Financial Accounting Standards Board

ORIGINAL PRONOUNCEMENTS

AS AMENDED

FASB Technical Bulletin No. 85-3

Accounting for Operating Leases with Scheduled Rent Increases

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STATUS

Issued: November 14, 1985

Effective Date: For leasing transactions entered into after November 14, 1985

Affects: No other pronouncements

Affected by: No other pronouncements

Other Interpretive Pronouncement: FTB 88-1

Issues Discussed by FASB Emerging Issues Task Force (EITF)

Affects: Nullifies EITF Issue No. 84-12

Interpreted by: Paragraphs 1 and 2 interpreted by EITF Issue No. 86-33

Related Issues: No EITF Issues

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References

FASB Statement No. 13, *Accounting for Leases,* paragraphs 15 and 19(b)
FASB Statement No. 29, *Determining Contingent Rentals*

Question

1. Certain operating lease agreements specify scheduled rent increases over the lease term. Such scheduled rent increases may, for example, be designed to provide an inducement or "rent holiday" for the lessee, to reflect the anticipated effects of inflation, to ease the lessee's near-term cash flow requirements, or to acknowledge the time value of money. For operating leases that include scheduled rent increases, is it ever appropriate for lessees or lessors to recognize rent expense or rental income on a basis other than the straight-line basis required by Statement 13?

Response

2. The effects of those scheduled rent increases, which are included in minimum lease payments under Statement 13, should be recognized by lessors and lessees on a straight-line basis over the lease term unless another systematic and rational allocation basis is more representative of the time pattern in which the leased property is physically employed. Using factors such as the time value of money, anticipated inflation, or expected future revenues to allocate scheduled rent increases is inappropriate because these factors do not relate to the *time pattern* of the physical usage of the leased property. However, such factors may affect the periodic reported rental income or expense if the lease agreement involves contingent rentals, which are excluded from minimum lease payments and accounted for separately under Statement 13, as amended by Statement 29.

Effective Date and Transition

3. The provisions of this Technical Bulletin are effective for leasing transactions entered into after November 14, 1985. Earlier application of this Technical Bulletin is encouraged in annual or interim financial statements that have not been previously issued.

The Financial Accounting Standards Board has authorized its staff to prepare FASB Technical Bulletins to provide guidance on certain financial accounting and reporting problems on a timely basis, pursuant to the procedures described in FASB Technical Bulletin No. 79-1 (Revised), ***Purpose and Scope of FASB Technical Bulletins and Procedures for Issuance.*** **The provisions of Technical Bulletins need not be applied to immaterial items.**

Appendix

BACKGROUND INFORMATION AND CONSIDERATION OF COMMENTS RECEIVED ON THE PROPOSED TECHNICAL BULLETIN

Background Information

4. Paragraph 15 of Statement 13 discusses the lessee's recognition of expense under an operating lease:

> Normally, rental on an operating lease shall be charged to expense over the lease term as it becomes payable. If rental payments are not made on a straight-line basis, rental expense nevertheless shall be recognized on a straight-line basis unless another systematic and rational basis is more representative of the time pattern in which use benefit is derived from the leased property, in which case that basis shall be used.

Paragraph 19(b) discusses the lessor's recognition of income under an operating lease:

> Rent shall be reported as income over the lease term as it becomes receivable according to the provisions of the lease. However, if the rentals vary from a straight-line basis, the income shall be recognized on a straight-line basis unless another systematic and rational basis is more representative of the time pattern in which use benefit from the leased property is diminished, in which case that basis shall be used.

5. Notwithstanding the requirements in the above paragraphs, some have suggested that, under certain conditions, rentals should be recognized on a basis that is neither straight-line nor representative of the time pattern of the physical usage of the leased property. Such conditions include (a) granting "rent holidays" or reduced rentals in the early part of the lease term as an inducement for the lessee to sign the lease agreement and (b) scheduling rent increases that are designed to reflect the anticipated effects of inflation. Some have suggested that, under those conditions, rentals should be recognized in the period that the rental payment is due.

6. Others believe that, because a lease with scheduled rent increases typically requires rental payments in the early years in amounts less than the amount of rentals to be recognized as income or expense under Statement 13, such a lease implicitly involves a borrowing by the lessee of the difference, that is, the amounts charged to expense by the lessee but not paid to the lessor. Thus, they believe the lessee is obtaining the use of the leased asset as well as the temporary use of some cash in those early years of the lease term. Accordingly, they recommend that both the lessor and lessee impute interest on that borrowing from the lessor. They suggest that the time value of money should be recognized as follows: (a) a level rental schedule should be computed that has the same present value as the present value of the escalating lease payments, (b) the computed level rental amount should be recorded as rental expense or income, and (c) interest expense or income should be imputed on the deferred amount recorded on the balance sheet that results from the difference between actual payments and the computed level rental amounts. Such an interest imputation allocation approach would generally result in lower total expense or income (including both the rental and interest elements) in the early years and the closing years of the lease than would a straight-line allocation approach. Since the amount allocated to "rental" is recorded on a straight-line basis, proponents of such an approach argue that it meets the requirements of Statement 13.

Consideration of Comments Received on the Proposed Technical Bulletin

7. A proposed Technical Bulletin, *Accounting for Operating Leases with Scheduled Rent Increases,* was released for comment on June 24, 1985. Thirty-two letters of comment were received on the proposed Technical Bulletin. Certain of the comments received and consideration of them are discussed in the following paragraphs.

8. The proposed Technical Bulletin indicated that it is not appropriate to use the time value of money as a factor in recognizing rentals under an operating lease. Thus, the proposed Technical Bulletin indicated that the interest imputation allocation approach is unacceptable. A majority of the respondents who addressed that approach agreed with the guidance in the proposed Bulletin. However, some respondents supported the interest imputation allocation approach, arguing that it reflects the economic substance of the transaction. They also indicated that the time value of money is an economic reality that warrants recognition.

9. The time value of money is an important concept underlying the fundamental accounting in Statement 13. That Statement specifies criteria for identifying the leases (known as capital leases) for which the lessee must recognize an asset and a liability, the initial measurements of which are based on present value. However, that Statement also stipulates the accounting for the leases (known as operating leases) that do not meet those criteria. That accounting does not recognize a liability for the lessee's obligation to pay all the future minimum rentals under an operating lease, nor does it permit the time value of money to affect the accounting for those future rentals. Statement 13 views operating leases as executory contracts, not as financing transactions, for accounting purposes.

10. The proposed Technical Bulletin indicated that inducements in the form of rent abatements in the early part of the lease term do not warrant special accounting treatment that differs from the requirements of Statement 13. Thus, the proposed

Bulletin effectively required inducements to be recognized over the term of the lease. Substantially all the respondents commenting on this issue supported the position in the proposed Technical Bulletin.

11. The proposed Technical Bulletin also indicated that scheduled rent increases designed to reflect the anticipated effects of inflation do not warrant special accounting treatment that differs from the requirements of Statement 13. A majority of the respondents who addressed that issue indicated support for the guidance in the proposed Bulletin. However, some respondents opposed the proposed guidance and suggested that recognizing rent expense as paid would provide a better matching of revenues and expenses and be more representative of the economics of the lease agreements.

12. Recognizing scheduled rent increases as rent expense as paid would effectively account for those mandatory increases in the same manner as for contingent rentals. The accounting for operating leases under Statement 13, as amended by Statement 29, however, differentiates between (a) scheduled rent increases that are not dependent on future events and (b) increases or decreases in rentals that are dependent on future events such as future sales volume, future inflation, future property taxes, and so forth. The former are minimum lease payments to be accounted for under paragraphs 15 and 19(b) of Statement 13. The latter are contingent rentals that affect the measure of expense or income as accruable, as specified by Statement 29. Opponents of the guidance in the proposed Technical Bulletin asserted that the economic substance of contingent rentals and scheduled rent increases designed to reflect the anticipated effects of inflation are the same and should be accounted for similarly.

13. There is an important substantive difference between lease rentals that are contingent upon some specified future event and scheduled rent increases that are unaffected by future events; the accounting under Statement 13 reflects that difference. If the lessor and lessee eliminate the risk of variable payments inherent in contingent rentals by agreeing to scheduled rent increases, the accounting should reflect those different circumstances.