

## LEASE TPAs

### **TPA 5600.07: Determining a lease term for accounting purposes**

Inquiry: How should a lessee and lessor determine, for accounting purposes, the lease term of a lease, which is fundamental to determining the appropriate accounting for that lease?

Reply: *Paragraph 5f of FASB Statement No. 13, Accounting for Leases, as amended by paragraph 22a of FASB Statement No. 98, Accounting for Leases, provides a definition of "lease term," as follows.*

*Lease term. The fixed noncancelable term of the lease plus (i) all periods, if any, covered by bargain renewal options (as defined in paragraph 5(e)), (ii) all periods, if any, for which failure to renew the lease imposes a penalty (as defined in paragraph 5(o)) on the lessee in such amount that a renewal appears, at the inception of the lease, to be reasonably assured, (iii) all periods, if any, covered by ordinary renewal options during which a guarantee by the lessee of the lessor's debt directly or indirectly related to the leased property\* is expected to be in effect or a loan from the lessee to the lessor directly or indirectly related to the leased property is expected to be outstanding, (iv) all periods, if any, covered by ordinary renewal options preceding the date as of which a bargain purchase option (as defined in paragraph 5(d)) is exercisable, and (v) all periods, if any, representing renewals or extensions of the lease at the lessor's option; however, in no case shall the lease term be assumed to extend beyond the date a bargain purchase option becomes exercisable. A lease that is cancelable (a) only upon the occurrence of some remote contingency, (b) only with the permission of the lessor, (c) only if the lessee enters into a new lease with the same lessor, or (d) only if the lessee incurs a penalty in such amount that continuation of the lease appears, at inception, reasonably assured shall be considered "noncancelable" for purposes of this definition.*

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*\*The phrase indirectly related to the leased property is used in this paragraph to describe provisions or conditions that in substance are guarantees of the lessor's debt or loans to the lessor by the lessee that are related to the leased property but are structured in such a manner that they do not represent a direct guarantee or loan. Examples include a party related to the lessee guaranteeing the lessor's debt on behalf of the lessee, or the lessee financing the lessor's purchase of the leased asset using collateral other than the leased property.*

### **TPA 5600.08: Lease term for accounting purposes differs from term stated in lease (part 1)**

Inquiry: Can a lease term for accounting purposes begin before an initial fixed noncancelable term stated in a lease agreement?

*Reply: Yes. Question 1 of FASB Technical Bulletin 88-1, Issues Relating to Accounting for Leases, provides that a lease term for accounting purposes includes all periods in which a lessee has access to and control over leased space, even if those periods precede the fixed noncancelable term stated in the lease agreement. For example, a lease agreement is signed on January 1 but the initial fixed noncancelable term begins on April 1. The lease allows the lessee to make improvements to the leased space at any time starting after January 1. In this situation, the lease term for accounting purposes starts on January 1.*

**TPA 5600.09: Lease term for accounting purposes differs from term stated in lease (part 2)**

Inquiry: Can a lease term for accounting purposes extend beyond an initial fixed noncancelable term stated in a lease agreement?

*Reply: Yes. Paragraph 5f of FASB Statement No. 13, Accounting for Leases, as amended by paragraph 22a of FASB Statement No. 98, Accounting for Leases, identifies situations in which the lease term for accounting purposes extends beyond the fixed noncancelable term stated in a lease agreement. TPA 5600.07 identifies those situations in paragraph 5f of FASB Statement No. 13. For example, the lease term for accounting purposes would include renewal periods that at lease inception appear reasonably assured because failure to exercise renewal periods would impose a penalty on the lessee.*

**TPA 5600.10: Rent expense and rent revenue in an operating lease - general**

Inquiry: In an operating lease, how should a lessee accrue rent expense and a lessor recognize rent revenue?

*Reply: Paragraph 15 of FASB Statement No. 13, Accounting for Leases, says that the lessee should accrue rent expense on a straight line basis over the lease term unless another systematic and rational basis is more representative of the time pattern use of the property.*

*Paragraph 19 of FASB Statement No. 13 says that the lessor should recognize rent revenue on a straight line basis over the lease term unless another systematic and rational basis is more representative of the time pattern use of the property.*

*Also see TPA 5600.11.*

**TPA 5600.11: Rent expense and rent revenue in an operating lease – scheduled increase in rental space**

Inquiry: Related to TPAs 5600.08 and 5600.10, assume a lessee has access to and use of one floor of a building as of the beginning of a lease agreement in year 1. In accordance

with the agreement and at the start of year 3, the lessee will have access to and the ability to occupy a second floor in addition to the first floor, and will pay an additional rental fee starting at that time. In this situation, how should the lessee accrue rent expense and the lessor recognize rent revenue before the lessee is allowed to occupy the second floor?

*Reply: Question 1 of FASB Technical Bulletin 88-1, Issues Relating to Accounting for Leases is the applicable guidance. In years 1 and 2, the lessee should accrue rent expense on a straight line basis (unless another systematic and rational basis is more representative of the time pattern use of the property) for the one floor and not include the rental of the second floor in its accrual because the lessee does not have access to and control over the second floor until the start of year 3. Starting in year 3, the lessee should accrue rent expense on a straight line basis for both floors.*

*The lessor's accounting for revenue is parallel to that of the lessee for expense in this fact pattern.*

**TPA 5600.12: Rent expense and rent revenue in an operating lease – rent holiday**

Inquiry: A lessee has a 120 month lease for \$10,000 per month on space owned by a lessor. The lease term for accounting purposes is 120 months. As an incentive to sign the lessee to the lease agreement, the first 6 of those months are rent free. In an operating lease, if a lease term includes a period of free or reduced rent (rent holiday), how does the rent holiday factor into the lessee's recognition of rent expense and the lessor's recognition of rent revenue?

*Reply: Paragraphs 1-2 of FASB Technical Bulletin 85-3, Accounting for Operating Leases with Scheduled Rent Increases, provides that the lessee should recognize rent expense of \$9,500 per month ( $\$10,000 \times 114 \text{ months} / 120 \text{ month lease term}$ ) for 120 months, which is on a straight line basis. Likewise, the lessor should recognize rent revenue of \$9,500 per month.*

**TPA 5600.13: Rent expense and rent revenue in an operating lease – scheduled rent increases**

Inquiry: In an operating lease, how should a lessee accrue rent expense and a lessor recognize rent revenue using the straight line method (see TPA 5600.10) when the lease agreement contains scheduled rent increases over the lease term?

*Reply: Paragraphs 1-2 of FASB Technical Bulletin 85-3, Accounting for Operating Leases with Scheduled Rent Increases, provides that the lessee and lessor should add up all rental payments over the lease term and divide that number by the number of periods in the lease term to arrive at the expense/revenue amounts to be accrued/recognized on a straight line basis.*

**TPA 5600.14: Amortization/Depreciation of leasehold improvements in an operating lease (part 1)**

Inquiry: A lessee enters into an operating lease in which the lease term for accounting purposes is 10 years. Upon signing the lease, the lessee acquires leasehold improvements that have a useful life of 15 years. Over what period should the lessee amortize/depreciate the leasehold improvements?

*Reply: For leasehold improvements contemplated at or near the beginning of an initial lease term, the lessee should amortize/depreciate the leasehold improvements over the shorter of the (a) useful life of the improvements or (b) remaining lease term, which is 10 years in this inquiry. If the leasehold improvements are acquired and placed in service significantly after the inception of a lease, EITF 05-6, Determining the Amortization Period for Leasehold Improvements Purchased after Lease Inception or Acquired in a Business Combination, requires that the lessee amortize/depreciate leasehold improvements over the shorter of the useful life of the leasehold assets or a term that includes required lease periods and renewals that are deemed to be reasonably assured at the date the leasehold improvements are acquired. Note that EITF 05-6 does not apply to pre-existing leasehold improvements.*

**TPA 5600.15: Leasehold improvements and lease term in an operating lease (part 2)**

Inquiry: A lessee enters into an operating lease in which the initial fixed noncancelable term within the lease agreement is 10 years and the agreement includes three 5-year renewal periods. Upon signing the lease, the lessee plans to acquire leasehold improvements that have a useful life of 15 years. Is the lessee's plan to acquire the leasehold improvements a factor in determining the lease term for accounting purposes?

*Reply: Yes, the lessee should consider the impact on the lease term for accounting purposes, if any, of the plan to acquire leasehold improvements. If the leasehold improvements are expected to have a significant value at the end of the initial 10 year term such that the lessee would not be willing to abandon these assets (that is, effectively incur a penalty) resulting in a renewal option being reasonably assured of being exercised, that renewal period would be added to the initial fixed noncancelable term in determining the appropriate lease term for accounting purposes.*

**TPA 5600.16: Landlord incentive allowance in an operating lease**

Inquiry: A lessee enters into an operating lease in which the landlord offers an incentive allowance towards the cost of the lessee making leasehold improvements. The leasehold improvements are the lessee's assets and cost \$1 million, and the incentive allowance totals \$500,000. Should the lessee net the \$500,000 allowance received from the landlord against the \$1 million leasehold improvement asset?

*Reply: No. In accordance with Question 2 of FASB Technical Bulletin 88-1, Issues Relating to Accounting for Leases, the \$500,000 allowance should be reported by the lessee as a liability and amortized straight line over the lease term as a reduction of rent*

*expense. Therefore, the lessee's amortization/depreciation calculation is based on the \$1 million leasehold improvements.*

**TPA 5600.17 – Cash flows statement presentation of landlord incentive allowance in an operating lease**

Inquiry: Related to TPA 5600.16, how should a lessee categorize expenditures for leasehold improvements and a related cash incentive allowance received from a landlord in the statement of cash flows?

*Reply: In accordance with FASB Statement No. 95, Statement of Cash Flows, a lessee should report expenditures for leasehold improvements in the investing section of a statement of cash flows. Cash allowances received from the landlord should be presented in the lessee's operating activities section of its statement of cash flows. The cash allowances from the lessor are treated for accounting purposes as adjustments of rent. FASB Statement No. 95 does not identify rent payments on operating leases as investing or financing activities.*