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Spotlight

Lease accounting

Transformational Change

Considering the impact of the proposed new lease accounting guidance on lessees in the Retail and Consumer Industry

Highlights

- *The FASB and IASB are moving forward with a lease accounting overhaul that will bring substantially all leases onto the balance sheet and change income statement recognition*
- *The proposed changes will impact key financial metrics*
- *The impact on retail and consumer companies which typically have a large number of operating leases will be significant*
- *Changing accounting standards will have far-reaching impacts on your organization's business processes, systems, and controls.*
- *Companies should begin now to prepare, in a measured way, for the upcoming business process changes.*

June 2013

Background

A process will be required for the identification and assessment of all potential lease arrangements

Leasing is widely used to secure access to an asset. It enables companies to use property, plant and equipment without making large initial cash outlays. It provides flexibility, enabling lessees to address the issue of obsolescence. Sometimes, leasing is the only way to obtain the use of an asset that is not available for purchase.

Currently, lessees account for leases either as operating or as capital leases, depending on "bright-line" tests. Operating leases appeal to many companies because they provide nearly the same risks and rewards as outright ownership but do not result in debt on the balance sheet. Further, instead of recognizing a front-loaded expense from financing of an asset purchase, operating lease expense is recorded on a straight-line basis.

Rationale for the change

Critics say that it is difficult to compare financial statements of companies that buy assets with those that lease equivalent assets because current accounting rules do not portray the true economics of a lease. As standard-setting boards push for change, various constituents appear to agree that for greater transparency, future lease commitments should be reported on a lessee's balance sheet.

Where we stand today

On May 16, 2013, the FASB and IASB issued a revised *Leases* exposure draft (ED) that represents an overhaul of lease accounting rules. There is a 120 day comment period from issuance date of the ED. Due to the far reaching consequences, we recommend that companies engage in this process and provide comments by September 13, 2013.

The ED requires lessees to capitalize all leases that extend for more than one year on the balance sheet. Income statement recognition will depend on the nature of the leased asset. Leases of property will be presumed to apply a straight line lease expense pattern, similar to current operating leases (Type B). In contrast, leases of non-property (e.g., equipment) will be presumed to apply a front loaded expense profile with the expense allocated between interest and amortization (Type A).

The potential consequences

The proposed changes will affect metrics such as EBITDA, net income and cash flows from operations. These in turn will likely affect loan covenants, credit ratings, and other external measures of financial strength. These impacts may spur companies to reassess lease-versus-buy decisions.

Lessees will need to consider business process changes in multiple areas, including finance and accounting, IT, procurement, tax, treasury, legal, operations, corporate real estate and HR. The following discussion highlights steps that companies should consider for the impact of the ED.

Step 1: Do I have a lease?

The analysis

The analysis starts with determining if a contract meets the definition of a lease. This generally means that the customer receives the right to control an identified asset for a period of time in exchange for consideration.

The assessment of whether an arrangement contains a lease is similar to existing guidance. However, some changes are proposed which will affect current practice.

Today, several arrangements may embed an operating lease (e.g., outsourced warehousing operations, datacenter/hosting arrangements, exclusive supply arrangements, etc.). However, many entities do not separate the "embedded" operating lease because the accounting for an operating lease and for a service/supply arrangement generally do not have a materially different impact on the financial statements.

Under the ED, accounting for the lease and non-lease elements of a contract will change because leases, other than short term leases, will be recognized on the balance sheet, and certain leases will recognize a front-loaded, rather than straight-line expense.

The process

Entities will need to inventory their contracts for leases, catalogue the identified leases, and identify lease and non-lease elements in multi-element arrangements. There is no grandfathering of existing arrangements.

Step 2: How do I initially measure the lease?

The analysis

When the asset becomes available to the lessee for its intended use a lease liability and

Depending upon the nature of the leased assets, the income statement will have a mix of front loaded and straight line expense from leases; ongoing volatility in financial statements may also result from required reassessments

right-of-use asset will be recorded on the lessee's balance sheet unless the arrangement qualifies for the short-term exception.

The lease liability will be the present value of the lease payments to be made during the lease term. The discount rate used in determining the liability will be the rate the lessor charges or, if this rate is not available, the company's incremental borrowing rate.

The right-of-use asset will be equal to the lease liability plus any initial direct costs, such as commissions or legal fees.

The process

Entities will need to gather data about leases such as property type, lease term, renewal options and lease payments data to determine amounts to be recorded on the balance sheet and income statement.

Step 3: How do I model the expense?

The analysis

The expense recognition pattern will depend upon the primary leased asset.

Leases requiring front-loaded expense recognition (generally non-property) will recognize interest and amortization expense. Interest expense will be recognized by unwinding the present value "discount" on the lease liability; amortization expense will be recognized against the right-of-use asset, typically on straight-line basis. Both will be shown separately in the income statement.

Leases meeting the criteria for straight line expense (typically property) will recognize periodic operating expense based on average lease payments during the lease term. This expense will comprise of the unwinding of the discount on the lease liability, consistent with the front loaded expense approach. However, to obtain the overall straight-line recognition pattern, amortization of the right-of-use-asset will be back-end loaded.

The process

A different process will be needed to classify a lease as front-loaded or straight line lease compared to the existing process of classification as an operating or capital lease.

Step 4: How do I identify and unbundle lease components?

Some entities may lease a bundle of assets instead of a single asset (e.g., land and building; or land, building and equipment; etc.). The question then is should the lease be separated into its individual elements?

The ED introduces the concept of components. An identified asset is a separate lease component only if (a) the lessee can benefit from use of the asset on its own or with other readily available resources; and (b) the asset is not dependent on or highly interrelated with other underlying assets in the contract; otherwise, the identified asset will be part of another lease component.

Each identified separable lease component will be accounted for as a separate lease. If a component contains multiple assets, the nature of the primary asset in that component will determine if a front-loaded or straight line income statement approach applies.

The process

A process will be needed to identify lease components in a contract and the primary asset in a multi-asset component before a lease can be classified as a front-loaded or straight line lease. This will be different from the existing process of fragmenting a lease for classification as an operating or capital lease.

Step 5: What are the ongoing requirements?

The analysis

Periodic reassessment will be required under the ED, since lease renewal periods and index based rents will need to be reassessed and the related estimates trued up as facts and circumstances change. These reassessments may produce significant financial statement volatility; so the current "set it and forget it" accounting will no longer be feasible.

The process

Lease accounting will become more complex, requiring attention on an ongoing basis. Companies will need to put a process in place to monitor contractual changes and to update management judgments relating to contingent payments and renewals.

Developing a roadmap to implementation

Based on the above analysis, companies will need to sketch out a roadmap and develop a plan to implement the new requirements.

Management will need to identify internal and external users of information who will be affected by the leasing changes and develop a communication strategy to help them understand transition - before, during and after the new standard is adopted.

Management may also want to revisit lease/buy processes and strategies.

Arrangements in the Retail & Consumer industry that will be accounted for as leases may be different compared to those that are accounted for as leases today

Analysis

A concession arrangement may contain an embedded lease

The following examples illustrate how an entity in the retail and consumer sector would analyze whether or not an arrangement contains an embedded lease. This analysis can become very judgmental and practical application may be hard.

The facts

A consumer fashion company ("the concessionaire") enters into a contract with a department store ("the store") whereby the store agrees to provide a concession area to the concessionaire within the store.

Both parties agree upon the specific concession area at the commencement of the agreement. However the store may, at its sole discretion, alter either the size or location of the area by giving one month's prior written notice to the concessionaire.

The concessionaire will bear the cost of installing and maintaining fixtures and will retain ownership of such fixtures; however, the design and alteration of the design of the space must be approved by the store.

The store will provide general heating, lighting and cleaning services and will charge a service fee to the concessionaire.

The concessionaire must provide its own staff.

The concessionaire will pay 8% commission on all sales to the company.

The analysis

In order for an arrangement to contain a lease, it must involve an identified asset and the right to control the use of the underlying asset throughout the term of the contract must be transferred to the customer.

Identified asset

Fulfillment of the contract depends upon the use of a specified location with a specified square footage identified in the contract. However, the store has the contractual right at its sole discretion to substitute the location for another location in the store without the concessionaire's consent or any economic or other disincentives (only a one month written notice is required). Therefore, there is no identified asset.

In this fact pattern, based on the above analysis, the arrangement does not contain a lease because the identified asset criterion is not met.

What if in the above example, all facts remain the same except that the concessionaire is a coffee shop and the concessionaire bears the cost of all fixtures, which includes installing the plumbing. Would this arrangement contain an embedded lease?

In order for an arrangement to contain a lease, it must involve an identified asset and the right to control the use of the underlying asset throughout the term of the contract must be transferred to the customer.

Identified asset

In this example with the coffee shop, the fixed plumbing makes changing the coffee shop location economically unfeasible. Therefore, even though the store has the contractual right to substitute the location of the coffee stop, it is not an operable provision. In this fact pattern, it may be reasonable to conclude that the location specified in the contract is an identified asset.

Control

The concessionaire has the right to direct the use of the identified asset because the concessionaire controls the most significant decisions relating to use during the contract period, i.e., product range served, use of own employees who process the transactions, service the customers, etc. The concessionaire also obtains substantially all of the economic benefits during the contract term with respect to the concession area because the concessioner keeps 92% of the sales revenue. The concessionaire therefore has the right to control the use of the indentified asset throughout the term of the contract.

Based on the above fact pattern and analysis, the arrangement contains a lease because both the identified asset criterion and the control criterion are met.

Lease term and lease payments...some good, some not so good

Determining the lease term may not be that simple

The facts

A luxury goods retailer enters into a lease for a retail store in a large metropolitan city that it previously had little presence in.

The lease is for 10 years with three 10 year renewal periods.

When designing the store interior and fitting out the space the retailer plans to make a large capital investment due to the geographical location of the store and the branding it will provide to the retailer.

The retailer has some history of opening similar "flagship" type stores in other locations and in such locations typically exercises at least one or two renewal options due to the magnitude of the investment made in the store.

The analysis

Based on the fact pattern above, given the amount of capital investment the retailer has made in the store and the unique geographical location, the retailer may determine that it has a significant economic incentive to renew the store lease for at least one renewal period. Therefore, the retailer may initially conclude at lease commencement that the lease term is 20 years (10 years base term plus 10 years from the exercise of 1 renewal option).

The retailer will have to revisit this assumption, from a practical perspective, every reporting period and true up as facts and circumstances change. For example, if 8 years into the lease, the retailer's strategy changes as it relates to this geographic region, the retailer may conclude that there is no longer a significant economic incentive to exercise the first renewal option.

These reassessments and the consequential true-ups may produce significant financial statement volatility.

Performance based contingent payments may be easier to account for than initially proposed

The facts

A retailer enters into a store lease which includes fixed payments of $1,000,000 per year, which approximates market rates for the location. The lease also requires continent payments, based on a percentage of sales, if the total sales for the year exceed a specified threshold. This arrangement is consistent with industry practice and the usual business terms offered by the lessor.

The analysis

In determining the lease liability the lessee must include fixed lease payments, less any cash lease incentives receivable from the lessor. Variable lease payments that are usage or performance based, unless they are in-substance fixed lease payments, are not included.

Based on the fact pattern above, the payments used for initial measurement of the lease liability would include the fixed lease payments of $1,000,000 per year, less any cash incentive provided by the lessor.

As the contingent payments are performance based, and not based on a rate or an index, they would not be included in the initial measurement of the lease liability unless the retailer determined they were "disguised" or in-substance lease payments. Given the fixed lease payments are based on market rates, and the contingent payments are based on sales exceeding a significant threshold, the contingent payments would not be considered in-substance fixed lease payments and would not be included in the measurement of the lease liability.

Index based payments may still be problematic

The facts

Assume the same facts as in the example above, except that from the second year onwards, at the beginning of each year, the monthly rent will increase by the change in CPI during the prior year. Once the rent increases based on a change in CPI, it cannot decrease.

The analysis

At the commencement date, the retailer will measure the lease liability on the basis of annual fixed payments of $1,000,000 per month.

At the end of the first year of the lease, if there is an increase in CPI, the retailer will calculate the impact on payments for the second year – and all future years, adjusted for the actual change in CPI. The retailer will need to reassess and if required, carry out this adjustment at each subsequent anniversary of the arrangement for the remaining term of the arrangement.

In the case of a lease of multiple assets, front loaded or straight line expense will depend upon the nature of the primary asset

Since all of the remeasurement relates to future periods, the retailer will adjust the carrying amount of the right-of-use asset and liability.

The retailer does not reassess the discount rate because a change in variable lease payments that depend on a CPI index does not require the discount rate to be reassessed. However, the discount rate will need to be re-assessed if there is a change in the reference rate and variable payments are determined using that rate (e.g., LIBOR).

Leases may have more than one component

The facts

A consumer products company leases a building for 10 years to be used as a manufacturing plant. The building has a remaining economic life of 40 years. The contract also includes standard detachable warehouse shelving that exists in the building.

The analysis

The company must identify if there are separate lease components in the contract.

In this situation, the contract contains two lease components, (a) land and building (property); (b) shelving (non-property). This is because the shelving is not highly interrelated to the use of building, could be sourced from various vendors, and the company could benefit from the use of the standard shelving in another building.

As provided in the ED, land and building are not separated for classification purposes. The land and building lease component will be classified based on the remaining economic life of the building. Based on the facts in this example, the land and building lease component would follow a straight-line expense recognition pattern since they would qualify as a property lease (Type B).

The second lease component is the shelving, which is equipment which would follow a front loaded expense recognition pattern (Type A).

What if in the above example, the facts remain the same except that the equipment included is not standard shelving, but logistics equipment such as a conveyor belt system which is integrated in the building and without which the building would not be able to serve its intended use. Would the contract still contain two lease components? If not, what is the primary asset?

In this situation, the company would need to consider whether it can benefit from the use of the conveyor belt system in some other building, or whether the conveyor belt system is highly interrelated with the building. If the company determines it could not benefit from the use of the conveyor belt line in some other building, then it would conclude that there is one lease component in the arrangement which comprises land, building and conveyor belt.

Assuming that in this example, the company concludes that there is one lease component, the classification would depend on the primary asset in that component. If the main purpose to enter into this arrangement was to get access to a specialized conveyor belt, then the company would conclude that the lease is an equipment lease in its entirety and would follow a front loaded expense recognition pattern.

Determining the lease components in these situations and what the primary asset is within a lease component will depend on the facts and circumstances and significant judgment may be required.

Next Steps

Pervasive impacts will require a well-planned, but measured approach without "boiling the ocean"

Historically, many lessees have not needed robust systems and controls for their leases. A process was needed to initially classify a lease as operating or capital, and once the lease was classified the accounts payable or fixed asset systems generally sufficed.

Under the ED, the initial balance sheet recognition and the subsequent reassessment of lease term, payment estimates and support for management assumptions may require significant changes to existing processes and internal controls. Monitoring changes, evaluating the estimates and updating the balances may also require more personnel resources than those needed under current accounting rules.

Prior to adoption, management will need to catalogue existing contracts and gather data about payments, renewal options and the length of the arrangements.

Depending on issues like the number of leases, the inception dates, and the availability of records, the process of gathering and analyzing the information could take considerable time and effort. In many cases, original records may be difficult to find or may not be available. Other factors that had not been a focus before, such as embedded leases, will need to be identified and recorded.

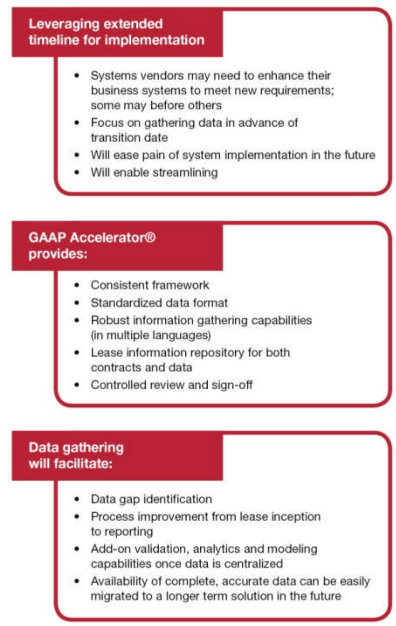
Entities should plan to evaluate their systems and controls to ensure they have the appropriate infrastructure in place prior to the effective date of the new model. This includes assessing the ability of systems and processes to report on multiple bases which may include dual reporting under old GAAP and new GAAP (on a prospective basis).

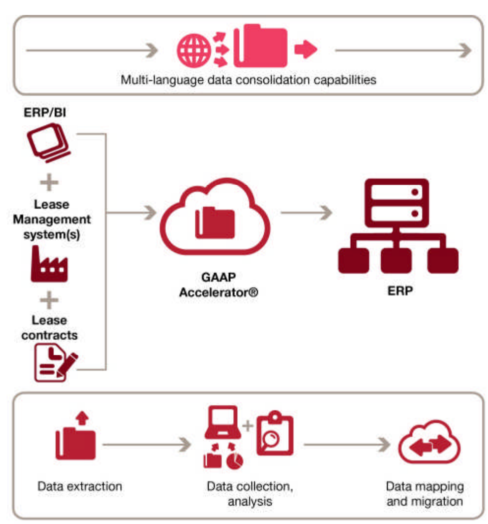
Companies may need to invest in new information systems, including ones that capture and catalog relevant information and support reassessing lease term and payment estimates at each reporting period.

We recommend considering these and other issues now, so organizations will be ready to capture dual-reporting values on a prospective basis as soon as the new standards are finalized and implemented.

Additionally, assessing the current state of your leasing systems and processes now can benefit your existing accounting and reporting. Tools such as the GAAP Accelerator® are available to help with the current state assessment and gathering information about leases.

Systems and data





Questions & Answers

There are a number of frequently asked questions that companies are addressing in conjunction with the upcoming implementation

Q: What is the process for transitioning to this new guidance?

A: Issuance of a final standard is unlikely before 2014 and is not likely to be effective before 2017. The transition approach will be either "modified retrospective" or full retrospective. Preparers will need to apply the guidance to all leases existing as of the beginning of the earliest comparative period presented (i.e., no grandfathering). Existing capital lease asset and liability balances will get carried forward. Some preparers are planning to maintain two sets of books as early as January 1, 2015.

Q: Will we need to develop an entirely new system to track and administer our leases?

A: Many lessees currently manage operating leases on spreadsheets or through accounts payable system. The ED will impose incremental accounting and disclosure requirements that will require extensive data capture. Most lessees may need to modify their information systems, processes, and internal controls to comply with the ED.

Q: Short term leases are eligible for scope-out from the ED. How is "short term" determined?

A: A lease is considered to be short term if the sum of the base lease term and all extension options available in the lease arrangement totals 12 months or less.

Q: The ED introduces the concepts of "insignificant", "major part" and "substantially all." How are they determined?

A: The ED does not define "insignificant", "major part" and "substantially all" required to assess the exception criteria for classifying leases. Therefore, the analysis will likely be subjective and judgmental.

Q: What will be the accounting for build-to-suit transactions?

A: The proposed guidance would significantly change current accounting for build-to-suit leasing transactions in the US. A lessee will no longer be required to consider and then possibly recognize the leased asset as if it were the legal owner during the construction period. Instead, the right-of-use asset and lease liability will be measured as a lease at lease commencement date. If a lessee incurs costs prior to lease commencement, the lessee will recognize those amounts as prepayments and add them to the right-of-use asset at lease commencement.

Q: How are lessors impacted?

A: Lessor guidance is changing to avoid inconsistencies with lessee accounting and to match up to the Boards' proposed approach around the new revenue recognition guidance. Sales-type leases will likely continue to qualify as receivable and residual leases under the ED, while property leases classified as operating under the current rules will still qualify as operating leases under the ED. Leveraged lease accounting, however, will not survive.

Q: How and when should I start a program to manage change and meet compliance?

A: Although the effective date is not expected until 2017, companies should take advantage of the intervening period to ready themselves for the changes. This will allow companies to take a measured approach, typically starting with a current state assessment of people, processes, systems, data, governance and policy. Tools such as GAAP Accelerator® are available now to help.

Q: What other departments may be impacted by the new guidance?

A: Changes will impact well beyond the accounting department. For example, tax considerations will need to be assessed as there may be impacts relating to increased deferred tax liabilities from the new guidance. Additionally, human resources may be impacted as compensation metrics may be impacted by the new guidance. Based on the far reaching impacts of the guidance, management should consider the impacts early in their process.

Contact Us

To have a deeper discussion about our point of view on leasing change, please contact:

Retail and consumer sector contacts			
US R&C Sector XLOS and Assurance Leader	Steve Barr	steven.j.barr@us.pwc.com	415.498.5190
US R&C Quality Leader	Ryan Swincicki	ryan.n.swincicki@us.pwc.com	614.629.5321
US R&C Senior Manager	Erin Devine	erin.e.devine@us.pwc.com	617.530.7468

Central leasing team contacts			
Advisory	Rich Cebula	richard.cebula@us.pwc.com	973.236.5667
Advisory	Tripp Davis	tripp.davis@us.pwc.com	312.298.3673
Assurance	Brad Helferich	brad.helferich@us.pwc.com	612.596.4799
Capital Market & Acctg. Advisory	Bob Malinowski	robert.malinowski@us.pwc.com	321.2984373
Capital Market & Acctg. Advisory	Paul Sheward	paul.sheward@us.pwc.com	312.298.2232
National Professional Services	Ashima Jain	ashima.jain@us.pwc.com	408.817.5008
National Professional Services	David Schmid	david.schmid@us.pwc.com	973.997.0768

Other industry sector contacts			
Aerospace & Defense	Scott Thompson	scott.d.thompson@us.pwc.com	202.346.5131
Automotive	James Will	james.c.will@us.pwc.com	216.875.3256
Banking & Capital Markets	David Lukach	david.m.lukach@us.pwc.com	646.471.3150
Chemicals	Anthony Scamuffa	anthony.j.scamuffa@us.pwc.com	267.330.2421
Entertainment, Media & Comm.	Tom Leonard	tom.leonard.jr@us.pwc.com	501.907.8092
Energy and Mining	Kurt Sands	kurt.sands@us.pwc.com	713.356.8249
Engineering & Construction	Meta Wendt	meta.wendt@us.pwc.com	213.356.6115
Healthcare	Timothy Weld	timothy.r.weld@us.pwc.com	646.471.2477
Manufacturing	Robert Bono	robert.b.bono@us.pwc.com	704.350.7993
Metals	Sean Hoover	sean.t.hoover@us.pwc.com	412.355.8087
Packaging	Max Blocker	max.blocker@us.pwc.com	678.419.4180
Pharmaceuticals & Life Sciences	Denis Naughter	denis.naughter@us.pwc.com	973.236.5030
Shipping/Airline/Rail/Logistics	Andre Chabanel	andre.chabanel@us.pwc.com	973.2364549
Real Estate	Tom Wilkin	tom.wilkin@us.pwc.con	646.471.7090
Technology	Cory Starr	cory.j.starr@us.pwc.com	408.817.1215
Utilities	David Humphreys	david.humphreys@us.pwc.com	973.236.4023

Geographic contacts			
Atlanta	Jill Niland	jill.niland@us.pwc.com	678.419.3454
Boston	Chris Whitley	chris.whitely@us.pwc.com	617.530.7331
Chicago	Pam Yanakopulos	pamela.yanakopulos@us.pwc.com	312.298.3798
Dallas	Jason Waldie	jason.waldie@us.pwc.com	214.754.7642
New York	Richard Veysey	richard.veysey@us.pwc.com	646.471.7973
San Jose/Los Angeles	Chris Smith	christopher.j.smith@us.pwc.com	408.817.5784
San Francisco/Pacific NW	Reto Micheluzzi	reto.micheluzzi@us.pwc.com	415. 498.7511
Washington/Philadelphia	Sheri Wyatt	sheri.wyatt@us.pwc.com	703.918.3602

