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Heads Up

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It's Official, 13 Is Unlucky!

SEC Clarification of Statement 13 Lease Accounting Issues Leads to Restatements

Introduction

Last week, the SEC staff clarified certain issues related to lessee accounting for operating leases. Several companies recently have corrected errors in previously issued financial statements. While the restatements, so far, have been made primarily by retail food franchisers, ***the accounting issues are relevant to any company*, regardless of industry, that leases a significant amount of real estate (and perhaps, equipment)**. The SEC's guidance, which takes the form of a letter to the Center for Public Company Audit Firms, can be found on the SEC's Web site.

Amortization of Leasehold Improvements

Some companies have run into trouble accounting for leasehold improvements. This occurs when the costs of the improvements are amortized over a term that includes an expected renewal period of the lease. But here's the rub. These companies have excluded renewal periods when:

- Performing the requisite lease classification tests (i.e., operating vs. capital), and
- Computing the amount of periodic rental cost to expense.

In the letter, the SEC staff indicates that amortizing leasehold improvements over a term that includes assumption of lease renewals is appropriate only when the renewals have been determined to be *reasonably assured*. FASB Statement No. 13, *Accounting for Leases*, indicates that a renewal period is reasonably assured, and should be considered part of the lease term, when failure to renew a lease imposes a **penalty** on the lessee.

Question

What constitutes a penalty?

Answer

According to Statement 13, one might exist when a lessee likely is unwilling to abandon leasehold improvements (or other assets) that are expected to have significant fair value to the lessee at the end of the fixed, noncancelable term of the lease. Similarly, lessees likely are unwilling to incur significant costs, directly or indirectly, in order to relocate leasehold improvements. The loss of significant fair value or the incurrence of significant costs could constitute an economic penalty.

If lease renewal is reasonably assured, then the lease term used to (1) determine the appropriate lease classification, (2) compute periodic rental expense, and (3) amortize leasehold improvements (unless their economic lives are shorter), should include the periods of expected renewal. If lease renewal is not reasonably assured, then amortization of the leasehold improvements should be over the shorter of the asset's economic life or lease term (which excludes renewal periods). If the lessee determines that equipment or other assets on leased property can be relocated or sold upon lease expiration, without a significant diminution in fair value, it may be appropriate to amortize the leasehold asset over the lease term to expected fair value. All facts and circumstances should be considered, and companies should establish an accounting policy that is applied consistently across similar transactions.

Question

What is the potential impact on companies restated financial statements?

Answer

The impact could be any of the following:

- Increased depreciation expense, resulting from shortening the depreciable life of leasehold improvements to be consistent with the lease term used for lease classification and recognition of rental expense;
- Increased rental expense (and a related accrued rent liability), resulting from the recognition of rent expense on a straight-line basis over the entire lease term, including option periods that are reasonably assured of renewal, when the renewal periods contain escalated rental payments;
- Change in lease classification (from operating to capital); and
- Errors in the determination of initial recoverability and calculation of recognized impairment losses under FASB Statement No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*.

Rent Holidays

A lease may contain a period of time during which the lessee has the right to occupy the space but pays no rent or a reduced rate of rent. For example, a "rent holiday" can be offered to provide the lessee time to build-out the space to its specifications. Although a company may take a holiday from making payments during this period, expense recognition never takes a day off. The SEC staff, pointing to Technical Bulletin 85-3,[1] concluded that it is inappropriate for a lessee to suspend recognition of rental expense during a rent holiday. Rather, rent expense in an operating lease should be recognized straight-line (or, unusually, on another systematic and rational basis) over the lease term, **including any rent holiday period**.

Example

Company A is leasing a building for a five-year period under an operating lease. The landlord provides a "rental holiday" for the first year so Company A can construct tenant improvements within the building. The second-year lease payment is $100,000, and the rental rate increases $100,000 per year for each subsequent year for a total required rent of $1,000,000 over the lease term. In this situation, Company A should record rent expense of $200,000 per year (total payments of $1,000,000 recognized straight-line over five years) starting with commencement of the lease term. In years one and two, Company A should record the difference between the rent expense ($200,000 each year) and the payment each year ($0 and $100,000 in years one and two, respectively) as accrued rental liability. In year three, the rent expense and the payment will be equal. In years four and five, the rent payments in excess of the rent expense each year should reduce the accrued liability.

1 FASB Technical Bulletin No. 85-3, *Accounting for Operating Leases With Scheduled Rent Increases*.

Landlord/Tenant Incentives

Sometimes a landlord pays the lessee an amount intended to reimburse the lessee for the cost, or a portion of the cost, of leasehold improvements. Some lessees have netted the funds received from the lessor against the amounts recorded as leasehold improvements. Lessees also have reflected the receipt of the funds as a reduction of capital expenditure outflows (an investing activity) on their statement of cash flows. The SEC staff has the following views:

- Improvements made by a lessee that are funded by the lessor generally should be recorded by the lessee as leasehold improvement assets, and amortized over the shorter of the economic useful life or the lease term;
- The funds received should be recorded as deferred rent and amortized as reductions to lease expense over the lease term (they should not be netted against the leasehold improvements);[2] and
- The incentive payment should be recorded as an operating activity in the statement of cash flows. The acquisition of leasehold improvements for cash is an investing activity.

The SEC staff also recognizes that the issue of determining whether improvements are assets of the lessee or the lessor may require significant judgment; the letter does not deal with this evaluation.

Consequences

The SEC staff indicates that their views "are based upon existing accounting literature." Registrants/lessees that have made one or more of these errors, in consultation with their independent auditors, should follow one of two courses of action, as appropriate:

- Restate prior financial statements, and state that it results from the correction of errors; or
- If restatement is unnecessary, state that errors were immaterial to prior periods.

Disclosures

The SEC staff's letter highlights the importance of operating and capital lease disclosures in the notes to the financial statements and, when appropriate, in the critical accounting policies section of Management's Discussion and Analysis (MD&A). A company's disclosures should address the following:

- Material lease agreements or arrangements;
- The essential provisions of material leases (e.g., original term, renewal periods, rent escalations, rent holidays, contingent rent, rent concessions, leasehold improvement incentives, and unusual provisions);
- The company's accounting policy for leases, including the treatment of each item noted above;
- The specific basis on which contingent rental payments are determined;
- The amortization period of material leasehold improvements made, either at the inception of the lease or during the lease term, and how the amortization period relates to the initial lease term; and
- In MD&A, known trends and uncertainties in future rent or amortization expense that could materially impact operating results or cash flows.

2 See Question 2 of FASB Technical Bulletin No. 88-1, *Issues Relating to Accounting for Leases*.

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