



.....  
**All Leases Soon to Be Treated as Capital Leases**  
.....

Based on an exposure draft of an Accounting Standards Updated (ASU) released by the Financial Accounting Standards Board (FASB), it appears that the day is coming where there will no longer be the need to determine whether a lease transaction should be accounted for as an operating or a capital lease because all leases would effectively be treated as capital leases. The exposure draft period ended December 15, 2010 and the likelihood is that this new standard will become effective no earlier than for those periods that begin after December 15, 2011. For calendar year-end organizations, the new accounting treatment will be applicable for year ending December 31, 2012. For fiscal year ends, such as June and September, the effective date will be for years ending 2013. So, there is time to understand and do the research on these requirements but it is important to begin understanding what this will mean for your organization and how it will affect the financial statements.

Basically, for common property and equipment leases, the lessee will record an asset, which represents its right to use the asset, as well as a liability to make lease payments. This will be measured at the future minimum lease payments, using the measurement basis discussed below. The entry will look as follows:

Debit- Leased Asset  
Credit- Capital Lease Obligation

The lessor will recognize an asset, which represents the right to receive lease payments, with the offsetting credit either recognizing a lease liability obligation to provide the leased property or equipment (performance obligation approach), or derecognizing the rights in the underlying assets that have been transferred (de-recognition approach). If the lessor has risks or benefits associated with the underlying asset, then they will recognize lease liability and as the lease is satisfied will recognize interest and lease income (performance obligation approach). If the lessor does not retain that exposure to risks or benefits associated with the underlying asset, then they will recognize revenue immediately and interest income over the life of the lease (de-recognition approach). Under the performance obligation approach the initial entry for the lessor will look as follows:

Debit- Lease Receivable  
Credit- Lease Liability

As the lease term progresses, the following accounting entries would occur:

Debit- Cash  
 Credit- Lease Receivable  
 Credit- Interest Income

Debit- Lease Liability  
 Credit- Lease Income

Debit- Depreciation Expense  
 Credit- Accumulated Depreciation

Under the de-recognition approach the initial entry will look as follows:

Debit- Lease Receivable  
 Credit- Lease Income

Debit- Cost of Sales  
 Credit- Underlying Asset

This approach as stated above derecognizes the underlying asset, lease income is recorded at the present value, all or a portion of the underlying asset(s) that are being leased are effectively removed from assets; however, a portion of the asset that was not leased would be reclassified as a residual interest in that asset.

During the year the entries will be as follows upon payment:

Debit- Cash  
 Credit- Lease Receivable  
 Credit- Interest Income

As with any new standards there are exceptions. The new standard will not apply to leases of intangible assets, biological assets, or oil and gas properties (new standards already to conform to SEC guidance).

A challenge will be determining the incremental borrowing rate for the discount factor, which will be the interest rate implicit in the leases in order to establish the present value calculations. The measurement of these capital leases will undergo a slight change as well. The measurement basis assumes the longest possible lease term that is more likely than not to occur, which means there will be a need to analyze the probability of extending the lease or terminating the lease.

For example, a company rents a building for their main operations from a real estate entity and the term of the leases is five years. The lessee makes \$100 million of leasehold improvements and finances the improvements with 20 year debt. The lease terms include the option for three subsequent renewals at 5 years each. It appears that the company is more likely than not to renew the lease for each of the additional 3 5-year terms, so the capital lease would be recognized over a 20 year period. This measurement basis uses the expected outcome techniques, including contingent rentals and penalties. Management must update their calculations when changes of facts or circumstances indicate a significant change, which will be treated

as a change in estimate. The recognition of escalating payments will still be on a straight line basis.

This new standard is to be applied to all leases in existence at the time of transition. We recommend that you begin to analyze your organization's leases and identify those that have been treated as operating leases and thus would be subject to the capital lease accounting treatment upon transition to the new standard. Adding additional long term lease liabilities may impact certain loan covenants, thus it is best to understand the potential effect now so that you can engage for lender in discussions in advance should there appear to be an imminent ratio of covenant failure. Additionally, if you are currently entering into new long term debt agreements, you should consider the future effect on such covenants while negotiating those terms.

If you have any questions pertaining to the expected new lease accounting standard and how it may apply to specific situations, then please contact GBQ Partners LLC.