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Travel, Hospitality & Leisure Spotlight

Lease Accounting Model to Be Reexposed

In This Issue:

The Bottom Line

Implementation and ongoing compliance will involve detailed analysis of all lease contracts and may require data, systems, processes, and controls that do not currently exist.

- In an exposure draft (ED) issued last year, the FASB and IASB (the "boards") proposed a new lease accounting model that would have significantly changed current practice. Later redeliberations of the boards led to tentative decisions that substantially revised the proposed model, and as a result, the ED will be reexposed for public comment.
- Many companies in the travel, hospitality, and leisure (THL) industry provided the boards with feedback on the original ED. THL companies are encouraged to continue studying the effects of the proposed model and to prepare to comment on the reexposed ED, which is expected in early 2012.
- The boards made many adjustments to the proposed model in response to public comments; however, current practice is expected to change significantly, and companies will need considerable time and resources to implement the proposed requirements.
- The proposed provisions may significantly increase the lease-related assets and liabilities on the balance sheet and will most likely affect recognition (both timing and classification) of lease-related income and expense in the income statement.
- Companies are starting to prepare now by (1) performing preliminary assessments of the potential impact on key financial measures and the related implications and (2) beginning to identify the data, systems, and processes that will be essential to supporting a successful implementation.
- The effective date of a final lease standard is not likely to be earlier than 2015. A form of retrospective application would be required for companies that present comparative financial statements.

Beyond the Bottom Line

This inaugural issue of *Travel, Hospitality & Leisure Spotlight* highlights significant aspects of the proposed lease accounting model and the potential challenges associated with its adoption.

Proposed Changes in Lease Accounting

On the basis of feedback received from companies in many industries, including THL, the boards tentatively decided to make numerous significant adjustments to the originally proposed model. Key decisions the boards have made to date are outlined below.

Recognition of Lease Assets and Liabilities

The cornerstone of the proposed lease accounting model is the objective of developing a consistent, cohesive reflection of all leasing activities in the financial statements. Specifically, a lessee would recognize a right-to-use asset and a liability to make lease payments, while a lessor would apply a receivable and residual method to all leases. For lessees and lessors alike, the definition of a lease and the short-term lease exception will be critical to determining whether a contract requires balance sheet recognition as a lease.

Accounting for all leases on the balance sheet will be a major change that may affect key financial ratios and metrics.

Definition of a Lease

The ED proposed that lease accounting apply when an arrangement conveys the right to control the use of a specific asset. After the issuance of the ED, the boards explored broadening the definition of a specified asset and aligning the definition of control with that in the revenue recognition ED but only tentatively agreed to the latter. Specifically, the boards decided that the concept of control will be similar to that in the proposed revenue recognition model in that a contract would convey the right to control the use of a specified asset if the customer has the ability to direct the use, and receive benefits from use, of that asset.

> Distinguishing a lease from a service contract will often be straightforward, but certain arrangements may require careful evaluation, particularly when specific assets are referred to in a broader service arrangement. The significance of this assessment is greater than ever because of the proposal that all leases generally be reflected on the balance sheet. Moreover, hospitality companies in particular should consider the reexposed model's definition of control in the context of their hotel lease and hotel management agreements.

Short-Term Lease Exception

The ED proposed simplified lessee and lessor accounting for short-term leases, defined as leases with a maximum possible term of 12 months or less (including renewal periods). The boards' redeliberations indicated that for both lessees and lessors, this simplified accounting would not require any form of balance sheet recognition. The boards tentatively decided that an entity would apply the short-term lease guidance as an accounting policy election on the basis of asset class.

> Although balance sheet recognition may not be required, companies may still need to perform detailed tracking of short-term leases to comply with potential disclosure requirements, if material.

Measurement of Lease Assets and Liabilities

Critical to both lessee and lessor measurement of lease balances will be the evaluation of lease term, variable lease payments, and nonlease components.

Lease Term

The ED proposed that the lease term be the "longest possible term that is more likely than not to occur." The boards' redeliberations have resulted in a change to this proposal, and their most recent tentative decisions have clarified that in evaluating lease term, lessees and lessors will be required to assess whether there is a "significant economic incentive" for exercising renewal options. The following factors have been identified by the boards for entities to consider at lease commencement:

- *Contract-based factors* — Terms that are written into the lease contract that could create a significant economic incentive to exercise an option (e.g., nonrenewal penalties, bargain renewals, requirements to incur substantial costs to restore the asset before returning it to the lessor).
- *Asset-based factors* — Characteristics of the underlying leased asset that could create a significant economic incentive to exercise an option (e.g., loss of leasehold improvements upon nonrenewal, unique nature of the leased asset).
- *Entity-specific factors* — The historical practice of the entity, management intent, and common industry practice.
- *Market-based factors* — Market rentals for comparable assets.

Note that market-based factors, such as rental markets or asset values, would only be considered during the initial evaluation.

Much of the feedback to the boards reflected similar themes and indicated that lease term was one of the proposed model's more controversial topics.

The tentative decisions regarding the application of lease term, though notably different from the ED's proposals, may result in more renewal options being included in the recorded lease balances of lessees and lessors than are included under current practice, particularly if intent and past practice are factors. THL companies may find that the characteristics of their properties (e.g., extensive build-out, desirable location) could point to the existence of a significant economic incentive for exercising renewal options.

Variable Lease Payments

The ED proposed that an expected outcome approach be used to measure variable lease payments, including contingent rentals. However, the boards have tentatively decided that initial measurement would only include variable payments (1) based on an index or rate (e.g., the consumer price index) or (2) that are in-substance fixed lease payments (e.g., the lease contains disguised fixed lease payments).

The general exclusion of variable lease payments from the recorded balances will notably decrease the subjectivity and complexity of the proposed rules.

Nonlease Components

The ED proposed that lease accounting not apply to "distinct" service components of a contract. However, the boards tentatively decided to eliminate this threshold and to require that all nonlease components generally be separately accounted for; thus, payments would typically be allocated between lease components and nonlease components on the basis of their relative stand-alone purchase prices. For a lessee only, if there are no observable purchase prices of the individual components, the entire contract would be accounted for as a lease.

Cost pass-through items (e.g., insurance, tax, and maintenance) in real estate leases will most likely be considered nonlease components, typically resulting in separation from gross lease payments.

Recognition of Lease Income and Expense

The proposed changes to create uniform accounting for leasing in the income statement would affect lessees and lessors differently.

Lessees

The ED proposed a single lessee model that would apply to all leases. Under this model, the lessee's right-to-use asset would be amortized systematically (ordinarily straight-line) and entities would use the interest method to allocate lease payments between interest expense and a reduction of lease liability, which would result in higher interest expense in earlier periods. During their initial redeliberations, the boards considered whether there should be two types of leases for income statement recognition. However, the boards' recent tentative decisions indicate support for only one type of lease for lessees, which is consistent with the ED's proposal.

> A single lessee model will result in accelerated recognition of lease costs and characterization of those costs as amortization and interest expense for all leases.

Lessors

The ED proposed two accounting models for lessors — the performance obligation approach and the derecognition approach. However, the boards have since tentatively decided that a single lessor accounting model, similar to the partial derecognition approach, should apply to all leases. Under that model, a lessor will derecognize an underlying asset and recognize (1) a lease receivable measured as the present value of the lease payments and (2) a residual asset measured on an allocated-cost basis. Day-one profit would be recognized if it is reasonably assured.

The proposed lessee and lessor models would change both the timing and characterization of lease-related income and expense for leases currently treated as operating.

> Lessor accounting is expected to receive significant attention during reexposure. The outcome will be important to THL companies that sublease space to third parties; applying the derecognition model to a component of a building, for example, will be challenging.

Challenges for THL Companies

In addition to the proposed rule's technical requirements, many of its broader implications may present significant challenges to THL companies. Such challenges include business implications related to:

- *Data* — For THL companies to implement the anticipated financial reporting changes, they will need to summarize, validate, and analyze contract terms — on a lease-by-lease basis — to assess the proper accounting treatment. The preliminary experience of companies that have started planning indicates that tracking down lease information on an entity-wide basis can be challenging, especially if lease contracts and data have not been centrally managed.
- *Technology* — THL companies will need to consider whether their current systems allow them to store the key data, perform the necessary calculations, and provide accounting entries on an ongoing basis. The automation of this process will be imperative for effective and efficient financial reporting.
- *Debt covenants* — The ability of THL companies to comply with leverage-based covenants in debt arrangements may be jeopardized by the recording of substantial lease liabilities. Furthermore, the replacement of rent expense with amortization and interest affects EBITDA calculations. Many companies are already starting to assess the ED's impact on covenants by creating pro forma financial statements.

- *Taxes* — The tax departments of THL companies will need to determine how the final standard will affect the overall tax analysis, including possible changes in cash taxes paid (financial statement changes may affect transfer pricing, state apportionment, or non-U.S. taxes) as well as changes in deferred tax positions related to book/tax differences in accounting for leases.
- *Investor education* — Investors will need to understand the impact on the key performance indicators. THL companies should (1) consider providing additional disclosures to explain the changes to the balance sheet and income statement and (2) assess the impact on comparability to competitors.

Thinking Ahead

The boards most likely will issue an updated ED, with a 120-day comment period, in early 2012. THL companies should carefully examine and provide feedback on the proposed model.

Because the broad requirements of the proposed model are well defined, there are many things THL companies can do to begin preparing, such as identifying and evaluating the challenges to implementation. By planning early, THL companies can more effectively manage what promises to be, for many, a complex and resource-intense implementation.

Other Deloitte Resources

- August 17, 2011, *Heads Up*, "Recap of Lease Redeliberation Results."
- September 8, 2011, *Dbriefs* webcast, "Leases: A Comprehensive Update on the Joint Project."

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