



Update: Changes in GAAP Lease Accounting

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Three important, albeit tentative, decisions have been made by the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB), in regards to the proposed changes to Generally Accepted Accounting Principles (GAAP) lease accounting, since our last update in November 2010. See our November 10, 2010 article entitled "[Proposed Major Changes in Lease Accounting](#)." The decisions were the product of deliberations at the joint FASB/IASB board meetings on February 16 and 17, of this year. Although the boards discussed at the meeting a number of potential changes to the proposed standards, they reached a decision only as to three.

First, in regards to whether or not option periods (including both extension options, and early termination options) should be included in calculating lease liabilities and assets to be booked by tenants and landlords under GAAP accounting, the boards tentatively decided that such options should not be included in such calculations, unless there is a "significant economic incentive" for the tenant to exercise the option. This represents a significant departure from the proposal set forth in the Exposure Draft issued August 27, 2010, jointly issued by FASB and IASB (the "Exposure Draft"), which required such options to be included in determining the lease term of a tenant if the options were more likely than not to be exercised by the tenant. To the extent to which renewal option periods are not required to be included by a tenant in its lease accounting, the tenant will of course benefit in the form of recordation by the tenant of a smaller lease liability on its financial statements.

No guidance was given in the meeting's summaries as to what would constitute a "significant economic incentive," but in the case of an option to renew or extend, below market rental rates, or above market build-out or refurbishment allowances, under such an option would certainly seem to qualify. Whether or not factors extraneous to the lease option terms, such as established goodwill in the case of a lessee of retail space, or difficulty or cost of relocation in the case of a lessee of data center space, could constitute a "significant economic incentive" remains to be seen.

Second, in contrast to the requirements proposed under the Exposure Draft, the boards also tentatively decided that in lieu of requiring tenants and landlords to reassess the inclusion of option terms in connection with the preparation of each new set of financial statements, tenants and landlords would be required to reassess the inclusion of option terms only when there is a significant change to the status or scope of economic incentives to exercise or not exercise the options. This change potentially reduces the accounting burden associated with periodic reassessment of lease options, at least for some tenants.

Third, as to variable lease payments (such as percentage rent under a retail lease, or CPI-based rent escalations), the boards tentatively decided that such lease payments should be included in the calculation of lease-related liabilities and assets for tenants and landlords if: (i) such payments depend on an index or rate; (ii) such payments are ones "for which the variability lacks commercial substance;"



or (iii) such payments meet a "high recognition threshold," such as ones which are reasonably certain to be realized. Under the proposed standards originally announced in the Exposure Draft, landlords and tenants were required to estimate and include in lease liabilities and assets the amounts of anticipated variable lease payments, generally based on the best available data. Under the boards' tentative decision, only those variable lease payments which fall within one of the above three categories will be required to be included. Further guidance as to the meaning and interpretation of the standards to be used here, particularly as to items (ii) and (iii), will be needed if this change is to result in actual simplification of accounting for variable lease payments by tenants and landlords.

Additional potential changes to the proposed lease accounting standards, including possible straight line recognition of lease income and lease expense in the case of leases which do not feature a significant financing element, were also discussed by the boards, but no decision was reached as to such matters, and the boards announced their intention to obtain more industry input concerning such matters. It is possible that obtaining and studying such additional input might delay the boards in issuing their final lease accounting standards beyond their proposed deadline of June 30, 2011, but the board meeting minutes, at least, do not reflect any change to that anticipated deadline.

We will continue to monitor significant developments as to the lease accounting standards, and update you when appropriate.

For more information on the matters discussed in *Locke Lord's QuickStudy*, please contact the author:

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