

- ① • From the e-Activity, analyze the results of the proposed changes to lease accounting on operating and capital leases. Identifying how the right-of-use model will impact financial reporting, indicate how companies are likely to manage the change in reporting.

Use the Internet to research the current provisions and proposed changes reflected in the exposure draft for lease accounting under generally accepted accounting principles (GAAP) and international financial reporting standards (IFRS). Be prepared to discuss.

- ② • Discuss recommendations you would make to chief financial officers (CFOs) of retailers, service providers, and other businesses that lease several locations or have substantial leases of real estate or other assets. Indicate the pros and cons of each approach.

Attached

- ③ • From the case study, create an argument for the use of principles-based accounting for leases over rules-based accounting under GAAP, based on the financial statement restatements in the restaurant industry. Provide support for your argument.

- ④ • Assess the materiality of the errors, direction provided by the Securities and Exchange Commission (SEC), and the Sarbanes-Oxley Act (SOX) on the decision by management to restate the financial statements. Indicate the likely impact to stakeholders when financial statements are restated.

CASE 3.2

Lease Restatements in the Restaurant Industry, 2004–2005

Prior to 1970, most U.S. firms used leasing for short-term needs. A small firm might lease an office, copier, or manufacturing space for one or two years to limit the risk if the business failed. If a larger firm needed expensive equipment or a building, it often financed the asset by borrowing from a bank, using the asset as collateral. No lease accounting rules existed and none were necessary. Firms simply recorded lease expense when they made each month's rent or lease payment.

Beginning in about 1970, U.S. firms realized they could structure long-term lease agreements that were equivalent to buying an asset with debt. A firm might purchase a \$50 million building with a \$50 million bank loan to be repaid over a 20-year period at \$410,000 per month (an effective annual interest rate of about 8%). Instead, the firm might ask its bank to structure the transaction as a \$410,000 per month 20-year lease, with the additional stipulation that at the end of 20 years the firm must purchase the building for \$1. The firm would also maintain and insure the building.

Except for the additional \$1 after 20 years, the terms are identical, thus the bank should be indifferent as to whether the transaction is called a loan or a lease. With a lease, however, the firm would not record the building as an asset or record the present value of lease payments as debt. Using the example in the previous paragraph, suppose the firm had \$150 million of assets, \$50 million of debt, and \$100 million of equity prior to the transaction, its debt-to-equity ratio would have been 0.5. With \$50 million of added assets and debt, the debt-to-equity ratio would increase to 1.0; with a lease, the ratio would remain at 0.5. Firms began to use leasing as one of the first forms of off-balance sheet financing. Leasing became so common that in November 1976 the newly established Financial Accounting Standards Board (FASB) issued guidance on how to account for leases (Section 840, previously FAS 13).

ACS 840 (FAS 13), *Accounting for Leases*

The FASB classified leases into two categories, shorter-term operating leases and longer-term capital leases. For an operating lease, the lessee records lease expense each month when it pays the rent or lease cost. The journal entry is a debit to lease or rent expense and a credit to cash, although as discussed later in this case, in practice the journal entries are more complex.

With a capital lease, the lessee records the lease so it is equivalent to buying an asset with debt. Thereafter, the lessee separates lease payments into an interest component and a partial principal repayment. The lessee also depreciates the leased asset over the lease term, as if it bought the asset with borrowed funds.

Capital Lease Example

Exhibit 1 provides a simple example of a two-year capitalized lease. Typically, capital leases are for much longer periods, but conceptually they are identical to this example. The lessee makes a \$10,000 lease payment at the beginning of each month, starting January 1, 2008 (second column). The lessee computes the lease's present value, which requires a discount rate. FASB's guidance on accounting for leases requires

that the rate be the lessee's incremental borrowing rate, or the rate the lessee could have borrowed the funds it needed to purchase the leased asset.¹

Exhibit 1 assumes an 8% effective annual borrowing rate, or a .643% monthly rate.² The present value of the 24 \$10,000 monthly payments is \$223,155.73 (the \$10,000 initial payment, plus the net present value [NPV] of the remaining 23 payments, discounted at .643% monthly). That amount is recorded as a lease asset and a lease liability at the lease inception. Because the lessee pays \$10,000 at the beginning of the month, the present value of the lease liability immediately declines to \$213,115.73.

During January, the lessee incurs \$1,371.45 of interest expense (.643% monthly interest rate, multiplied by the \$213,115.73 lease payable at the beginning of January). The journal entries to record those transactions are shown at the lower left of Exhibit 1. The lessee also records straight-line depreciation expense each month over the 24-month lease term. The journal entries to record the activity for February are shown in the lower right of Exhibit 1.

Each month the \$10,000 lease payment is separated into two components: interest expense and principal repayment (repayment of the lease liability). At the end of the lease, the lease liability declines to zero and accumulated depreciation increases to \$223,155.73 (the value of the leased asset at inception). Interest expense plus accumulated depreciation equals the \$240,000 of lease payments.

Had this been recorded as an operating lease, the lessee would have debited lease expense and credited cash for \$10,000 each month. Total expenses would still be \$240,000, but the lessee would not have recorded a lease asset or a lease liability at lease inception.

Test for Operating or Capital Lease

Operating leases are short-term leases with few ownership characteristics. If a realtor leases 750 square feet of office space for a year, with no requirement or incentive to renew the lease, there is no reason to believe the lease is equivalent to buying the office space. In contrast, capital leases have substantial ownership characteristics. The guidance on accounting for leases established four tests for a capital lease; if a lease passes any of the following four tests (slightly simplified), then it is classified as a capital lease:

1. The lease transfers ownership to the lessee at the end of the lease.
2. The lease contains a bargain purchase option.
3. The lease term is equal to 75% or more of the economic life of the leased property.
4. The present value at the lease inception of the minimum lease payments equals 90% or more of the fair value of the leased property.³

The first two tests are relatively straightforward; the last two are not. If the lease term is equal to 75% or more of the economic life of the leased property, then the lease is a capital lease. An asset's economic life, however, is highly subjective. In some instances, such as semiconductor production, equipment becomes obsolete in 2 or 3 years; in other instances, equipment may be used for 50 or 75 years. As a result, firms can often justify an economic life far beyond the lease term and thereby circumvent the third test.

1. ACS 840; previously FAS 13, *Lease Accounting*, Financial Accounting Standards Board, November 1976, paragraph 7.

2. $1.08^{(1/12)} - 1 = 0.00643$.

3. FAS 13, paragraph 5, subparagraph L.

The fourth test, although far less subjective than the third, is subject to manipulation. Sometimes a firm's incremental borrowing rate is readily determined, but often it is not. As a result, some firms have assumed unrealistically high borrowing rates to circumvent the fourth test. There are also many subtleties that the last test does not address. For example, suppose the lease term for a building is 10 years and the present value of the lease payments is only 60% of the building's fair value. That clearly does not equal or exceed the 75% requirement of the fourth test, so the transaction seems to qualify as an operating lease.

However, suppose that if the lessee fails to renew the lease for a second 10-year period, the lessee must pay a \$15 million penalty. As another alternative, suppose there is no failure-to-renew penalty, but that the lessee guarantees the building will have a fair value of at least \$30 million at the end of the 10-year lease. Over the years, a large number of issues arose that were not fully addressed by the guidance on accounting for leases. As a result, the FASB, Securities and Exchange Commission (SEC), and American Institute of Certified Public Accountants (AICPA) issued about 100 additional leasing guidelines, clarifications, and rules.

As the rules for leases and other accounting issues became more complex, large CPA firms established technical groups to provide guidance to engagement partners (partners responsible for conducting an audit). Technical groups include senior partners and managers who are experts in fields such as revenue recognition, leasing, derivatives, hedging, employee compensation, taxes, and international operations. In these areas, accounting rules are detailed, complex, and unsettled.

Each of the four large accounting firms (Deloitte & Touche, Ernst & Young, KMPG, and PwC) has a technical group of at least 100 partners and managers. The groups receive several thousand relatively formal inquiries each month from engagement partners and managers, although many partners call their technical groups almost daily with less formal questions. Technical groups can sometimes answer a question with little or no research but usually research a topic and then provide an answer. In many instances they must contact technical groups of the other big four firms or, if necessary, the FASB and SEC.

In contrast, the International Financial Reporting Standards (IFRS) has only one leasing standard, International Accounting Standard (IAS) 17, *Leases*. The IFRS standard has five tests for whether a lease is a finance (the IFRS term for capital lease) or operating lease. The first two are very similar to those under U.S. GAAP. IFRS takes a more general view on the next two. Instead of a lease term that is 75% or more of the asset's life, IAS 17 requires that "the lease term is for the major part of the economic life of the asset even if title is not transferred." Instead of 90% or more of the asset's present value, IAS 17 requires that "at the inception of the lease, the present value of the minimum lease payments amounts to at least substantially all of the fair value of the leased asset." In practice, at least some of the large accounting firms simply use the 75% and 90% bright-line tests from the lease accounting guidance under U.S. GAAP when applying lease accounting to firms that report under IFRS. The IFRS also requires that a lease be capitalized (reported as a finance lease) if "the leased assets are of such a specialized nature that only the lessee can use them without major modification."

Leasing Problems in the Restaurant Industry

Prior to 2002, the AICPA administered peer reviews in which CPA firms reviewed the work of similar-size firms. In response to perceived widespread financial manipulation, in 2002 the U.S. Congress passed the Sarbanes-Oxley Act. Part of that act established the Public Company Accounting Oversight Board (PCAOB), which replaced peer reviews with a far more rigorous PCAOB inspection process. In 2003, the

PCAOB conducted limited inspections of the four remaining large CPA firms. In 2004, the PCAOB began conducting complete inspections annually for all CPA firms with 100 or more publicly traded clients and every three years for those with at least 1, but fewer than 100, publicly traded clients.

During the initial PCAOB inspections of the accounting firm audits, PCAOB accountants identified numerous problems with how publicly traded companies accounted for operating leases. The PCAOB discovered four main issues (all now covered by ACS 840-20 [*Operating Leases*]):

1. FASB Technical Bulletin 85-3 requires that payments under operating leases with scheduled rent increases must be expensed on a straight-line basis over the lease term. Suppose a three-year operating lease requires monthly lease payments of \$10,000 in 2008 and, to cover anticipated inflation, payments of \$10,400 in 2009 and \$10,800 in 2010. Under this rule, the firm records monthly lease expense of \$10,400 for each of the 36 months. During the first year, the firm debits rent expense for \$10,400, credits cash for \$10,000, and credits lease liability for \$400. During the last year, the firm debits rent expense for \$10,400 and lease liability for \$400 and credits cash for \$10,800. Many firms simply recorded their monthly cash payment as lease expense.
2. Tenants often modify leased space before moving into the property. These leasehold improvements are usually capitalized and then amortized over the shorter of the asset life or the lease term. Landlords often provide tenants with cash incentives to offset the cost of modifying rental space. A retail clothing store may wish to construct changing rooms, a fitting room, check-out counters, and display areas using a corporate-wide design theme. Suppose the construction cost and cash incentive are each \$300,000 and the lease term is 60 months. FASB Technical Bulletin 88-1 (and other rules) requires that firms record the \$300,000 cash received as a liability and the \$300,000 paid as an asset. Thereafter, each month the tenant debits the liability for \$5,000 and credits rent expense for \$5,000. Assuming the improvements have a 60-month life, the tenant also debits depreciation expense for \$5,000 and credits accumulated depreciation for \$5,000. Many firms simply offset the cash incentive against the cost of leasehold improvements at the lease inception, so no additional accounting was needed other than to debit lease expense and credit cash each month.
3. FAS 98, *Accounting for Leases*, requires that leasehold improvements be amortized on a straight-line basis over the shorter of either the lease term or the estimated useful life of the leasehold improvement. If a lease contains a renewal option, the lease term should include both the initial lease term, plus the renewal period, only if the renewal is reasonably assured. For example, if the lessee must pay a substantial penalty for failing to renew, then the renewal may be reasonably assured. Many firms included the renewal period as part of the period over which leasehold improvements were amortized, even though renewal was not reasonably assured under the FASB definition. In other instances, lessees amortized leasehold improvements only over the initial lease period even though, under FASB rules, renewal seemed to be reasonably assured.
4. Landlords often provide tenants with a rent holiday; for example, no rent due while the space is being modified. Suppose a tenant signs a 60-month lease at \$10,000 per month, but the landlord waives rent for the first 2 months while the tenant constructs leasehold improvements. Under ACS 840-20 (previously Technical Bulletin 85-3), the lessee must spread the \$580,000 of lease expense over the entire 60-month period on a straight-line basis (\$9,666.67 per month). Many firms recorded no lease accounting entries during the first 2 months and then recorded \$10,000 of rent expense for each of the remaining 58 months.

Partially in response to the PCAOB inspection findings, numerous companies filed restated financial statements with the SEC to correct some or all of the above errors. Because lease accounting errors were so widespread, the AICPA asked the SEC whether it was necessary for firms to restate their previously issued financial statements to correct their lease accounting. In response, the SEC sent the AICPA the letter in Exhibit 2.

Although the above problems were not restricted to restaurant and retail chains, the larger chains have hundreds of or thousands of leases, so their problems were often significant. The following is a partial list of restaurants and other retailers with lease accounting issues for 2004 or 2005:

Abercrombie & Fitch	Applebee's	Benihana
Big Lots	Borders Group	Brinker International
Buca di Beppos	CKE Restaurants	Cracker Barrel
Darden Restaurants	Dollar General	Jack in the Box
Kohl's	Krispy Kreme Doughnuts	Lone Star Steakhouse
Lowe's	McDonald's	Pep Boys
Rubios Restaurants	Ruby Tuesday	Sears
Starbucks	Target	Total Entertainment
Restaurant	Toys 'R Us	Tully's Coffee

Brinker International

Brinker International owns Chili's, On the Border, Maggiano's Little Italy, and Romano's Macaroni Grill. On December 22, 2004, Brinker filed a Form 8-K with the SEC detailing the following problems with its lease accounting:

Following a review of its accounting policy and in consultation with its independent registered public accounting firm, KPMG LLP, the company has corrected its computation of straight-line rent expense and the related deferred rent liability. This move is similar to recent restatements announced by other KPMG client restaurant companies.

Historically, when accounting for leases with renewal options, rent expense has been recorded on a straight-line basis over the initial non-cancelable lease term. Buildings and leasehold improvements on those properties are depreciated over a period equal to the shorter of the term of the lease—including option periods provided for in the lease—or the useful life of the assets. Brinker will recognize rent expense on a straight-line basis over sufficient renewal periods to equal the depreciable life of 20 years, including cancelable option periods where failure to exercise such options would result in an economic penalty.

For the year ended June 30, 2004, correcting the errors in lease accounting, and another minor item, reduced after-tax net income from \$153.961 million to \$150.918 million.

Starbucks Corporation

Starbucks determined in 2005 that its then-current method of accounting for leasehold improvements under operating leases (tenant improvement allowances) and its then-current method of accounting for rent holidays were not compliant with GAAP. The company restated its financial statements for fiscal years 2004, 2003, and 2002.

Starbucks included the following in Item 6. Selected Financial Data, in the Management Discussion and Analysis section of its 2004 10-Q:

The Company had historically accounted for tenant improvement allowances as reductions to the related leasehold improvement asset on the consolidated balance sheets and capital expenditures in investing activities on the consolidated statements of cash flows. Management determined that Financial Accounting Standards Board ("FASB") Technical Bulletin No. 88-1, Issues Relating to Accounting for Leases, requires these allowances to be recorded as deferred rent liabilities on the consolidated balance sheets and as a component of operating activities on the consolidated statements of cash flows. Additionally, this adjustment results in a reclassification of the deferred rent amortization from "Depreciation and amortization expenses" to "Cost of sales including occupancy costs" on the consolidated statements of earnings.

The Company had historically recognized rent holiday periods on a straight-line basis over the lease term commencing with the initial occupancy date, or the opening date for Company-operated retail stores. The store opening date coincided with the commencement of business operations, which corresponds to the intended use of the property. Management reevaluated FASB Technical Bulletin No. 85-3, Accounting for Operating Leases with Scheduled Rent Increases, and determined that the lease term should commence on the date the Company takes possession of the leased space for construction purposes, which is generally two months prior to a store opening date. Excluding tax impacts, the correction of this accounting requires the Company to record additional deferred rent in "Accrued occupancy costs" and "Other long-term liabilities" and to adjust "Retained earnings" on the consolidated balance sheets as well as to correct amortization in "Costs of sales including occupancy costs" on the consolidated statements of earnings for each of the three years in the period ended October 3, 2004. The cumulative effect of these accounting changes is a reduction to retained earnings of \$8.6 million as of the beginning of fiscal 2002 and decreases to retained earnings of \$1.3 million, \$1.5 million and \$1.2 million for the fiscal years ended 2002, 2003 and 2004, respectively (Note: Starbucks's retained earnings were restated downward from \$2.487 billion to \$2.474 billion at the end of fiscal 2004.)

Required

1. Suppose you were advising the CEO and CFO of Brinker International or Starbucks Corporation about whether to restate financial statements for the errors discussed in this case. After reading SEC Chief Accountant Donald T. Nicolaisen's letter to the AICPA, what would you recommend?
2. Evaluate the four operating lease rules discussed in this case. Are the rules needed? How difficult are the lease rules to implement in a large restaurant chain or retail chain, with hundreds or thousands of leases? As part of your answer, would it be reasonable for these chains to force landlords to enter into leases with standard terms that would simplify their lease accounting?
3. U.S. firms may soon shift to International Financial Reporting Standards (IFRS), where accounting standards are based far more on general principles than on highly detailed rules. For example, the International Accounting Standards Board has one standard on leases (IAS 17, *Leases*), and two lease interpretations (IFRIC 4, *Determining Whether an Arrangement Contains a Lease*, and SIC-15, *Operating Leases—Incentives*). Discuss the advantages and disadvantages of far less detailed rules.
4. The IASB is considering a highly simplified lease accounting rule that would require firms to capitalize all leases with a term of more than two or three years. Discuss the advantages and disadvantages of such a simple rule.

EXHIBIT 1

CAPITAL LEASE EXAMPLE: LESSEE

Annualized interest rate	8.000%				
Monthly interest rate	0.643%				
Present value of lease payments	\$223,155.73				
	Lease payment, beginning of month	Lease payable, beginning of month	Interest expense for month	Reduction to lease payable	Depreciation expense
January-08	\$10,000	\$213,155.73	\$1,371.45	\$8,628.55	\$9,298.16
February-08	\$10,000	\$204,527.18	\$1,315.93	\$8,684.07	\$9,298.16
March-08	\$10,000	\$195,843.11	\$1,260.06	\$8,739.94	\$9,298.16
April-08	\$10,000	\$187,103.17	\$1,203.83	\$8,796.17	\$9,298.16
May-08	\$10,000	\$178,307.00	\$1,147.23	\$8,852.77	\$9,298.16
June-08	\$10,000	\$169,454.23	\$1,090.27	\$8,909.73	\$9,298.16
July-08	\$10,000	\$160,544.50	\$1,032.95	\$8,967.05	\$9,298.16
August-08	\$10,000	\$151,577.45	\$975.25	\$9,024.75	\$9,298.16
September-08	\$10,000	\$142,552.71	\$917.19	\$9,082.81	\$9,298.16
October-08	\$10,000	\$133,469.89	\$858.75	\$9,141.25	\$9,298.16
November-08	\$10,000	\$124,328.64	\$799.93	\$9,200.07	\$9,298.16
December-08	\$10,000	\$115,128.58	\$740.74	\$9,259.26	\$9,298.16
January-09	\$10,000	\$105,869.32	\$681.17	\$9,318.83	\$9,298.16
February-09	\$10,000	\$96,550.49	\$621.21	\$9,378.79	\$9,298.16
March-09	\$10,000	\$87,171.69	\$560.87	\$9,439.13	\$9,298.16
April-09	\$10,000	\$77,732.56	\$500.13	\$9,499.87	\$9,298.16
May-09	\$10,000	\$68,232.69	\$439.01	\$9,560.99	\$9,298.16
June-09	\$10,000	\$58,671.70	\$377.50	\$9,622.50	\$9,298.16
July-09	\$10,000	\$49,049.20	\$315.58	\$9,684.42	\$9,298.16
August-09	\$10,000	\$39,364.78	\$253.27	\$9,746.73	\$9,298.16
September-09	\$10,000	\$29,618.06	\$190.56	\$9,809.44	\$9,298.16
October-09	\$10,000	\$19,808.62	\$127.45	\$9,872.55	\$9,298.16
November-09	\$10,000	\$9,936.07	\$63.93	\$9,936.07	\$9,298.16
December-09	\$10,000	\$0.00	\$0.00		\$9,298.16
Depreciation expense					\$223,155.73
Interest expense			\$16,844.27		\$16,844.27
Total expense					\$240,000.00
Reduction to lease payable				\$213,155.73	
Total lease payments	\$240,000				

Lessee Journal Entries			Lessor Journal Entries		
January 1, 2008			January 1, 2008		
Lease asset	\$223,156		Accrued interest (liability)	\$1,371.45	
Lease liability		\$223,156	Lease liability	\$8,628.55	
Lease asset and liability at inception			Cash		\$10,000.00
			Second lease payment		
Lease liability	\$10,000				
Cash		\$10,000	February 28, 2008		
First lease payment			Interest expense	\$1,315.93	
			Accrued interest (liability)		\$1,315.93
January 31, 2008			Interest expense, February		
Interest expense	\$1,371.45				
Accrued interest (liability)		\$1,371.45	Depreciation expense	\$9,298.16	
Interest expense, January			Accumulated dep, leased asset		\$9,298.16
			Depreciation expense, February		
Depreciation expense	\$9,298.16				
Accumulated dep, leased asset		\$9,298.16			
Depreciation expense, January					

EXHIBIT 2

SEC STAFF LETTER
TO THE AICPA:
LEASES

Robert J. Kueppers
Chairman
Center for Public Company Audit Firms
American Institute of Certified Public Accountants
Harborside Financial Center
201 Plaza Three
Jersey City, NJ 07311-3881

February 7, 2005

Dear Mr. Kueppers:

In recent weeks, a number of public companies have issued press releases announcing restatements of their financial statements relating to lease accounting. You requested that the Office of the Chief Accountant clarify the staff's interpretation of certain accounting issues and their application under generally accepted accounting principles relating to operating leases. Of specific concern is the appropriate accounting for: (1) the amortization of leasehold improvements by a lessee in an operating lease with lease renewals, (2) the pattern of recognition of rent when the lease term in an operating lease contains a period where there are free or reduced rents (commonly referred to as "rent holidays"), and (3) incentives related to leasehold improvements provided by a landlord/lessor to a tenant/lessee in an operating lease. It should be noted that the Commission has neither reviewed this letter nor approved the staff's positions expressed herein. In addition, the staff's positions may be affected or changed by particular facts or conditions. Finally, this letter does not purport to express any legal conclusion on the questions presented.

The staff's views on these issues are as follows:

Amortization of Leasehold Improvements—The staff believes that leasehold improvements in an operating lease should be amortized by the lessee over the shorter of their economic lives or the lease term, as defined in paragraph 5(f) of FASB Statement 13 ("SFAS 13"), Accounting for Leases, as amended. The staff believes amortizing leasehold improvements over a term that includes assumption of lease renewals is appropriate only when the renewals have been determined to be "reasonably assured," as that term is contemplated by SFAS 13.

Rent Holidays—The staff believes that pursuant to the response in paragraph 2 of FASB Technical Bulletin 85-3 ("FTB 85-3"), Accounting for Operating Leases with Scheduled Rent Increases, rent holidays in an operating lease should be recognized by the lessee on a straight-line basis over the lease term (including any rent holiday period) unless another systematic and rational allocation is more representative of the time pattern in which leased property is physically employed.

Landlord/Tenant Incentives—The staff believes that: (a) leasehold improvements made by a lessee that are funded by landlord incentives or allowances under an operating lease should be recorded by the lessee as leasehold improvement assets and amortized over a term consistent with the guidance in item 1 above; (b) the incentives should be recorded as deferred rent and amortized as reductions to lease expense over the lease term in accordance with paragraph 15 of SFAS 13 and the response to Question 2 of FASB Technical Bulletin 88-1 ("FTB 88-1"), Issues Relating to Accounting for Leases, and therefore, the staff believes it is inappropriate to net the deferred rent against the leasehold improvements; and (c) a registrant's statement of cash flows should reflect cash received from the lessor that is accounted for as a lease incentive within operating activities and the acquisition of leasehold improvements for cash within investing activities. The staff recognizes that evaluating when improvements should be recorded as assets of the lessor or assets of the lessee may require significant judgment and factors in making that evaluation are not the subject of this letter.

(continued)

**EXHIBIT 2—
continued**SEC STAFF LETTER
TO THE AICPA:
LEASES

To the extent that SEC registrants have deviated from the lease accounting standards and related interpretations set forth by the FASB, those registrants, in consultation with their independent auditors, should assess the impact of the resulting errors on their financial statements to determine whether restatement is required. The SEC staff believes that the positions noted above are based upon existing accounting literature and registrants who determine their prior accounting to be in error should state that the restatement results from the correction of errors or, if restatement was determined by management to be unnecessary, state that the errors were immaterial to prior periods.

Registrants should ensure that the disclosures regarding both operating and capital leases clearly and concisely address the material terms of and accounting for leases. Registrants should provide basic descriptive information about material leases, usual contract terms, and specific provisions in leases relating to rent increases, rent holidays, contingent rents, and leasehold incentives. The accounting for leases should be clearly described in the notes to the financial statements and in the discussion of critical accounting policies in MD&A if appropriate. Known likely trends or uncertainties in future rent or amortization expense that could materially affect operating results or cash flows should be addressed in MD&A. The disclosures should address the following:

Material lease agreements or arrangements.

The essential provisions of material leases, including the original term, renewal periods, reasonably assured rent escalations, rent holidays, contingent rent, rent concessions, leasehold improvement incentives, and unusual provisions or conditions.

The accounting policies for leases, including the treatment of each of the above components of lease agreements.

The basis on which contingent rental payments are determined with specificity, not generality.

The amortization period of material leasehold improvements made either at the inception of the lease or during the lease term, and how the amortization period relates to the initial lease term.

As you know, the SEC staff is continuing to consider these and related matters and may have further discussions on lease accounting with registrants and their independent auditors.

We appreciate your inquiry and further questions about these matters can be directed to Tony Lopez, Associate Chief Accountant in the Office of the Chief Accountant (202-942-7104) or Louise Dorsey, Associate Chief Accountant in the Division of Corporation Finance (202-942-2960).

Sincerely,

Donald T. Nicolaisen
Chief Accountant

cc:	Carol Stacey, Chief Accountant, Division of Corporation Finance Robert Herz, Chairman, Financial Accounting Standards Board AICPA SEC Regulations Committee
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<http://www.sec.gov/info/accountants/staffletters/cpcf020705.htm>

