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Retail & Distribution Spotlight
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Leases Refashioned

The Bottom Line

- On February 25, 2016, the FASB issued its new leases standard, ASU 2016-02,[1] which marks the end of the Board's nearly decade-long deliberations with the IASB to address concerns about the current lease accounting requirements.
- The new standard introduces a model that brings most leases onto a lessee's balance sheet and thus could significantly change the balance sheets of organizations that rely heavily on leases of properties and equipment that are classified as operating leases under current U.S. GAAP.
- For leases accounted for as operating leases, the resulting recognition of lease costs in the income statement will generally be similar to that under current practice (i.e., a straight-line method).
- The new standard retains much of the current lessor model but aligns certain of its underlying principles with those of the new revenue recognition standard (ASC 606[2]).
- The new guidance is effective for public companies for annual periods beginning after December 15, 2018 (i.e., calendar year-ends beginning January 1, 2019), and interim periods therein. For all other entities, the ASU is effective for annual periods beginning after December 15, 2019 (i.e., calendar year-ends beginning January 1, 2020), and interim periods thereafter. Early adoption is permitted for all entities irrespective of the status of their adoption of the new revenue standard.

[1] FASB Accounting Standards Update No. 2016-02, *Leases*.
[2] For titles of *FASB Accounting Standards Codification* (ASC) references, see Deloitte's "Titles of Topics and Subtopics in the FASB Accounting Standards Codification."

Beyond the Bottom Line

This publication provides insight into aspects of the new leases standard that are relevant to companies in the retail and distribution industry. For a comprehensive overview of the standard, see Deloitte's March 1, 2016, *Heads Up*.

Background

The new standard requires lessees to adopt a right-of-use (ROU) asset approach that brings substantially all leases, with the exception of short-term leases (i.e., those with a lease term of 12 months or less), onto the balance sheet. Under this approach, a lessee records an ROU asset representing its right to use the underlying asset during the lease term and a corresponding lease liability (in a manner similar to the current approach for capital leases) regardless of the lease classification. The subsequent accounting for the ROU asset depends on the classification of the lease as either a finance lease or an operating lease (referred to as the dual-model approach).

Key Issues

The paragraphs below discuss provisions of the final standard that may be of particular interest to companies in the retail and distribution industry.

Classification

An entity will determine a lease's classification in accordance with criteria that are similar to those used for lease classification in existing U.S. GAAP and are consistent with those under IAS 17.[3] For finance leases, the lessee recognizes interest expense on its lease liability and amortization of the ROU asset in a manner similar to a financed purchase arrangement, which will typically result in greater total expense during the early years of the lease. For operating leases, the lessee will also recognize an ROU asset and a lease liability but will recognize total lease expense on a straight-line basis.

Thinking It Through

The IASB decided on a different approach for a lessee's subsequent accounting for the ROU asset. Under the IASB's method, all leases are accounted for as a financed purchase arrangement in a manner consistent with the FASB's guidance on finance leases. Therefore, entities that are subject to dual reporting under both U.S. GAAP and IFRSs (e.g., a parent entity that applies U.S. GAAP and has international subsidiaries applying IFRSs for statutory reporting) will be required to account for leases under both models.

Whether a lease should be classified as a finance or an operating lease depends on whether control of the underlying asset is transferred to the lessee. Therefore, a lease would be classified as a finance lease (from the standpoint of a lessee) or a sales-type lease (from the standpoint of a lessor) if any of the following criteria are met:

- "The lease transfers ownership of the underlying asset to the lessee by the end of the lease term."
- "The lease grants the lessee an option to purchase the underlying asset that the lessee is reasonably certain to exercise."
- "The lease term is for the major part of the remaining economic life of the underlying asset."[4]

[3] International Accounting Standard 17, *Leases*.

[4] The ASU provides an exception to this lease classification criterion for leases that commence "at or near the end" of the underlying asset's economic life. Further, the ASU indicates that a lease that commences in the final 25 percent of an asset's economic life is "at or near the end" of the underlying asset's economic life.

- “The present value of the sum of the lease payments and any residual value guaranteed by the lessee . . . equals or exceeds substantially all of the fair value of the underlying asset.”
- “The underlying asset is of such a specialized nature that it is expected to have no alternative use to the lessor at the end of the lease term.”

Leases that do not meet any of these criteria (i.e., leases in which the lessee does not effectively obtain control of the underlying asset) would be classified as operating leases by the lessee and as either operating leases or direct financing leases by the lessor.

Thinking It Through

The ASU eliminates the bright-line rules under the ASC 840 lease classification requirements — namely, whether the lease term is for 75 percent or more of the economic life of the asset or whether the present value of the lease payments (including any guaranteed residual value) is at least 90 percent of the fair value of the leased asset. While removal of the bright-line tests could reduce structuring opportunities, the ASU’s implementation guidance indicates that entities may use thresholds similar to those they currently use to determine lease classification. Therefore, practice may not be significantly altered as a result of this change.

Initial Measurement — Lessee

The initial measurement of a lease is based on an ROU asset approach. Accordingly, **all** leases (finance and operating leases) other than those that qualify for the short-term exception must be recognized as of the lease commencement date on the lessee’s balance sheet. A lessee will recognize a liability for its lease obligation, measured at the present value of lease payments not yet paid (excluding variable payments), and a corresponding asset representing its right to use the underlying asset over the lease term. The initial measurement of the ROU asset will also include (1) initial direct costs (e.g., commissions paid) that are directly attributable to negotiating and arranging the lease and that would not have been incurred had the lease not been executed and (2) any lease payments made to the lessor before or at the commencement of the lease. The ROU asset will be reduced for any lease incentives received by the lessee (i.e., consideration received from the lessor would reduce the ROU asset).

Subsequent Measurement — Lessee

Finance Leases

For finance leases, the lessee will use the effective interest rate method to subsequently account for the lease liability incurring interest expense during the lease term. The lessee’s amortization of the ROU asset will be similar to the amortization of other nonfinancial assets; that is, the lessee should generally depreciate the ROU asset on a straight-line basis unless another systematic method is more appropriate. Together, these expense components will result in a front-loaded expense profile similar to that of a capital lease arrangement under current U.S. GAAP. Entities should separately present the interest and amortization expenses in the income statement.

Operating Leases

For operating leases, the lessee will also use the effective interest rate method to subsequently account for the lease liability. However, the subsequent measurement of the ROU asset will be linked to the amount recognized as interest expense on the lease liability (unless the ROU asset is impaired — see the Impairment section below). Accordingly, the ROU asset will be measured as the lease liability adjusted by (1) any accrued or prepaid rents, (2) unamortized initial direct costs and lease incentives, and (3) impairments of the ROU asset. The total lease payments made over the lease term will therefore be recognized as lease expense (presented as a single line item) on a straight-line basis unless another systematic method is more appropriate.

Another way to describe subsequent measurement under an operating lease would be from the viewpoint of the income statement. The entity first calculates the interest on the liability by using the discount rate for the lease and then deducts this amount from the required straight-line expense amount for the period (determined by taking total payments over the life of the lease, net of any lessor incentives, plus initial direct costs, divided by the lease term). This difference is simply "plugged" as amortization of the ROU asset to result in a single straight-line rent expense over the lease term. Under either the balance sheet or income statement approach as described above, the lease expense will be recorded on a straight-line basis and the reduction in the ROU asset will be equal to the lease expense less the interest calculated on the lease liability, resulting in lower amortization in the early years of the lease term to offset the higher interest on the liability.

Lease Term

Under the ASU, the lease term, as determined at lease commencement, is the noncancelable lease period and any optional periods if (1) it is reasonably certain that the lessee will exercise a renewal option or not exercise a termination option or (2) the lessor controls the exercise of those options.

Throughout the lease, an entity must reassess the lease term after lease inception if (1) there is a significant event or change in circumstances that is directly attributable to the lessee's actions, (2) a contract term obliges the lessee to exercise (or not exercise) an option to extend or terminate the lease, or (3) the lessee elects to exercise (or not exercise) an option to renew or terminate the contract that it had previously determined was not (or was) reasonably certain to be exercised.

By contrast, a lessor is not required to reassess the lease term unless the lease is modified and the modification is not accounted for as a separate contract.

Variable Lease Payments

An entity should include variable lease payments in its initial measurement of the lease liability and ROU asset (lessee) or the net investment in the lease (lessor) only if such payments are tied to an index or a rate or are in-substance fixed payments (such as when subject to a guaranteed minimum amount, or floor). However, the entity would not include variable lease payments that are based on usage or performance of the asset (e.g., percentage rent). A lessee would recognize any variable payments not included in the original lease obligation as an expense in the period in which the obligation is incurred.[5] A lessor would recognize variable lease payments not included in the original net investment in the lease in the period a change occurs in the facts and circumstances on which the variable lease payments are based (e.g., "when the lessee's sales on which the amount of the variable payment depends occur"). Even if a variable lease payment is virtually certain (e.g., contingent on a retail store's achievement of a nominal sales volume), the payment would not be included in the calculation of a lessee's lease obligation and ROU asset or a lessor's net investment in the lease.

[5] The period in which the obligation is "incurred" refers to the period when it becomes probable that the specified target that triggers the variable lease payments will be achieved.

Thinking It Through

While variable payments that do not depend on an index or rate are not included in the ROU asset and lease liability, an entity must consider when to record the cost of variable payments. For variable payments based on usage that are resolved each reporting period, there is no need for the entity to assess the probability of achieving that target because the amount owed by the lessee is determinable each period. However, for discrete cumulative targets, the entity would assess the probability of achievement over time. See below for an example of cost recognition.

Example 1 — Timing of Lessee Recognition of Lease Expense on the Basis of Discrete Cumulative Targets

Retailer Z is a lessee in a five-year operating lease that requires it to pay base rent of $500 per month plus an additional $100 per month beginning if and when cumulative store sales exceed $100,000. Retailer Z believes that it is probable that this sales target will be achieved by the end of year 2 (i.e., rent will become $600 per month after the target is met). Retailer Z should quantify the amount that it is probable for the entity to incur on the basis of its achievement of the target ($3,600, or $100 per month × 36 months) and should apportion that amount to each period beginning at commencement. That is, since eventual achievement of the cumulative sales target is deemed probable at commencement, the $3,600 should be recognized ratably over the five-year term (i.e., $500 per month for 24 months plus $600 per month for 36 months, resulting in an expense of $560 per month), even though the target has not yet been achieved. This is an appropriate accounting outcome because sales in years 1 and 2 contribute to the achievement of the target, and therefore years 1 and 2 should be burdened by an appropriate amount of the incremental lease expense.

Example 2 — Variable Lease Payments

A retailer enters into a lease of a retail space for five years with the following terms:

Lease term	5 years (no renewal options)
Lessee's incremental borrowing rate[a]	7%
Lease classification	Operating lease
Annual lease payments	$100,000 (base amount) adjusted for the change in the consumer price index (CPI) as of the preceding year-end compared with the base rate (i.e., CPI at 1/1/20X1).

The first lease payment was made on January 1. Each subsequent payment is made on December 31. There were no initial direct costs or lease incentives.

Date	Year	CPI	Payment	Liability[b]	<A> Interest	<B> Fixed Lease Expense	<C> Variable Lease Expense	<B> – <A> = <D> Amortization Expense	<A> + <C> + <D> Total Expense Recognized[c]	ROU Asset[d]
1/1/20X1	0	172	$ 100,000	$ 338,721						$ 438,721
12/31/20X1	1	174	101,163	262,432	$ 23,710	$ 100,000	—	$ 76,290	$ 100,000	362,432
12/31/20X2	2	175	101,744	180,802	18,370	100,000	$ 1,163	81,630	101,163	280,802
12/31/20X3	3	177	102,907	93,458	12,656	100,000	1,744	87,344	101,744	193,458
12/31/20X4	4	178	103,488	—	6,543	100,000	2,907	93,457	102,907	100,000
12/31/20X5	5	180	—	—	—	100,000	3,488	100,000	103,488	—
Total			$ 509,302			$ 500,000	$ 9,302	$ 438,721	$ 509,302	

(a) The incremental borrowing rate is used because the rate the lessor charges the lessee is not known.

(b) The liability is measured at the present value of the four remaining future lease payments (by using the base amount of rent at lease commencement) as the initial payment was made on January 1. The effect of CPI was not included in the initial measurement of the liability because the variable payments are based on changes in the CPI rather than a specified index or rate at the commencement date. The lease liability and the ROU asset are not remeasured as a result of changes to the CPI.

(c) The total lease expense recognized includes both the fixed lease expense at lease inception and the variable lease expense for the change in the CPI for the year.

(d) The ROU asset is measured at the present value of the lease payments at the commencement of the lease (the present value of four payments of $100,000 (lease payments in arrears) plus $100,000 of prepaid rent). In subsequent years, the ROU asset is amortized consistent with the model described above for operating leases. Note that amortization expense is calculated as the fixed lease expense less interest.

Thinking It Through

The subsequent measurement guidance in ASC 842-10-35-4(b) requires an entity to remeasure the lease payments and therefore adjust the lease liability when a "contingency upon which some or all of the variable lease payments that will be paid over the remainder of the lease term are based is resolved such that those payments now meet the definition of lease payments."

Under the FASB's model, we understand, given our discussions with the FASB staff, that lease liability remeasurement following the resolution of a contingency was not meant to apply to index-based escalators even when they serve to establish a new floor for the remaining lease payments. Therefore, the ROU asset and lease liability are not updated to reflect changes to variable payments that are based on an index or rate, even if those changes establish a new floor.

Under IFRSs, however, for lease payments that are based on an index or rate, the lease liability and ROU asset are remeasured each period to reflect changes to variable lease payments. Therefore, entities that are subject to dual reporting under both U.S. GAAP and IFRSs (e.g., a parent entity that applies U.S. GAAP and has international subsidiaries applying IFRSs for statutory reporting) will be required to account for leases under both models.

Lease Incentives

When entering into a lease, a lessee may receive lease incentives from the lessor (e.g., an allowance for leasehold improvements), which may be payable before, at, or after lease commencement. The ROU asset would be reduced for any lease incentives received by the lessee (i.e., consideration received from the lessor would reduce the ROU asset).

Example 3 — Lease Incentives

Retail Co. leases property from Lessor Co. with the following terms:

Lease term	10 years (no renewal options and no purchase options)
Lessee's incremental borrowing rate[(a)]	6%
Annual base lease payments (in arrears)	$10,000 increasing 5% each year during the lease term
Lease incentive paid to lessee at lease commencement	$10,000
Lease classification	Operating lease
Initial direct costs	$5,000

				<A>	<B>	<B> – <A>	
Date	Year	Payment	Lease Liability[(b)]	Interest Expense[(c)]	Lease Expense[(d)]	Amortization Expense[(e)]	ROU Asset[(f)]
1/1/20X1	0		$ 90,434				$ 85,434
12/31/20X1	1	$ 10,000	85,860	$ 5,426	$ 12,078	$ 6,652	78,782
12/31/20X2	2	10,500	80,511	5,152	12,078	6,926	71,856
12/31/20X3	3	11,025	74,317	4,831	12,078	7,247	64,608
12/31/20X4	4	11,576	67,200	4,459	12,078	7,619	56,989
12/31/20X5	5	12,155	59,077	4,032	12,078	8,046	48,944
12/31/20X6	6	12,763	49,859	3,544	12,078	8,534	40,410
12/31/20X7	7	13,401	39,449	2,992	12,078	9,086	31,324
12/31/20X8	8	14,071	27,745	2,367	12,078	9,711	21,613
12/31/20X9	9	14,775	14,635	1,665	12,078	10,413	11,200
12/31/20X0	10	15,513	—	877	12,077	11,200	—
Total		$ 125,779		$ 35,345	$ 120,779	$ 85,434	

(a) Retail Co.'s incremental borrowing rate is used because the rate the lessor charges the lessee is not known.

(b) The lease liability is initially measured at the present value of the remaining future lease payments (the net present value of each rental payment beginning with $10,000 in year 1 and increasing by 5 percent each year thereafter). The lease liability is discounted by the lessee's incremental borrowing rate at lease commencement (6 percent).

(c) The interest expense is calculated by using Retail Co.'s 6 percent incremental borrowing rate on the basis of the lease liability during the year. This amount is used to determine the amortization of the ROU asset for each year.

(d) Because the above lease is an operating lease, the total lease expense is recognized in operations on a straight-line basis. The total lease expense is equal to (1) the total payments over the life of the lease less (2) the $10,000 lease incentive paid by the lessor plus (3) the initial direct costs of $5,000. That is, $120,779 = ($125,779 – $10,000 + $5,000). Since this is a 10-year lease, $12,078 is recognized each year ($12,078 = $120,779 ÷ 10 years).

(e) The amount of amortization used to reduce the ROU asset in each period is equal to the total lease expense minus the interest expense.

(f) The ROU asset is initially measured at (1) the initial amount of the lease liability ($90,434) less (2) the amount of lease incentives received by the lessor ($10,000) at lease commencement plus (3) the initial direct costs of $5,000. That is, $85,434 = ($90,434 – $10,000) + $5,000.

Impairment

The new standard requires that a lessee, regardless of the lease classification, apply ASC 360 to test the ROU asset for impairment (this requirement is similar to the requirements for other long-lived assets). Under ASC 360, an asset (or asset group) is tested for impairment whenever circumstances indicate that the carrying amount might not be recoverable. When an impairment test is performed, the ROU asset is combined with other long-lived assets in that asset group (e.g., leasehold improvements). The new standard does not change the recognition and measurement criteria under ASC 360.

If the ROU asset for a lease classified as an operating lease is impaired, the lessee would amortize the remaining ROU asset under the subsequent-measurement requirements for a finance lease — evenly over the remaining lease term unless another systematic method is more appropriate. As a result, after the impairment of an operating lease, the way in which a lessee records lease expense will be similar to that used for a finance lease, in which the lease cost is equal to the sum of (1) straight-line amortization of the ROU asset plus (2) interest expense of the liability. Despite this shift, in periods after the impairment, a lessee will continue to present the ROU asset amortization and interest expense as a single line item.

Thinking It Through

Because the new standard establishes an ROU asset for operating leases, the FASB discussed[6] appropriate application of the impairment model on a recurring basis as well as at transition. To apply the model on a recurring basis, a lessee would test the asset group in a manner similar to the way it tests today's capital leases (i.e., by excluding financing costs). Thus, the lease liability would be included in the book value of the asset group, and only the principal portion of the rental payments would be included in the undiscounted cash flows. Under this approach, it is acknowledged that the new lease liability for operating leases is similar to the lease liability in today's capital leases (i.e., a debt-like obligation).

To apply the model at transition, a lessee would record the ROU asset for operating leases and assess for impairment at the effective date (e.g., January 1, 2019) and prospectively but would not be required to consider whether the ROU asset would have been part of an asset group that was previously impaired. In addition, the lessee will not be required to allocate a portion of any historical impairment to the newly recognized ROU asset.

A lessee may decide to terminate its lease before the expiration. Upon such an early termination, the lessee should remove the ROU asset and the lease liability and record a gain or loss for the difference.

Thinking It Through

The requirement to test the ROU asset for impairment during use could lead entities to recognize losses related to leases associated with underperforming stores earlier than they do under current U.S. GAAP. Before the adoption of ASC 842, an entity applies the guidance on exit costs in ASC 420-10-30-7 through 30-9 when recognizing such losses. ASC 420-10-30-8 indicates that when an entity terminates an operating lease contract before the end of its term, "the fair value of the liability at the cease-use date shall be determined based on the remaining lease rentals," adjusted for prepayments and hypothetical sublease amounts. When ASC 842 becomes effective, it will supersede ASC 420-10-30-8. Therefore, the impairment of the ROU asset under ASC 842 could occur before an entity exits a leased facility.

[6] See Deloitte's December 5, 2016, journal entry.

Lease and Nonlease Components

Lessees and lessors are required to separate lease components and nonlease components (e.g., any services provided or common-area maintenance charges) in an arrangement and allocate the total transaction price to the individual components. Lessors should perform the allocation in accordance with the guidance in the new revenue recognition standard, and lessees should do so on a relative stand-alone-price basis (by using observable stand-alone prices or, if the prices are not observable, estimated stand-alone prices). However, lessees are permitted to elect, as an accounting policy by class of underlying asset, not to separate lease components from nonlease components and instead to account for them together as a single lease component.

Thinking It Through

When evaluating whether an activity should be considered a separate nonlease component, an entity should consider whether the activity transfers a separate good or service to the lessee. A component includes only those items or activities that transfer a good or service to the lessee. For example, in a real estate lease, maintenance services (including common-area maintenance services) and utilities paid for by the lessor but consumed by the lessee would be separate nonlease components because the lessee would have been required to otherwise contract for these services separately. However, payments for property taxes or insurance do not transfer a separate good or service to the lessee, and therefore any such payments would be allocated to lease and nonlease components. Such treatment could affect classification, as it may increase the lease liability by including amounts that are currently considered executory costs. From a practical standpoint, however, such amounts are frequently variable and therefore would not be included in the measurement of the lease liability.

Build-to-Suit Accounting

The final standard replaces the risks and rewards-based requirements in current U.S. GAAP with a control-based model. Under current U.S. GAAP, the lessee is sometimes deemed the accounting owner during the construction period, resulting in recognition of the project on the lessee's books. Furthermore, under current U.S. GAAP, at lease commencement, the lessee often cannot satisfy the requirements of sale-and-leaseback accounting because of its continuing involvement with the asset.

The new standard stipulates that an asset controlled[7] by a lessee during the construction period would be subject to sale-and-leaseback accounting upon completion of construction (i.e., the asset is effectively owned by the lessee during the construction period and is essentially sold — to the legal owner — and leased back upon completion of construction). The ASU provides guidance on how to account for certain costs the lessee incurs in connection with the construction or design of the underlying asset if the lessee does not control the asset under construction. Costs incurred for goods or services provided to the lessee, as well as other construction-related outflows or inflows for items such as loans, guarantees, and sales of component parts, would be accounted for in accordance with other ASC topics.

Upon transition to the new ASU for build-to-suit arrangements, a lessee must apply the modified retrospective transition approach to build-to-suit leases that are currently recorded on a lessee's books. If the assets and liabilities recorded as a result of a previous build-to-suit arrangement were recognized solely as a result of the build-to-suit designation under

[7] ASC 842-40-55-5 provides indicators for lessees to consider when determining whether the lessee controls the underlying asset being constructed.

ASC 840, the lessee should derecognize the assets and liabilities[8] from the build-to-suit arrangements as of the later of (1) the earliest financial statement period presented or (2) the date on which the entity was deemed the accounting owner.

Any differences between the assets and liabilities derecognized on the transition date would be recorded in equity on that date. Further, if the construction period ended before the earliest comparative period presented and the transaction subsequently qualified for and was accounted for as a sale-and-leaseback transaction, the entity should consider the general lessee transition requirements.

Thinking It Through

The criteria for the determination of the accounting owner under current U.S. GAAP are based on whether the lessee has assumed substantially all of the construction period risks, whereas under ASC 842, the lessee would be deemed the accounting owner if it controls the asset during construction. As a result of these differing criteria, a lessee may have previously *not* been deemed the accounting owner of an asset under construction in accordance with current U.S. GAAP, but upon transition to the new standard, the lessee may become the accounting owner on the basis of the criteria in ASC 842. Given our discussions with the FASB, in these situations, a lessee would be required to evaluate whether it was deemed the accounting owner under ASC 842 for only those construction projects that were ongoing upon the effective date of the standard. In other words, for construction in which the lessee was not deemed the owner of the construction project under ASC 840, a lessee would not be required to assess whether it was the accounting owner under ASC 842.

Sale-and-Leaseback Accounting

The FASB also aligned sale-and-leaseback accounting with the underlying principles in the new revenue recognition standard. Under the new leases guidance, the seller-lessee in a sale-and-leaseback transaction must evaluate the transfer of the underlying asset (sale) in accordance with ASC 606 to determine whether the transfer qualifies as a sale (i.e., whether control has been transferred to the buyer). The existence of a leaseback by itself would not indicate that control has not been transferred (i.e., it would not preclude the transaction from qualifying as a sale) unless the leaseback is classified as a finance lease. In addition, if the arrangement includes an option for the seller-lessee to repurchase the asset, the transaction would not qualify as a sale unless (1) the option is priced at the fair value of the asset on the date of exercise and (2) alternative assets exist that are substantially the same as the transferred asset and are readily available in the marketplace.

Thinking It Through

Given our discussions with the FASB staff, real estate is considered to be a unique asset in the context of a sale-and-leaseback transaction. Therefore, if a sale-and-leaseback arrangement involves an option for the seller-lessee to repurchase real estate, then the transaction would not qualify as a sale (i.e., a failed sale-and-leaseback transaction), as the second criterion described above, in which alternative assets that are substantially the same are readily available, could never be met.

If the transaction does not qualify as a sale, the seller-lessee and buyer-lessor would account for the transaction as a financing arrangement (i.e., the buyer-lessor would account for its payment as a financial asset and the seller-lessee would record a financial liability).

[8] The assets and liabilities arose in situations in which the lessee was deemed to be the owner and could not derecognize the asset under the legacy sale-leaseback requirements.

Upon transition to the new leases standard, if the entity has a failed sale-and-leaseback transaction as of the standard's effective date, the entity is required to reassess its conclusion that the transaction continues to be disqualified from the application of sale accounting under ASC 606.

In addition, the transition guidance contains the following requirements related to circumstances in which a previous sale-and-leaseback transaction was accounted for as a capital lease or an operating lease:

- The seller in a sale-and-*capital*-leaseback transaction must recognize any deferred gain or loss that exists as of the later of (1) the earliest period presented or (2) the date of the sale of the underlying asset as follows:
    - If the underlying asset is land only, on a straight-line basis over the remaining lease term.
    - If the underlying asset is other than land only and the leaseback is a finance lease, over the remaining lease term in proportion to the amortization of the ROU asset.
    - If the underlying asset is other than land only and the leaseback is an operating lease, over the remaining lease term in proportion to the total lease cost.
- The seller in a sale-and-*operating*-leaseback transaction is required to recognize any deferred gain or loss resulting from off-market terms as an adjustment to the leaseback ROU asset (loss) or lease liability (gain) as of the date of initial application. The seller is required to recognize any deferred gain or loss not resulting from off-market terms as a cumulative-effect adjustment to opening equity (if the transaction occurred before the earliest year presented) or earnings in the comparative period (if the transaction occurred within one of the comparative periods presented).

Subleases

Under the new standard, a lessee that enters into a sublease becomes an intermediate lessor and will need to apply the new lessor guidance to that transaction. When accounting for a sublease as the intermediate lessor, the intermediate lessor would classify the sublease independently from its determination of the classification of the original lease (i.e., the head lease). The classification assessment will be based on the underlying asset itself (rather than the sublessor's ROU asset).

Example 4 — Subleases

Retailer X (head lease lessee) enters into an agreement to lease retail space — consisting of a building with a remaining economic useful life of 40 years — for a 32-year period. At the same time, X subleases a quarter of the retail space to another retailer (Optician B) for a 25-year period. In determining which lessor accounting model to apply to its sublease, X will base its evaluation of how to classify the lease on the underlying property — that is, the building — rather than on the ROU asset (i.e., the right to use the building for 32 years).

Retailer X (the original lessee) would account for the head lease (i.e., the original lease of the retail space) as a finance lease because the lease term is for a major part of the life of the underlying asset of the lease (i.e., the lease term of 32 years represents 80 percent of the remaining economic life of the underlying asset). Conversely, assuming none of the other finance lease classification criteria are met, X would account for the lease to B (the sublease) as an operating lease because the term of the sublease is not for a major part of the remaining life of the underlying asset of the sublease (i.e., the sublease term of 25 years represents only 63 percent of the remaining 40-year life of the retail space).

Thinking It Through

The classification of a sublease as outlined above under U.S. GAAP is based on the relationship between the sublease terms and the underlying asset. In contrast, the IASB concluded that the intermediate lessor should determine its classification with reference to the ROU asset subject to the sublease. In the example above using the IASB approach, the sublease represents 78 percent of the economic life of its ROU asset (25 years divided by 32 years). Therefore, without other contradictory evidence, the sublessor under IFRSs would classify this lease as a finance lease rather than an operating lease. As a result, entities that are subject to dual reporting under both U.S. GAAP and IFRSs (e.g., a parent entity that applies U.S. GAAP and has international subsidiaries applying IFRSs for statutory reporting) will be required to account for leases under both models.

Modifications

The new standard provides guidance on accounting for modifications to leases. Modifications are any changes to the contractual terms and conditions of a lease that were not part of the original terms and conditions of the lease. Some modifications occur when an entity enters into an additional separate lease, while others occur when the terms of the original lease are amended without a separate lease. A lessee or lessor would account for a lease modification as a separate contract when, as a result of the modification, (1) the lessee is granted an additional ROU asset (e.g., one that is physically distinct from the original ROU asset) and (2) the price of the additional ROU asset is commensurate with its stand-alone price (in the context of that particular contract).

If the modification **is a separate contract**, the lessee or lessor would apply the new requirements to the separate contract. If the lease modification is **not a separate contract**, both the lessee and lessor would reassess the lease classification of the modified lease (by using the modified lease terms, including the discount rate as of the effective date of the modification). In addition, the lessee would use the updated lease payments and discount rate to first revise the lease liability. If the modification was for an additional ROU or a change to either the lease term or consideration, the difference between the new lease liability and the old lease liability would be recognized as an adjustment to the ROU asset. However, if the modification had reduced the scope of the original lease contract, after decreasing the lease liability for the reduced payments, the lessee would also derecognize a proportionate amount of the ROU asset, recognizing any difference as a gain/loss through earnings.

Thinking It Through

When retailers renegotiate pricing or lease terms, careful consideration will be required to determine the type of modification, either (1) a separate contract whereby the lease would not be recognized until its new separate lease commencement date or (2) a modification to the existing lease. If the modification is determined to be a separate contract, then the accounting for such change does not occur until the new lease commencement date (although disclosure of the lease commitment would be required). In contrast, if the modification is not determined to be a separate contract, immediate recognition of the change is required.

A separate contract cannot result if there is no additional ROU asset (e.g., an additional floor of a building or additional retail space) or if the price is not commensurate with the asset's stand-alone price. For example, a retailer's entering into a renewal of an existing lease (e.g., a particular retail location in a mall for an additional five-year term) commensurate with market rates would not result in a separate lease contract, given that an *additional* ROU asset (such as an additional floor of an office building) is not being transferred.

When the modification is not accounted for as a separate contract, as of the modification effective date, the treatment of the ROU asset will depend upon whether the modification increases or decreases the scope of the contract. An increase in scope would result in the value of the ROU asset's being adjusted for the difference between the new and old lease liabilities, while a decrease to the scope would result in an adjustment to the ROU asset that is based on either a proportionate decrease to the lease liability or a decrease that is based on the reduction in the amount of assets subject to the lease.

Challenges

Entities may encounter numerous complexities in implementing the new standard, including:

- *Increased judgment* — Given the replacement of bright-line rules with a more principles-based approach, entities will have to increase their use of judgment (e.g., in determining lease classification, measuring lease payments, and determining lease term). Entities will need to ensure that such judgments are applied consistently from period to period and, in some cases, throughout an organization if the accounting is decentralized.
- *Data requirements* — Entities will need to summarize, validate, and analyze detailed data from individual leases to implement the new requirements. Organizations that operate within a number of jurisdictions often do not have a central repository housing key data on all lease contracts. To ensure consistent application, entities may need to gather these details for the entire organization, which is likely to be complex and time-consuming.
- *Changes in systems, processes, and controls* — Entities will most likely need to make several changes to systems, processes, and controls to store key data, perform calculations, and process accounting entries in a controlled and secure environment. An entity should investigate these changes well before it implements the new standard, given that many such changes require lengthy lead times. Automation of this process would be imperative for effective and efficient financial reporting.
- *Contractual terms tied to financial metrics* — The changes will affect many key financial statement measures tied to the balance sheet (e.g., leverage ratios) and income statement (e.g., EBITDA[9]). Entities should assess the impact of the accounting changes on contracts with terms linked to financial metrics, such as debt arrangements, earn-outs, and compensation arrangements, before the adoption of the new standard.
- *Taxes* — Tax departments will need to evaluate how the accounting changes will affect the overall tax analysis, including possible changes in cash taxes paid (i.e., financial statement changes may affect transfer pricing, property taxes, state apportionment, or non-U.S. taxes) and changes in deferred tax positions related to book/tax differences in accounting for leases.

Thinking Ahead

Although the ASU is not effective until annual reporting periods beginning after December 15, 2018 (i.e., calendar year-ends beginning January 1, 2019), for public companies and December 15, 2019, for all other entities (i.e., calendar year-ends beginning January 1, 2020), retail and distribution entities should start carefully examining the ASU and assessing the effect it may have on their current accounting policies, procedures, systems, and processes.

[9] Earnings before interest, taxes, depreciation, and amortization.

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