not identical) to that used by the lessee. The lessor would determine the lease payments using an expected outcomes approach, and would discount the payments using the rate the lessor charges the lessee. The lessor would incorporate contingent payments into its calculation of expected payments, but a lessor is subject to a higher recognition threshold in that a lessor can only include such amounts if they can be “reliably measured.” The lessor would also adjust the asset by the amount of recoverable initial direct costs incurred by the lessor.

It should be noted that, because the lessor may lack insight to the lessee’s intent regarding exercise of renewal options, etc., it is possible that the lessor and lessee reach different conclusions related to the lease term.

Subsequently, the lessor would amortize the asset representing the right to receive rental payments and would use the interest method to recognize interest income. The lessor would also amortize the performance obligation into lease income, using a systematic and rational approach. If a method, based on use is not available, the lessor should amortize the performance obligation using straight-line amortization.

Lessors would be required to reassess expected lease payments each reporting period if any new facts or circumstances indicate that significant changes may have occurred in the right to receive rental payments. If, as a result of this reassessment, the lease term changes, the effect would be recognized by an adjustment of the lease liability and the asset. Changes to contingent payments (contingent rents, termination penalties, residual value guarantees, etc.) would be recorded in the income statement if the lessor has satisfied the lease liability. If the lessor has not satisfied the lease liability, the effect of these changes would be reflected as adjustments to the lease liability.

Derecognition Approach

Under the derecognition approach, the lessor is considered to have sold a right-of-use asset to the lessee. Consequently, the lessor will derecognize a portion of the underlying asset (representing the portion of the asset that was transferred to the lessee) and will also recognize an asset for the residual economic benefits not transferred to the lessee. The lessor will also recognize a lease receivable (and a corresponding amount of revenue) upon inception of the lease.

The lessor would calculate the portion of the underlying asset to remove (which will also represent the cost of sales) by dividing the fair value of the right to receive lease payments by the fair value of the underlying asset, and multiplying that percentage by the carrying amount of the underlying asset. The remainder of the carrying amount of the underlying asset would be the amount of the residual asset.

Several lease-related topics are not addressed in the proposal: related-party leases, lease modifications, implicit renewal options. In our comment letter, McGladrey recommended that the Boards address these issues in a final standard.

These calculations will require application of the concepts of ASC 820, *Fair Value Measurements and Disclosures*.

Note that, although the recognition of income and expense upon commencement of the lease may be similar to the existing accounting for sales-type leases, the amount of profit recognized under the proposed model is not necessarily the same as would be recognized under sales-type lease accounting, because of the different treatment of contingent payments.

Subsequent to initial recognition, the residual asset is not remeasured unless the lease term changes or the asset becomes impaired.

The lessor would be required to reassess the expected lease payments each reporting period if new facts or circumstances indicate there has been a significant change in the right to receive lease payments. Any changes to the lease receivable as a result of a reassessment of the lease term are allocated between the derecognized rights and the residual asset. The carrying amount of the residual asset will move in an inverse relationship with the lease term. That is, if the lease term increases, the recorded amount of the residual asset will decrease, because the lessor's asset related to that residual asset has decreased. Conversely, if the lease term decreases, the fact that the lessor will receive the benefits related to the residual asset earlier than originally expected means that the residual asset would *increase*.

Any changes to the lease receivable that arise out of changes in contingent payments are recognized in income, with no adjustment to the carrying amount of the residual asset.

Presentation and Disclosure

Lessees

Lessees would be required to present the right-of-use assets separately from non-leased assets within property, plant and equipment. The lease payment obligation would be presented separately from other financial liabilities. Interest expense and amortization expense related to leases would be presented separately from other interest and amortization expense (either in the income statement itself or in the notes). Cash payments for principal and interest would be classified as financing activities and presented separately in that section of the statement of cash flows.

Lessors—Derecognition Approach

Lessors that use the derecognition approach would present the lease receivable separately from other financial assets. The residual assets recorded under this approach should be presented separately within property, plant and equipment.

Income statement presentation for lessors that use the derecognition approach would be gross or net, depending on the lessor's business model. A lessor that has a business model of using leases for financing would use a net presentation. Conversely, other entities that use leasing as an alternative to sales would use a gross presentation.

Lessors—Performance Obligation Approach

A lessor that uses the performance obligation approach would present the underlying leased asset, the receivable and the lease liability gross on the asset side of its balance sheet, totaling to a net lease asset or a net lease liability. Such a lessor would also present the interest income, lease income and depreciation

expense separately, and then total the balances to come to a net lease income or expense. Cash receipts from lease payments should be classified as operating activities and presented separately in that section of the statement of cash flows.

Transition

The lease proposal defines the date of initial application as “the beginning of the first comparative period presented in the first financial statements in which the entity applies this guidance.” Entities would be required to apply the provisions of the lease proposal to all outstanding leases as of that date, using a “simplified retrospective” approach.

Under this simplified retrospective approach, a lessee would be required to recognize an obligation and a right-of-use asset for any outstanding lease as of the date of initial application. The obligation and asset as of that date would be measured at the present value of the remaining lease payments, discounted using the lessee’s incremental borrowing rate on the date of initial application. If lease payments are not even over the lease term, the recognized right-of-use asset would have to be adjusted by the amount of any recognized prepaid or accrued lease payments.

For leases under the performance obligation approach, lessors would be required to recognize an asset (for the right to receive lease payments) and a liability (for the performance obligation) that would be measured at the present value of the remaining lease payments, discounted using the “rate charged in the lease determined at the date of inception of the lease.” Additionally, if the lessor had derecognized any asset previously, that asset would be restored at depreciated cost (as if the asset had never been derecognized).

For leases under the derecognition approach, lessors would be required to recognize an asset (for the right to receive lease payments) measured at the present value of the remaining lease payments, discounted using the “rate charged in the lease determined at the date of inception of the lease.” The lessor would also be required to recognize a residual asset, which would be measured at fair value as of the date of initial application.

Disclosures

The lease proposal requires that entities disclose quantitative and qualitative information that identifies and explains the amounts recognized in the financial statements that arise from leases and that describes how leases might affect the timing, amount and uncertainty of the entity’s cash flows.

Other Topics

In addition to the above, the lease proposal contains discussion of short-term leases and sale-leaseback transactions.

Short-term leases

At the date of inception of a lease, a lessee that has a short-term lease can make an election (on a lease-by-lease basis) to measure the liability to make lease payments at the undiscounted amount of the lease payments and the right-of-use asset at that amount, plus initial direct costs.

With respect to lessors in short-term leases, any such lessor may make an election, at the date of inception of a lease, to not recognize assets or liabilities arising from short-term leases and not to derecognize any portion of the underlying asset.

Sale-leaseback transactions

The lease proposal would result in significant changes for sale-leaseback accounting. If a sale and leaseback transaction qualifies as a sale, the seller-lessee would account for the sale in accordance with other ASC Topics and would account for the right-of-use asset in accordance with the lease proposal. If the contract does not qualify as a sale, the seller-lessee would account for the contract as a financing.

Potential Impact

The proposal will have significant impacts on the financial statements of both lessees and lessors.

For lessees, the change that will be the most significant is the recording of assets and liabilities on the balance sheet. It is possible, if not likely, that the requirement to record an asset and a liability will significantly impact the lease/buy decision of entities. The “grossing up” will in turn impact financial ratios (leverage and capital ratios). Other changes that would result include the “geography” in the income statement and a related change in the recognition pattern of lease expense.

The expected impact on the income statement of lessees was discussed earlier in this document (that is, front-ended recognition of expense as compared to current GAAP and changes to financial measures like EBITDA and ratios like interest coverage ratio).

On the lessor side, income on operating leases under current GAAP generally is recognized on a straight-line basis. Under the proposal, the recognition of income will be front-end loaded (in much the same way as expense recognition is front-end loaded for lessees). Lessors that apply the performance obligation approach would experience a “grossing up” of their balance sheets.

Next Steps

The final standard is not expected to be issued until 2011, and will not be effective for several years after that. It is probable that the Boards will make changes in response to input received on the proposal. Although it is impossible to state definitively what the ultimate standard will contain, the general feeling is that the requirement to record assets and liabilities for each lease is likely to be retained in the final standard.

At the very least, entities should familiarize themselves with the proposal, and might wish to make a reasonable assessment as to the impact that the proposal would have on their financial statements if it were to be finalized in its current state. Entities should be aware of the proposal and follow developments in the project once the Boards commence redeliberations. Moreover, entities should keep the proposal in mind as they enter into new lease arrangements.

Additionally, entities should be cognizant of the potential impact on loan covenants and financing arrangements, as well as other types of arrangements that might include performance-based measures (e.g., employment agreements).

Highlights of McGladrey & Pullen’s Comment Letter

McGladrey & Pullen submitted a comment letter to the proposed ASU. Some of the more significant comments are summarized below.

Lessee recognition of (and accounting for) a right-of-use asset and a liability to make payments

We agree with the boards’ conclusion that a lessee should recognize a right-of-use asset and a liability to make lease payments.

We agree that a lessee should amortize the right-of-use asset and recognize interest on the liability to make lease payments.

Lessor accounting

We agree that neither the performance obligation approach nor the derecognition approach individually sufficiently addresses all issues related to lessor accounting. We agree, therefore, with the hybrid approach to lessor accounting, but believe that additional guidance is needed to assist entities in determining when to use each approach.

Simplified approach to short-term leases

We agree with the proposed simplified accounting for lessors. However, we believe that lessees should be provided with an option similar to that extended to lessors; that is, a lessee that has a short-term lease should be permitted to elect not to recognize a liability to make lease payments or a right-of-use asset.

Contracts that contain service components and lease components

Many real estate leases are billed “gross” which includes executory costs. However, it is sometimes difficult to identify specific services associated with the inclusion of executory costs. It would appear that the proposal in the proposed ASU could result in capitalization of certain executory costs that likely would not be capitalized if the asset were purchased or if the lease were a “net” lease that required the lessee to directly pay real estate taxes, insurance, etc. We request the Boards provide guidance on which of the services typically included in such leases would constitute “distinct service components.”

Reassessment

We agree that lessees and lessors should remeasure assets and liabilities arising under a lease when changes in facts or circumstances indicate that there is a significant change in the liability to make lease payments or in the right to receive lease payments arising from changes in the lease term or contingent payments (including expected payments under term option penalties and residual value guarantees) since the previous reporting period. However, we believe that lessees and lessors also should be required to reassess upon the occurrence of specified “events.” For example, we believe that reassessment should occur whenever term options or extension options become exercisable (whether exercised or not).

Appendix

The following tables provide a high-level summary of the differences between current GAAP and the proposal.

Lessee Accounting

	Current GAAP Operating Leases	Current GAAP Capital Leases	Proposal
Balance Sheet		<ul style="list-style-type: none"> Asset Liability (to make lease payments) 	<ul style="list-style-type: none"> Right of use asset Liability (to make lease payments)
Income Statement	<ul style="list-style-type: none"> Rent expense 	<ul style="list-style-type: none"> Depreciation expense Interest expense 	<ul style="list-style-type: none"> Amortization of right of use asset Interest expense
Statement of Cash Flows	<ul style="list-style-type: none"> Operating activity 	<ul style="list-style-type: none"> Financing activity 	<ul style="list-style-type: none"> Financing activity

Lessor Accounting

	Current GAAP Operating Lease	Current GAAP Direct Financing Lease	Current GAAP Sales-Type Lease	Proposal Performance Obligation Approach	Proposal Derecognition Approach
Balance Sheet		<ul style="list-style-type: none"> Recognize net investment in lease Derecognize underlying asset 	<ul style="list-style-type: none"> Recognize net investment in lease Derecognize underlying asset 	<ul style="list-style-type: none"> Right to receive lease payments Lease liability 	<ul style="list-style-type: none"> Recognize right to receive lease payments Recognize residual asset Derecognize underlying asset
Income Statement	<ul style="list-style-type: none"> Rental income Depreciation 	<ul style="list-style-type: none"> Interest income 	<ul style="list-style-type: none"> Revenue/income Cost of sales Interest income 	<ul style="list-style-type: none"> Lease income Depreciation 	<ul style="list-style-type: none"> Revenue/income Cost of sales Interest income
Statement of Cash Flows	<ul style="list-style-type: none"> Operating activity 	<ul style="list-style-type: none"> Operating activity 	<ul style="list-style-type: none"> Operating activity 	<ul style="list-style-type: none"> Operating activity 	<ul style="list-style-type: none"> Operating activity

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