FASB Emerging Issues Task Force

Issue No. 05-6

Title: Determining the Amortization Period for Leasehold Improvements

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Dates previously discussed: None

Previously distributed EITF materials: None

References:

FASB Statement No. 13, *Accounting for Leases* (FAS 13)

FASB Statement No. 98, *Accounting for Leases* (FAS 98)

FASB Statement No. 141, *Business Combinations* (FAS 141)

FASB Statement No. 142, *Goodwill and Other Intangible Assets* (FAS 142)

FASB Interpretation No. 21, *Accounting for Leases in a Business Combination* (FIN 21)

APB Opinion No. 12, *Omnibus Opinion-1967, Deferred Compensation Contracts*, as amended by FASB Statement No. 106, *Employers' Accounting for Postretirement Benefits Other Than Pensions* (APB 12)

International Accounting Standard No. 16, *Property, Plant and Equipment* (IAS 16)

International Accounting Standard No. 17, *Leases* (IAS 17)

* **The alternative views presented in this Issue Summary are for purposes of discussion by the EITF. No individual views are to be presumed to be acceptable or unacceptable applications of Generally Accepted Accounting Principles until the Task Force makes such a determination and it is ratified by the Board.**

Scope

1. This Issue addresses the determination of the amortization period for leasehold improvements in operating leases that are either (a) purchased subsequent to the inception of the lease or (b) acquired in a business combination. This Issue does not address the amortization of intangible assets that may be recognized in a business combination for the favorable or unfavorable terms of a lease relative to market prices. The objective of the Board's current project, Useful Life and Amortization of Intangible Assets, is to provide guidance on certain aspects of the determination of the useful life and amortization of renewable intangible assets under FAS 142.

Background

2. FAS 13 requires a lessee to determine the "lease term" at the inception of a lease. Paragraph 5(f) of FAS 13 defines lease term as the fixed noncancelable term of the lease plus all periods covered by bargain renewal options or for which failure to renew the lease imposes a penalty on the lessee in such an amount that a renewal appears to be reasonably assured. Penalty, as used in the definition of lease term, is discussed in paragraph 5(o) of FAS 13, as amended. Factors to consider in evaluating whether a penalty would be incurred if the lessee failed to renew include: "the uniqueness of purpose or location of the property, the availability of a comparable replacement property, the relative importance or significance of the property to the continuation of the lessee's line of business…," and "the *existence of leasehold improvements or other assets whose value would be impaired by the lessee vacating or discontinuing use of the leased property*…" (emphasis added).

3. Once the lease term (including renewals that are deemed reasonably assured) is determined, an entity can then determine (a) the classification of the lease (capital versus operating) and (b) the period to recognize straight-line rents.

4. Paragraph 11(b) of FAS 13 requires that assets recognized under capital leases (and in which the lease does not (a) transfer ownership of the property to the lessee at the end of the lease term or (b) contain a bargain purchase option) be amortized in a manner

consistent with the lessee's normal depreciation policy except that the amortization period is limited to the lease term (which includes renewal periods that are reasonably assured). In other words, a lessee should expect that it will not control assets recognized under capital leases in periods that are not reasonably assured of renewal and, therefore, the lessee cannot expect to receive any economic benefits from those assets in periods that are not reasonably assured of renewal. While the amortization period of leasehold improvements for operating leases is not addressed in FAS 13, practitioners generally analogize to the guidance provided in paragraph 11(b) of FAS 13. This analogy is generally accepted because, similar to assets recognized under capital leases, an entity should expect that it will not control leasehold improvements in periods that are not reasonably assured of renewal and, therefore, the lessee cannot expect to receive any economic benefits from those assets in periods that are not reasonably assured of renewal. Accordingly, practice has evolved such that leasehold improvements placed in service (or contemplated) at or near the beginning of the initial lease term are amortized over the lesser of the leasehold improvement's useful life or the lease term.

5. Questions have been raised regarding the determination of the amortization period for leasehold improvements that are purchased *subsequent* to the inception of the lease (that is, leasehold improvements that are not placed in service (or contemplated) at or near the beginning of the initial lease term). Practitioners observe that FAS 13 does not allow a change to the lease term for purposes of lease classification unless certain conditions are met. Specifically, paragraph 9 of FAS 13 provides the following limitations with respect to whether a lease can be reclassified subsequent to lease inception:

> If at any time the lessee and lessor agree to change the provisions of the lease, other than by renewing the lease or extending its term, in a manner that would have resulted in a different classification of the lease under the criteria in paragraphs 7 and 8 had the changed terms been in effect at the inception of the lease, the revised agreement shall be considered as a new agreement over its term, and the criteria in paragraphs 7 and 8 shall be applied for purposes of classifying the new lease. Likewise, except when a guarantee or penalty is rendered inoperative as described in paragraphs 12 and 17(e), any action that extends the lease beyond the expiration of the

> existing lease term (see paragraph 5(f)), such as the exercise of a lease renewal option other than those already included in the lease term, shall be considered as a new agreement, which shall be classified according to the provisions of paragraphs 6–8. Changes in estimates (for example, changes in estimates of the economic life or of the residual value of the leased property) or changes in circumstances (for example, default by the lessee), however, shall not give rise to a new classification of a lease for accounting purposes.

6. In short, pursuant to paragraph 9 of FAS 13, the lease term for purposes of lease classification cannot be changed unless either (a) the provisions of the lease are modified in a manner that results in the lease being considered a new agreement or (b) the lease is extended or renewed beyond the existing lease term. Therefore, practitioners question whether the amortization period for leasehold improvements purchased subsequent to lease inception can extend beyond the lease term that was determined at lease inception.

7. A similar question has been raised regarding leases assumed in a business combination.

8. As part of a business combination, the acquiring entity may assume existing lease agreements of the acquired entity and acquire the related leasehold improvements. The principles of accounting for business combinations require the acquiring entity to incorporate assumptions that marketplace participants would use in making estimates of the fair value of existing assets and obligations, including those pertaining to leases (such as assumptions about future contract renewal). Those principles include the guidance set forth in FIN 21. Paragraphs 12 and 13 of FIN 21 require that the acquiring entity retain the lease classification used by the acquired entity, unless one of the conditions of paragraph 9 of FAS 13 is met.

9. Practitioners observe that FAS 13 does not permit a change to the lease term for purposes of lease classification unless certain conditions specified in paragraph 9 of FAS 13 are met. Therefore, they question whether the amortization period for leasehold improvements acquired in a business combination can extend beyond the lease term that was determined by the acquiree at lease inception.

10. Since the principles of accounting for business combinations require the acquiring entity to measure acquired assets and liabilities at fair value (including those pertaining to leases), this Issue Summary addresses the amortization period for leasehold improvements acquired in a business combination separately from those purchased subsequent to lease inception.

Accounting Issues and Alternatives

Issue 1: The amortization period for leasehold improvements acquired in a business combination.

11. An entity may assume an off-market lease and acquire the related leasehold improvements in a business combination. FAS 141 requires the entity to recognize the favorable/unfavorable terms relative to market prices as an intangible asset. If a favorable lease has renewal options, some question whether the renewal periods should be considered in the fair value allocated to the favorable lease and the subsequent amortization of the intangible asset. The Board's current project, Useful Life and Amortization of Intangible Assets, is expected to provide guidance on the determination of the useful life of intangible assets (or liabilities) that represent favorable/unfavorable lease terms. Some believe that the treatment of lease renewals for determining the fair value and subsequent amortization of a favorable lease intangible asset should be consistent with the treatment for leasehold improvements. That is, evaluating whether an entity should anticipate lease renewal should be the same for leasehold improvements and lease related intangible assets. While others are uncertain whether the evaluation should be consistent, they believe that the Task Force would benefit from the Board's deliberations and conclusions related to intangible assets and, therefore, believe that the discussion of Issue 1 should be postponed.

12. In contrast, others believe that leasehold improvements acquired in a business combination are similar to leasehold improvements purchased subsequent to lease inception (Issue 2) and, therefore, do not believe that the Task Force should defer

discussions on Issue 1. The FASB staff will ask Task Force members whether they would like to address Issue 1 at the June meeting.

View A: Leasehold improvements acquired in a business combination should be amortized over the lesser of the useful life of the assets or a term that includes renewals that are reasonably assured at the date of acquisition.

13. The fair value of leasehold improvements acquired in a business combination may be such that the acquiree would expect to incur a penalty if it failed to renew the lease beyond the lease term (as determined by the acquiree) and, as a result, renewal of the lease appears reasonably assured at the date of acquisition. View A proponents believe that amortizing leasehold improvements acquired in a business combination over the lesser of their useful lives or the lease term, *as determined by the acquiree*, may lead to an amortization period that does not reflect the acquirer's expectation to receive economic benefits from those assets in one or more renewal periods *at the date of acquisition*.

14. Advocates of View A, therefore, believe that leasehold improvements acquired in a business combination should be amortized over the lesser of the useful life of the asset or a term that includes renewals that are reasonably assured (as described in paragraph 5(f) of FAS 13) at the date of acquisition. View A proponents acknowledge that FIN 21 prohibits a change in the classification of a lease in connection with a business combination absent a modification to the lease and, therefore, that the lease term does not change for the purpose of lease classification. However, View A proponents believe that FIN 21 was not intended to address the amortization of leasehold improvements.

View B: Leasehold improvements acquired in a business combination should be amortized over the lease term as determined by the acquiree.

15. View B proponents believe that lease term must be consistently applied in determining (a) the classification of the lease (capital versus operating), (b) the period to recognize straight-line rents, if any, and (c) the period to amortize leasehold

improvements. Also, they observe that the application of FIN 21 and FAS 13 prohibits a change to the lease term for purposes of lease classification unless a condition of paragraph 9 of FAS 13 is met. Furthermore, they observe that the acquisition of leasehold improvements is not an incremental capital investment in the assets related to the lease and, therefore, question whether an acquirer would incur a penalty if it failed to renew the lease beyond the lease term as determined by the acquiree. As a result, View B proponents believe that leasehold improvements should be amortized over the lesser of the leasehold improvement's useful life or the original lease term (or, if the lease had been modified, the modified lease term) as determined by the acquiree.

Issue 2: The amortization period of leasehold improvements purchased subsequent to the inception of a lease.

View A: Leasehold improvements purchased subsequent to the inception of a lease should be amortized over the lesser of the useful life of the assets or a term that includes renewals that are reasonably assured at the date the leasehold improvements are purchased.

16. The cost of leasehold improvements purchased subsequent to lease inception may be such that the entity would expect to incur a penalty if it failed to renew the lease beyond the lease term (as determined at lease inception) and, as a result, renewal of the lease appears reasonably assured at the date the leasehold improvements are purchased. View A proponents believe that amortizing leasehold improvements purchased subsequent to lease inception over the lesser of their useful lives or the lease term, *as determined at lease inception*, may lead to an amortization period that does not reflect the entity's expectation to receive economic benefits from those assets in one or more renewal period(s) *at the date the leasehold improvements are purchased*.

17. Advocates of View A, therefore, believe that leasehold improvements purchased subsequent to lease inception should be amortized over the lesser of the useful life of the asset or a term that includes renewals that are reasonably assured (as described in

paragraph 5(f) of FAS 13) at the date the leasehold improvements are purchased. Application of View A does not result in a change to the lease term.

View B: Leasehold improvements purchased subsequent to the inception of a lease should be amortized over the lesser of the leasehold improvement's useful life or the lease term.

18. View B proponents believe that lease term must be consistently applied to (a) the classification of the lease (capital versus operating), (b) the period to recognize straight-line rents, and (c) the period to amortize leasehold improvements. Also, they observe that FAS 13 prohibits a change to the lease term for purposes of lease classification unless a condition of paragraph 9 of FAS 13 is met. As a result, View B proponents believe that leasehold improvements should be amortized over the lesser of the leasehold improvement's useful life or the lease term.

IAS

19. IAS 16 and IAS 17, and their related interpretive guidance, do not provide guidance with respect to the amortization period of leasehold improvements for operating leases. Accordingly, a consensus on this Issue is not expected to result in a divergence in the literature promulgated by the FASB and the IASB.

Disclosure

20. Paragraph 5 of APB 12 requires the following disclosure:

> Because of the significant effects on financial position and results of operations of the depreciation method or methods used, the following disclosures should be made in the financial statements or in notes thereto:
>
> a. Depreciation expense for the period,
> b. Balances of major classes of depreciable assets, by nature or function, at the balance-sheet date,
> c. Accumulated depreciation, either by major classes of depreciable assets or in total, at the balance-sheet date, and

d. A general description of the method or methods used in computing depreciation with respect to major classes of depreciable assets.

21. The FASB staff recommends that the Task Force not require additional disclosure in this Issue.

Effective Date and Transition

22. The FASB staff's recommendation is that the consensuses in this Issue should be effective for periods beginning after Board ratification of the consensus. Early application of this guidance is permitted in periods for which financial statements have not yet been issued.

23. The FASB staff recommends that the consensus in this Issue be applied prospectively to the amortization period for newly acquired and the unamortized portion of existing leasehold improvements that were either (a) purchased subsequent to the inception of the lease or (b) acquired in a business combination.