

# TOP ACCOUNTING ISSUES FOR 2007 CPE COURSE

**BONUS  
CPE COURSE!**

EARN CPE CREDIT  
AND STAY ON TOP OF KEY  
ACCOUNTING ISSUES.  
SEE PAGE 279 FOR  
DETAILS.



**CCH**

a Wolters Kluwer business

---

# TOP ACCOUNTING ISSUES FOR 2007 CPE COURSE

---

CCH Editorial Staff Publication



**CCH**

a Wolters Kluwer business

## Contributors

Editor.....	Colleen Neuharth McClain, CPA
Contributing Editors.....	Julia K. Brazelton, Ph.D. Joseph V. Carcello, Ph.D., CPA CMA, CIA Steven C. Fustolo, CPA Jan R. Williams , Ph.D., CPA
Production Coordinator .....	Gabriel E. Santana
Cover Design .....	Craig Arritola
Layout & Design.....	Laila Gaidulis Heather Jonas

This publication is designed to provide accurate and authoritative information in regard to the subject matter covered. It is sold with the understanding that the publisher is not engaged in rendering legal, accounting, or other professional service. If legal advice or other expert assistance is required, the services of a competent professional person should be sought.

ISBN 0-8080-1537-0

ISBN 978-0-8080-1537-6

© 2006 CCH. All Rights Reserved.

4025 W. Peterson Ave.

Chicago, IL 60646-6085

1 800 344 3734

[www.CCHGroup.com](http://www.CCHGroup.com)

No claim is made to original government works; however, within this Product or Publication, the following are subject to CCH's copyright: (1) the gathering, compilation, and arrangement of such government materials; (2) the magnetic translation and digital conversion of data, if applicable; (3) the historical, statutory and other notes and references; and (4) the commentary and other materials.

Printed in the United States of America

---

## TOP ACCOUNTING ISSUES FOR 2007 CPE COURSE

### **Introduction**

---

CCH's Top Accounting Issues for 2007 Course helps CPAs stay abreast of the most significant new standards and important projects. It does so by identifying the events of the past year that have developed into hot issues and reviewing the opportunities and pitfalls presented by the changes. The topics reviewed were selected because of their impact on financial reporting and because of the role they play in understanding the accounting landscape in the year ahead. The topics examined in Top Accounting Issues for 2006 are:

- Leases
- Business Combinations
- Intangible Assets
- Balance Sheet Classifications
- Accounting and Financial Reporting: Current Developments
- FASB 123R: Share-Based Compensation

Throughout the course you will find Study Questions to help you test your knowledge. Examples are located throughout to assist you with comprehension of the course material.

This course is divided into three Modules. Take your time and review all course Modules. When you feel confident that you thoroughly understand the material, turn to the CPE Quizzer. Complete one, two or all Module Quizzers for continuing professional education credit. Further information is provided in the Quizzer instructions on page 279.

September 2006

## COURSE OBJECTIVES

This course was prepared to provide the participant with an overview of important developments affecting accounting. At the completion of the course, you will be able to:

- Be familiar with accounting and reporting by lessees, including capital leases and operating leases and the financial statement disclosure guidelines for each
- Prepare journal entries for a business combination
- Summarize the impairment rules regarding intangible assets
- Define basic concepts and terms associated with balance sheet classification
- Understand the selected Emerging Issues Task Force (EITF) consensus opinions discussed in the chapter, namely:
  - EITF Issue No. 04-5
  - EITF Issue No. 04-8
  - EITF Issue No. 04-10
  - EITF Issue No. 04-12
  - EITF Issue No. 05-2
  - EITF Issue No. 05-5
  - EITF Issue No. 05-6
  - EITF Issue No. 05-7
  - EITF Issue No. 05-8
- Identify the types of plans subject to FASB No. 123R

## CCH'S PLEDGE TO QUALITY

Thank you for choosing this CCH Continuing Education product. We will continue to produce high quality products that challenge your intellect and give you the best option for your Continuing Education requirements. Should you have a concern about this or any other CCH CPE product, please call our Customer Service Department at 1-800-248-3248.

**NEW ONLINE GRADING** gives you immediate 24/7 grading with instant results and no Express Grading Fee.

The **CCH Testing Center** website gives you and others in your firm easy, free access to CCH print Courses and allows you to complete your CPE Quizzers online for immediate results. Plus, the **My Courses** feature provides convenient storage for your CPE Course Certificates and completed Quizzers.

Go to **www.cchtestingcenter.com** to complete your Quizzer online.

One **complimentary copy** of this Course is provided with copies of selected CCH Accounting titles. Additional copies of this Course may be ordered for \$27.50 each by calling 1-800-248-3248 (ask for product 0-0996-200).

---

TOP ACCOUNTING ISSUES FOR 2007 CPE COURSE

## Contents

---

### MODULE 1

<b>1</b>	<b>Leases</b>	
	Learning Objectives .....	1
	Overview .....	1
	Background .....	4
	Terminology .....	5
	Accounting and Reporting by Lessees .....	15
	Accounting and Reporting by Lessors .....	26
	Leases Involving Real Estate .....	35
<b>2</b>	<b>Business Combinations</b>	
	Learning Objectives .....	59
	Introduction .....	59
	Getting Started .....	59
	Definitions Related to Business Combinations .....	62
	Allocation of Cost to Net Assets .....	69
	Special Circumstances for Banking and Thrift Enterprises .....	78
	Consolidated Financial Statements .....	78
	Disclosure Requirements .....	78
	Summary .....	79

### MODULE 2

<b>3</b>	<b>Intangible Assets</b>	
	Learning Objectives .....	81
	Accounting for Intangible Assets—Overview .....	81
	Determining Fair Value .....	83
	Determining the Amortization Period .....	83
	Testing Impairment of Intangibles .....	86
	Accounting for Research and Development Costs .....	89
	Definition of R&D .....	89
	Types of Costs Incurred .....	90
	Venture Arrangements for R&D .....	91
	Accounting for the Costs of Computer Software .....	94
	Technological Feasibility .....	95
	Accounting Treatment of Production Costs .....	96
	Purchased Software .....	98
	Accounting for Goodwill and Other Intangible Assets .....	101

EITF Issue No. 05-7: <i>Accounting for Modifications to Conversion Options Embedded in Debt Instruments and Related Issues</i> . . . . .	161
EITF Issue No. 05-8: <i>Income Tax Consequences of Issuing Convertible Debt with a Beneficial Conversion Feature</i> . . . . .	163
Summary of FASB Emerging Issues	
Task Force Opinions (EITFs) . . . . .	164
FASB Staff Positions (FSPs) . . . . .	166
Practice Issues: Cash Flow Shenanigans . . . . .	169
Clarifying the Useful Life of Intangible Assets—FASB No. 142 . .	185
Recent FASB Developments—Intangible Assets . . . . .	190

## **6 FASB 123R: Share-Based Compensation**

Learning Objectives . . . . .	193
Introduction . . . . .	193
Background of the Statement . . . . .	193
Effective Date of FASB No. 123R . . . . .	197
Effects of the Revision . . . . .	197
Requirement of the Statement . . . . .	199
Rules of FASB No. 123R . . . . .	199
Valuation Techniques . . . . .	206
Rules for Employee Stock Purchase Plans . . . . .	215
Recognition of Compensation Cost for an	
Award Accounted For As An Equity Instrument . . . . .	218
Accounting for Tax Effects of Shared-Based	
Compensation Awards . . . . .	233
Conclusion . . . . .	235
<b>Answers to Study Questions</b> . . . . .	<b>237</b>
<b>Index</b> . . . . .	<b>269</b>
<b>CPE Quizzer Instructions</b> . . . . .	<b>279</b>
<b>CPE Quizzer: Module 1</b> . . . . .	<b>281</b>
<b>CPE Quizzer: Module 2</b> . . . . .	<b>289</b>
<b>CPE Quizzer: Module 3</b> . . . . .	<b>297</b>
<b>Module 1: Answer Sheet</b> . . . . .	<b>307</b>
<b>Module 2: Answer Sheet</b> . . . . .	<b>311</b>
<b>Module 3: Answer Sheet</b> . . . . .	<b>315</b>
<b>Evaluation Form</b> . . . . .	<b>319</b>

Acquisition of Intangibles .....	102
Impairment .....	103
Internally Generated Intangibles .....	104
Goodwill .....	104

## 4 Balance Sheet Classifications

Learning Objectives .....	109
Overview .....	109
Background .....	110
Basic Definitions .....	111
Receivables .....	114
Cash Surrender Value of Life Insurance .....	118
Liability Classification Issues .....	120
Compensated Absences .....	125
Uncertain Tax Positions .....	129
Offsetting Assets and Liabilities—General .....	130

## MODULE 3

## 5 Accounting and Financial Reporting: Current Developments

Learning Objectives .....	139
FASB Emerging Issues Task Force (EITF)—Selected Issues .....	139
EITF Issue No. 04-5: <i>Determining Whether a General Partner, or the General Partners as a Group, Controls a Limited Partnership or Similar Entity When the Limited Partners Have Certain Rights</i> .....	140
EITF Issue No. 04-8: <i>The Effect of Contingently Convertible Debt on Diluted Earnings per Share</i> .....	148
EITF Issue No. 04-10: <i>Determining Whether to Aggregate Operating Segments That Do Not Meet the Quantitative Thresholds</i> .....	149
EITF Issue No. 04-12: <i>Determining Whether Equity-Based Compensation Awards Are Participating Securities</i> .....	150
EITF Issue No. 04-13: <i>Accounting for Purchases and Sales of Inventory with the Same Counterparty</i> .....	151
EITF Issue No. 05-2: <i>The Meaning of “Conventional Convertible Debt Instrument” in EITF Issue No. 00-19, “Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company’s Own Stock”</i> .....	155
EITF Issue No. 05-5: <i>Accounting for Early Retirement or Postemployment Program with Specific Features (Such as Terms Specified in Altersteilzeit Early Retirement Arrangements)</i> .....	157
EITF Issue No. 05-6: <i>Determining the Amortization Period for Leasehold Improvements Purchased after Lease Inception or Acquired in a Business Combination</i> .....	159



---

MODULE 1 – CHAPTER 1

## Leases

---

### LEARNING OBJECTIVES

Upon completion of this chapter, the practitioners should:

- Understand the terminology of leasing
- Be familiar with accounting and reporting by lessees, including capital leases and operating leases and the financial statement disclosure guidelines for each
- Be familiar with accounting and reporting by lessors, including capital leases, operating leases, lease sale or assignment to third parties, and financial statement disclosures for capital and operating leases
- Become familiar with the accounting procedures for leases involving real estate, including land, buildings and equipment

### OVERVIEW

A lease is an agreement that conveys the right to use property, usually for a specified period. Leases typically involve two parties: the owner of the property (lessor) and the party contracting to use the property (lessee). Because of certain tax, cash flow, and other advantages, leases have become an important alternative to the outright purchase of property by which companies (lessees) acquire the resources needed to operate.

Leases include agreements that, while not nominally referred to as leases, have the characteristic of transferring the right to use property (e.g., heat supply contracts), and agreements that transfer the right to use property even though the contractor may be required to provide substantial services in connection with the operation or maintenance of the assets (FAS-13, par. 1).

The term *lease*, as used in promulgated GAAP, does not include the following (FAS-13, par. 1):

- Agreements that are contracts for services that do not transfer the right to use property from one contracting party to another
- Agreements that concern the right to explore for or exploit natural resources such as oil, gas, minerals, and timber
- Agreements that represent licensing agreements for items such as motion picture films, plays, manuscripts, patents, and copyrights

A central accounting issue associated with leases is the identification of those leases that are treated appropriately as sales of the property by lessors and as purchases of the **property by lessees** (*capital leases*). Those leases that are not identified as capital leases are called *operating leases* and are not treated

as sales by lessors and as purchases by lessees. Rather, they are treated on a prospective basis as a series of cash flows from the lessee to the lessor.

GAAP for leases include the largest number of authoritative accounting pronouncements of any single subject in accounting literature. Pronouncements that follow FAS-13 (Accounting for Leases) explain, interpret, or amend that pronouncement in a variety of ways; many of them arose as a result of attempts to implement FAS-13. Following are pronouncements that collectively establish promulgated GAAP for lease accounting:

- FAS-13 *Accounting for Leases*
- FAS-22 *Changes in the Provisions of Lease Agreements Resulting from Refundings of Tax-Exempt Debt*
- FAS-23 *Inception of the Lease*
- FAS-27 *Classification of Renewals or Extensions of Existing Sales-Type or Direct Financing Leases*
- FAS-28 *Accounting for Sales with Leasebacks*
- FAS-29 *Determining Contingent Rentals*
- FAS-91 *Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases*
- FAS-98 *Accounting for Leases:*
  - Sale-Leaseback Transactions Involving Real Estate
  - Sales-Type Leases of Real Estate
  - Definition of the Lease Term
  - Initial Direct Costs of Direct Financing Leases
- FAS-145 *Rescission of FASB Statements No. 4, 44, and 64, Amendment of FASB Statement No. 13, and Technical Corrections*
- FIN-19 *Lessee Guarantee of the Residual Value of Leased Property*
- FIN-21 *Accounting for Leases in a Business Combination*
- FIN-23 *Leases of Certain Property Owned by a Governmental Unit or Authority*
- FIN-24 *Leases Involving Only Part of a Building*
- FIN-26 *Accounting for Purchase of a Leased Asset by the Lessee during the Term of the Lease*
- FIN-27 *Accounting for a Loss on a Sublease*

Following is a brief overview of the nine Statements of Financial Accounting Standards included in the promulgated GAAP for leases.

**FAS-13** defines a lease as an agreement that conveys the right to use assets (tangible or intangible) for a stated period. A lease that transfers substantially all the benefits and risks inherent in the ownership of property is called a *capital lease*. Such a lease is accounted for by the lessee as the acquisition of an asset and the incurrence of a liability. The lessor accounts for such a lease as a sale (sales-type lease) or financing (direct financing lease). All other leases are referred to as *operating leases*.

**FAS-22** addresses an inconsistency between FAS-13 and APB-26 (Early Extinguishment of Debt) arising from refundings of tax-exempt debt, including advance refundings that are accounted for as early extinguishments of debt. FAS-22 is covered in more detail later in this chapter.

**FAS-23** amends FAS-13 to specify that, if the leased property is yet to be constructed or acquired by the lessor at the inception of the lease, the lessor's criterion pertaining to "no important uncertainties of unreimbursable costs yet to be incurred by the lessor" is applied at the date that construction of the property is completed or the property is acquired. FAS-23 amends FAS-13 to specify that any increases in the minimum lease payments that have occurred during the preacquisition or preconstruction period as a result of an escalation clause are to be considered in determining the fair value of the leased property at the inception of the lease. FAS-23 also amends FAS-13 to limit the amount that can be recorded by the lessor for the residual value of leased property to an amount not greater than the estimate as of the inception of the lease. FAS-23 is discussed more fully throughout this chapter.

**FAS-27** modifies FAS-13 to require a lessor to classify a renewal or an extension of a sales-type or direct financing lease as a sales-type lease if the lease would otherwise qualify as a sales-type lease and the renewal or extension occurs at or near the end of the lease term. Otherwise, FAS-13 prohibits the classification of a renewal or extension of a sales-type or direct financing lease as a sales-type lease at any other time during the lease term.

**FAS-28** amends FAS-13 to specify the appropriate accounting for sale-leaseback transactions depending on the percentage amount of the property that the seller-lessee leases back (substantially all of the property, a minor portion of the property, or more than a minor portion of the property but less than substantially all) and whether the lease is classified as a capital lease or an operating lease.

**FAS-29** amends FAS-13 to provide a new definition for *contingent rentals* as those that cannot be determined at the inception of the lease because they depend on future factors or events. Rental payments based on future sales volume, future machine hours, future interest rates, and future price indexes are examples of contingent rentals. Contingent rentals can either increase or decrease lease payments.

**FAS-91** establishes accounting and reporting standards for nonrefundable fees and costs associated with lending, committing to lend, or purchasing a loan or group of loans. Under FAS-91, direct loan origination fees and costs, including initial direct costs incurred by a lessor in negotiating and consummating a lease, are offset against each other and the net amount is deferred and recognized over the life of the loan as an adjustment to the

yield on the loan. The provisions of FAS-91 apply to all types of loans, including debt securities, and to all types of lenders, including banks, thrift institutions, insurance companies, mortgage bankers, and other financial and nonfinancial institutions. However, FAS-91 does not apply to nonrefundable fees and costs that are associated with originating or acquiring loans which are carried at market value.

**FAS-98** amends FAS-13 to establish a new definition of *penalty* and *lease term* for all leasing transactions. FAS-98 specifies the appropriate accounting for a seller-lessee in a sale-leaseback transaction involving real estate, including real estate with equipment, such as manufacturing facilities, power plants, furnished office buildings, etc. FAS-98 establishes the appropriate accounting for a sale-leaseback transaction in which property improvements or integral equipment is sold to a purchaser-lessor and leased back by the seller-lessee who retains the ownership of the underlying land. FAS-98 also provides the appropriate accounting for sale-leaseback transactions involving real estate with equipment that include separate sale and leaseback agreements for the real estate and the equipment (a) with the same entity or related parties and (b) that are consummated at or near the same time, suggesting that they were negotiated as a package.

**FAS-145** amends FAS-13 to eliminate certain inconsistencies between how sale-leaseback transactions are accounted for under FAS-98 or FAS-28 and how certain lease modifications, where the modification results in the lease transaction being similar to a sale-leaseback, have been accounted for under FAS-13.

## BACKGROUND

Some lease agreements are such that an asset and a related liability should be reported on the balance sheet of the lessee enterprise. The distinction is one of *substance over form* when the transaction actually *transfers substantially all the benefits and risks inherent in the ownership of the property*.

Established in GAAP are criteria to determine whether a lease transaction is in substance a transfer of the incidents of ownership. If, *at its inception*, a lease meets one or more of the following four criteria, the lease is classified as a capital lease (FAS-13, par. 7):

1. By the end of the lease term, ownership of the leased property is transferred to the lessee.
2. The lease contains a bargain purchase option.
3. The lease term is substantially (75% or more) equal to the estimated useful life of the leased property.
4. At the inception of the lease, the present value of the minimum lease payments, with certain adjustments, is 90% or more of the fair value of the leased property.

## TERMINOLOGY

The authoritative literature includes many terms that are important for an understanding of lease accounting. Several of these terms are explained below.

**Capital lease.** A capital lease transfers the benefits and risks inherent in the ownership of the property to the lessee, who accounts for the lease as an acquisition of an asset and the incurrence of a liability (FAS-13, par. 6a).

**Sales-type lease.** A sales-type lease is a type of capital lease that results in a manufacturer's or dealer's profit or loss to the lessor and transfers substantially all the benefits and risks inherent in the ownership of the leased property to the lessee; in addition, (a) the minimum lease payments are reasonably predictable of collection and (b) no important uncertainties exist regarding costs to be incurred by the lessor under the terms of the lease (FAS-13, par. 6b).

In a sales-type lease, the *fair value* of the leased property at the inception of the lease differs from the cost or carrying amount because a manufacturer's or dealer's profit or loss exists. Fair value usually is the *normal selling price* of the property.

**Direct financing lease.** A direct financing lease is a type of capital lease that does *not* result in a manufacturer's or dealer's profit or loss to the lessor, but does transfer substantially all the benefits and risks inherent in the ownership of the leased property to the lessee; in addition, (a) the minimum lease payments are reasonably predictable of collection and (b) no important uncertainties exist regarding costs to be incurred by the lessor under the terms of the lease (FAS-13, par. 6b).

Separately identifying sales-type and direct financing leases is an accounting issue for the lessor only, who accounts for the two types of capital leases differently, as described later in this chapter. Both types of leases transfer substantially all the benefits and risks inherent in the ownership of the leased property to the lessee, who records the transaction as a *capital lease*.

**Fair value.** Fair value is the price for which the leased property could be sold between unrelated parties in an arm's-length transaction (FAS-13, par. 5c). For the manufacturer or dealer, fair value usually is the normal selling price less trade or volume discounts. Fair value may be less than the normal selling price, however, and sometimes less than the cost of the property. For others, fair value usually is cost less trade or volume discounts. Fair value may be less than cost, however, especially in circumstances in which a long period elapses between the acquisition of the property by the lessor and the inception of a lease.

**Fair rental.** Fair rental is the rental rate for similar property under similar lease terms and conditions.

**Related parties.** Related parties are one or more entities subject to the significant influence over the operating and financial policies of another entity (FAS-13, par. 5a).

**Executory costs.** Executory costs are items such as insurance, maintenance, and taxes paid in connection with the leased property (FAS-13, par. 7d).

**Bargain purchase option.** A bargain purchase option is a lessee's option to purchase the leased property at a sufficiently low price that makes the exercise of the option relatively certain (FAS-13, par. 5d).

**Bargain renewal option.** A bargain renewal option is a lessee's option to renew the lease at a sufficiently low rental that makes the exercise of the option relatively certain (FAS-13, par. 5e).

**Estimated economic life.** Estimated economic life is the estimated remaining useful life of the property for the purpose for which it was intended, regardless of the term of the lease (FAS-13, par. 5g).

**Estimated residual value.** Estimated residual value is the estimated fair value of the leased property at the end of the lease term. The estimated residual value shall not exceed the amount estimated at the inception of the lease except for the effect of any increases that result during the construction or preacquisition period, because of escalation provisions in the lease (FAS-13, par. 5h).

**Unguaranteed residual value.** Unguaranteed residual value is the estimated fair value of the leased property at the end of the lease term that is not guaranteed by either the lessee or a third party unrelated to the lessor. A guarantee by a third party related to the lessee is considered a lessee guarantee (FAS-13, par. 5i).

**Lessee's incremental borrowing rate.** The lessee's incremental borrowing rate is the rate of interest that the lessee would have had to pay at the inception of the lease to borrow the funds, on similar terms, to purchase the leased property (FAS-13, par. 5l).

**Inception of lease.** The inception of the lease is the date of the lease agreement or the date of a written commitment signed by the parties involved that sets forth the principal provisions of the lease transaction. A written commitment that does not contain all of the principal provisions of the lease transaction does not establish the inception date (FAS-23, par. 6).

**Interest rate implicit in the lease.** The interest rate implicit in the lease is the rate that, when applied to certain items (enumerated below), results in an aggregate present value equal to the fair value of the leased property at the beginning of the lease term, less any investment credit expected to be realized and retained by the lessor. The discount rate is applied to (a) the minimum lease payments, excluding executory costs such as insurance, maintenance,

and taxes (including any profit thereon) that are paid by the lessor and (b) the estimated fair value of the property at the end of the lease term, exclusive of any portion guaranteed by either the lessee or a third party unrelated to the lessor (unguaranteed residual value) (FAS-13, par. 5k).

**Initial direct costs.** The definition of *initial direct costs* is as follows (FAS-91, par. 24):

Initial direct costs (Initial direct cost shall be offset by nonrefundable fees that are yield adjustments as prescribed in FAS-91). Only those costs incurred by the lessor that are (a) costs to originate a lease incurred in transactions with independent third parties that (i) result directly from and are essential to acquire that lease and (ii) would not have been incurred had that leasing transaction not occurred and (b) certain costs directly related to specified activities performed by the lessor for that lease. Those activities are: evaluating the prospective lessee's financial condition; evaluating and recording guarantees, collateral, and other security arrangements; negotiating lease terms; preparing and processing lease documents; and closing the transaction. The costs directly related to those activities shall include only that portion of the employees' total compensation and payroll-related fringe benefits directly related to time spent performing those activities for that lease and other costs related to those activities that would not have been incurred but for that lease. Initial direct costs shall not include costs related to activities performed by the lessor for advertising, soliciting potential lessees, servicing existing leases, and other ancillary activities related to establishing and monitoring credit policies, supervision, and administration. Initial direct costs shall not include administrative costs, rent, depreciation, any other occupancy and equipment costs, and employees' compensation and fringe benefits related to activities described in the previous sentence, unsuccessful origination efforts, and idle time.

In determining the net amount of initial direct costs in a leasing transaction under FAS-13, a lessor shall apply the provisions of FAS-91 relating to loan origination fees, commitment fees, and direct loan origination costs of completed loans. Initial direct costs are accounted for by lessors as part of the investment in a direct financing lease.

#### **OBSERVATION**

The recognition of a portion of the unearned income at the inception of a lease transaction to offset initial direct costs is not permitted (FAS-91, par. 23).



**Contingent rentals.** Contingent rentals are those that cannot be determined at the inception of the lease because they depend on future factors or events. Rental payments based on future sales volume, future machine hours, future interest rates, and future price indexes are examples of contingent rentals. Contingent rentals can either increase or decrease lease payments (FAS-29, par. 11).

Increases in minimum lease payments that occur during the preacquisition or construction period as a result of an escalation clause in the lease are not considered contingent rentals (FAS-29, par. 11).

**Lease term.** The lease term includes all of the following (FAS-98, par. 22a):

- Any fixed noncancelable term
- Any period covered by a bargain renewal option
- Any period in which penalties are imposed in an amount that at the inception of the lease reasonably assures the renewal of the lease by the lessee
- Any period covered by ordinary renewal options during which a guarantee by the lessee of the lessor's debt that is directly or indirectly related to the leased property is expected to be in effect or a loan from the lessee to the lessor that is directly or indirectly related to the leased property is expected to be outstanding

#### NOTE

The phrase *indirectly related to the leased property* is used to cover situations 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.

- Any period covered by ordinary renewal options preceding the date on which a bargain purchase option is exercisable
- Any period representing renewals or extensions of the lease at the lessor's option. A lease term does not extend beyond the date a bargain purchase option becomes exercisable.

**Noncancelable lease term.** A noncancelable lease term is a provision in a lease agreement that specifies that the lease may be canceled only (a) on some remote contingency, (b) with permission of the lessor, or (c) if the lessee enters into a new lease with the same lessor (FAS-98, par. 22a).

**Penalty.** The term *penalty* refers to any outside factor or provision of the lease agreement that does or can impose on the lessee the requirement to disburse cash, incur or assume a liability, perform services, surrender or transfer an asset or rights to an asset or otherwise forego an economic benefit, or suffer an economic detriment (FAS-98, par. 22b).



### Minimum Lease Payments

Normal minimum lease payments for the lessee include (FAS-13, par. 5j):

- The minimum rent called for during the lease term
- Any payment or guarantee that the lessee must make or is required to make concerning the leased property at the end of the lease term (residual value), including:
  - Any amount stated to purchase the leased property
  - Any amount stated to make up any deficiency from a specified minimum
  - Any amount payable for failure to renew or extend the lease at the expiration of the lease term

When a lease contains a bargain purchase option, the minimum lease payments include only (a) the minimum rental payments over the lease term and (b) the payment required to exercise the bargain purchase option.

The following are excluded in determining minimum lease payments (FAS-13, par. 5j):

- A guarantee by the lessee to pay the lessor's debt on the leased property
- The lessee's obligation (separate from the rental payments) to pay executory costs (insurance, taxes, etc.) in connection with the leased property
- Contingent rentals (FAS-29, par. 10)

#### OBSERVATION

FIN-19 (Lessee Guarantee of the Residual Value of Leased Property) clarifies certain guarantees of the residual value of leased property made by a lessee, as follows:

- A guarantee by a lessee to make up a residual value deficiency caused by damage, extraordinary wear and tear, or excessive usage is similar to a contingent rental, since the amount is not determinable at the inception of the lease. Therefore, this type of lessee guarantee does not constitute a lessee guarantee of residual value for purposes of computing the lessee's minimum lease payments (FIN-19, par. 3).
- A lessee's guarantee to make up a residual value deficiency at the end of a lease term is limited to the specified maximum deficiency called for by the lease (FIN-19, par. 4).
- Unless the lessor explicitly releases the lessee, a guarantee of residual value by an unrelated third party for the benefit of the lessor does not release the obligation of the lessee. Therefore, such a guarantee by an unrelated third party shall not be used to reduce the lessee's minimum lease payments. Costs incurred in connection with a guarantee by an unrelated third party are considered executory costs and are not included in computing the lessee's minimum lease payments (FIN-19, par. 5).