

Retail & Distribution Spotlight

New Lease Accounting Open for Comment

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The Bottom Line

- On May 16, 2013, the FASB and IASB jointly issued a revised exposure draft (ED) on lease accounting. The proposal would significantly affect retail and distribution companies that rely heavily on the leasing of properties and equipment for their operations.
- Under the proposal, a lessee would generally recognize all leases on the balance sheet. The income statement impact of the lease would depend on the lease classification, which would be determined on the basis of the nature of the underlying asset and the terms of the lease.
- For property leases currently accounted for as operating leases, the resulting recognition of lease costs would generally be similar to that under current practice (i.e., a straight-line approach). However, the proposed qualifying criteria for the straight-line approach would not be identical to the existing operating lease classification criteria, and not all property leases that are currently accounted for as operating leases would qualify for the straight-line approach.
- For equipment leases, the resulting recognition of lease costs may differ significantly from that under current practice, since entities generally would be required to account for such leases in a manner consistent with the current capital lease accounting requirements (i.e., a financing approach).
- Entities with large lease portfolios will need significant resources to meet the ED's implementation and reassessment requirements.
- Comments on the ED are due by September 13, 2013.

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Beyond the Bottom Line

This *Retail & Distribution Spotlight* provides insight into select aspects of the ED that are relevant to companies in the industry. For a comprehensive overview of the ED, including illustrative examples, see Deloitte's May 17, 2013, *Heads Up*.

Background

In a manner consistent with the boards' original August 2010 ED, the ED proposes a lessee accounting model based on a right-of-use (ROU) approach. Under this approach, a lessee would recognize (1) an asset for the right to use the underlying asset (ROU asset) and (2) a liability to make lease payments. However, the ED reflects significant changes made on the basis of the feedback received on the original ED through comment letters, roundtables, and outreach sessions. Some of these changes include revisions to the definition of a lease, changes in the proposed accounting for variable lease payments, and the introduction of a two-model approach for expense recognition for lessee accounting.

The boards believe that a straight-line approach would be more appropriate for entities to use in accounting for certain types of leases (e.g., leases of real estate). Accordingly, under the ED, a lessee would classify its leases as either "Type A" (a financing approach) or "Type B" (a straight-line approach). The lease classification would depend on the nature of the underlying asset and the terms of the lease.

Key Issues

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

Classification

Under the ED, a lessee would recognize an ROU asset and a lease obligation for all leases, other than those with a maximum lease term of 12 months or less for which the lessee has elected to apply the short-term lease scope exception. A lessee would use the effective-interest method to subsequently measure the lease obligation. The subsequent accounting for the ROU asset would depend on the nature of the underlying asset — that is, whether the underlying asset is property, which is defined as "land or a building, or part of a building, or both." As part of this evaluation, the lessee would also consider the terms of the lease as follows:

Property	Other Than Property
A lessee will classify a lease of property as a Type B lease (straight-line approach) unless: <ol style="list-style-type: none">"The lease term is for the major part of the remaining economic life of the underlying asset" (emphasis added); or"The present value of the lease payments accounts for substantially all of the fair value of the underlying asset"; or"[The] lessee has a significant economic incentive to exercise an option to purchase the underlying asset."	A lessee will classify a lease of other than property as a Type A lease (financing approach) unless: <ol style="list-style-type: none">"The lease term is an insignificant part of the total economic life of the underlying asset" (emphasis added); or"The present value of the lease payments is insignificant relative to the fair value of the underlying asset." <p>* If a lessee has a significant economic incentive to exercise a purchase option to purchase the underlying asset, the lease would be classified as a Type A asset regardless of whether it meets the exceptions.</p>

For leases accounted for under the financing approach, the ROU asset would be amortized in the same manner as other nonfinancial assets. For leases accounted for under the straight-line approach, the ROU asset would be amortized in a way that ensures that lease expense (including the interest related to the lease liability) would be recorded on a straight-line basis.

The lease classification would depend on the nature of the underlying asset and the terms of the lease.

A lessee would determine the appropriate lease classification as of the lease commencement date and would not be required to reassess its classification unless the lease is subsequently modified and accounted for as a new lease.

The straight-line approach would apply to many current operating leases of property (although an entity would now recognize the lease obligation and ROU asset). However, unlike current U.S. GAAP, the ED does not contain any exemptions for evaluating the classification of a lease whose term begins during the last 25 percent of the asset's total economic life; therefore, under the proposal, property leases commencing within the last portion of the asset's total economic life are more likely to be treated as a financing.

The ED is expected to have a far greater impact on current operating leases of assets other than property (e.g., equipment). Only shorter-term leases for assets other than property would be expected to qualify for the straight-line approach.

A lessee would determine the appropriate lease classification as of the lease commencement date and would not be required to reassess its classification unless the lease is subsequently modified and accounted for as a new lease. For example, a lessee may initially determine that a six-month equipment lease, with an option to renew for an additional two years, qualifies for the straight-line approach because the lease term, which the lessee concludes should exclude the renewal option period, is considered an insignificant part of the total economic life of the underlying asset. If circumstances change and the lessee decides to renew the lease for the additional two years (i.e., the lessee now has a significant economic incentive to renew the lease), the lessee would not need to reconsider the lease classification.

Lease Term

The ED defines the lease term as the noncancelable period plus the period covered by an option to (1) "extend the lease if the lessee has a significant economic incentive to exercise that option" or (2) "terminate the lease if the lessee has a significant economic incentive not to exercise that option."

When evaluating whether a significant economic incentive exists at lease commencement, an entity should consider contract-based, asset-based, entity-based, and market-based factors. Throughout the lease, an entity must reassess the lease term when there is a change in relevant factors (other than market-based factors) that would result in a change to the conclusion about whether the lessee has a significant economic incentive to exercise an option to extend the lease (or not exercise an option to terminate the lease). When evaluating the lease term, a retailer would consider items such as build-outs, key locations, and subleases.

Variable Lease Payments

Under the ED, an entity would generally not include variable payments in the determination of lease payments when measuring the lease asset and liability. However, two types of variable payments would be considered lease payments under the ED — (1) "payments that depend on an index or a rate" and (2) "payments that are in-substance fixed payments . . . structured as [variable payments]." A lessee would update the lease liability (and ROU asset) in each reporting period for changes in an index or rate that affect lease payments.

Leases of retail property often contain various variable payment terms, including CPI-based rent adjustments and rent based on a percentage of sales (percentage rent). For CPI-based rent adjustments, a lessee would be required to incorporate the current index into lease payments upon initial recognition of a lease. And, as changes in CPI occur throughout the lease, the lease payments (and ultimately the ROU asset and liability) would need to be updated to reflect the rent adjustment. In contrast, percentage rent would not be reflected in lease payments and would instead be recognized as expense when incurred, which is consistent with current U.S. GAAP.

The following example illustrates the requirement to reassess variable lease payments that are based on an index:

Example 1: CPI Lease Payments

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

Terms	
Lease term	5 years (no renewal options)
Lessee's incremental borrowing rate ^(d)	7%
Lease type	Straight-line lease (Type B)
Annual lease payments	\$100,000 (base amount) — adjusted for changes in the CPI
The first lease payment was made on January 1. Each subsequent payment is made on December 31.	

Year	CPI Index	Payment	Liability ^(a)	Interest <A>	ROU Asset ^(b)	Amortization Expense – <A>	Lease Expense ^(c)
0	172	\$ 100,000	\$ 438,721		\$ 438,721		
1	174	101,163	265,483	\$ 23,710	366,646	\$ 76,290	\$ 100,000
2	175	101,744	183,955	18,584	285,700	82,579	101,163
3	177	102,907	96,175	12,877	199,082	88,867	101,744
4	178	103,488	–	6,732	103,488	96,175	102,907
5	180	–	–	–	–	103,488	103,488
Total		<u>\$ 509,302</u>		<u>\$ 61,903</u>		<u>\$ 447,399</u>	<u>\$ 509,302</u>

- (a) The liability is measured at the present value of the remaining expected future lease payments (by using the CPI spot rate). At the end of year 1, the liability is adjusted by \$4,215 (\$366,646 – \$362,431) to equal the present value of the four remaining lease payments of \$101,163 each (with an offsetting adjustment to the ROU asset). That is, the \$265,483 = \$438,721 – \$100,000 (January lease payment) + \$23,710 (interest expense) + \$4,215 (CPI adjustment) – \$101,163 (December lease payment).
- (b) The ROU asset is initially measured at the present value of the expected lease payments at the commencement of the lease (the present value of 5 payments of \$100,000 (advanced lease payments)). In subsequent years, the ROU asset is adjusted for (1) changes in the lease liability that result from a change in CPI and (2) amortization expense. In year 1, the adjustment to the lease liability (and, accordingly, the ROU asset) as a result of the change in CPI is an increase of \$4,215. That is, \$366,646 = \$438,721 – \$76,290 (amortization) + \$4,215 (CPI adjustment).
- (c) The lease expense equals a pro rata portion of the undiscounted sum of total expected lease payments (adjusted for changes in the spot CPI rate) less the lease expense already recognized. These amounts are calculated at the beginning of each year. For year 2, the lease expense is calculated as a pro rata portion of the \$504,652 expected total lease payments (1 payment of \$100,000 and 4 payments of \$101,163) less the amount of lease expense previously recognized (\$100,000). That is, \$101,163 = (\$504,652 – \$100,000) ÷ 4.
- (d) The incremental borrowing rate is used because the rate the lessor charges the lessee is not known.

For any variable payment mechanism, a lessee will need to consider whether it is an in-substance fixed payment.

For any variable payment mechanism, a lessee will need to consider whether it is an in-substance fixed payment. Some mechanisms may clearly be in-substance fixed payments (e.g., a “floor” on CPI rent adjustments), but many others may not (e.g., percentage rent).

Companies with portfolios of leases that contain CPI adjustment provisions may find it burdensome to continually update lease balances for changes in an index or rate.

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. Under the ED, lease incentives would result in a reduction of the ROU asset. For lease incentives that are only received from the lessor after the lease commencement date, the amount receivable would be included in the initial measurement (i.e., a reduction) of the lease liability.

Example 2: Accounting for Lease Incentives Received

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

Terms	
Lease term	3 years (no renewal options)
Lessee's incremental borrowing rate ^(a)	5%
Annual base lease payments (in arrears)	\$24,000
Upfront leasehold improvement allowance	\$10,000 (the economic useful life of the leasehold improvements is 5 years)
Year 1 rent holiday	\$12,000 (i.e., the year 1 lease payment is \$12,000)
Lease classification	Straight-line lease (Type B)

Year	Payment	Lease Liability ^(b)	Interest Expense <A>	ROU Asset ^(c)	Amortization Expense – <A>	Lease Expense ^(d) 	Leasehold Improvements ^(e)	Depreciation Expense
0	\$ –	\$ 53,929		\$ 43,929			\$ 10,000	
1	12,000	44,625	\$ 2,696	29,958	\$ 13,971	\$ 16,667	6,667	\$ 3,333
2	24,000	22,857	2,232	15,524	14,435	16,667	3,334	3,333
3	24,000	–	1,143	–	15,523	16,666	–	3,334
Total	\$ 60,000		\$ 6,071		\$ 43,929	\$ 50,000		\$ 10,000

- (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 discounted by the lessee's incremental borrowing rate at lease commencement (5 percent).
- (c) The ROU asset is initially measured at the (1) initial amount of the lease liability (\$53,929), less (2) the amount of lease incentives received by the lessor (\$10,000). That is, $\$43,929 = \$53,929 - \$10,000$.
- (d) The lease expense for the first year is measured as (1) the remaining lease cost of \$50,000, divided by (2) the remaining lease term of 3 years. That is, $\$16,667 = (\$50,000) \div 3$.
- (e) Retail Co. completes the installment of all leasehold improvements at the lease commencement date. The leasehold improvements are depreciated over the shorter of (a) their remaining economic life (5 years) and (b) the remaining lease term (3 years).

Impairment

The ED requires that a lessee apply ASC 360¹ to test the ROU asset for impairment. 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 would be combined with other long-lived assets in that asset group (e.g., leasehold improvements). The ED does not indicate whether the lease payments should be included in the undiscounted cash flows used to test for recoverability or the discounted cash flows used to measure fair value.

The requirement to test the ROU asset for impairment could lead to the earlier recognition of losses on leases associated with underperforming stores. Under current U.S. GAAP, an entity is prohibited from taking a "charge" on an operating lease until the "cease-use date." However, the impairment of the ROU asset recorded under the ED could occur well before an entity exits a leased facility.

¹ FASB Accounting Standards Codification Topic 360, *Property, Plant, and Equipment*.

Under the ED, lessees that enter into subleases will need to apply lessor guidance to these transactions.

Scope

The ED defines a lease as “a contract that conveys the right to use an asset . . . for a period of time.” An arrangement would be considered a lease if it meets two criteria — (1) “fulfillment of the contract depends on the use of an identified asset” and (2) “the contract conveys the right to control the use of the identified asset for a period of time.” Although the definition of a lease has not changed significantly from current practice, such an analysis will become more important under the proposal because of the on-balance-sheet outcome. Under the proposed model, retail and distribution companies would need to carefully evaluate certain arrangements (e.g., shipping/delivery arrangements that require the use of specified vehicles or distribution centers) to ascertain whether they include a lease.

Nonlease Components

The ED requires that a lessee separate amounts attributable to nonlease components from lease payments (i.e., so that they are not recognized in the ROU asset and lease liability). A lessee would allocate consideration in the lease contract between lease and nonlease components on the basis of the observable stand-alone prices for each component (a relative value method) or, secondarily, the observable stand-alone price for one component (a residual method). If observable stand-alone prices do not exist for any component, the lessee will combine the nonlease components with the lease components and the combined components will be accounted for as a lease.

In typical commercial property leases, nonlease components can include taxes, insurance, and common area maintenance (CAM) charges. A lessee may find it difficult to identify observable stand-alone prices for the nonlease components. For example, a lessee may struggle to determine an observable stand-alone price for CAM charges that are embedded in the lease contract given that such nonlease components always accompany an associated property lease and are not entered into separately (and vice versa). As a result, it may not be possible to exclude these amounts from the ROU asset and lease liability. In contrast, variable, rather than flat, CAM charges are more likely to be excluded from lease payments because they may have a stand-alone observable price.

Build-to-Suit Accounting

The ED does not contain any specific accounting requirements related to build-to-suit leases (i.e., when a lessee is involved in the construction of an asset). Under current GAAP, the lessee is sometimes deemed the accounting owner during the construction period, resulting in recognition of the project on the lessee’s books. At lease commencement, the lessee often fails to achieve sale-and-leaseback accounting because of its continuing involvement with the asset.

Under the ED, the construction of the asset would be accounted for in accordance with other applicable U.S. GAAP and the ROU asset would be recognized at lease commencement. This could result in a significant change from current practice (i.e., a lessee would not be required to recognize the asset under construction on its books before lease commencement).

Any payments made by the lessee for the right to use the asset (regardless of whether they are made during the construction period) would be accounted for as lease payments. In addition, when the lessee controls the underlying asset before lease commencement (e.g., the land on which the leased property will be constructed), the lessee should apply sale-and-leaseback accounting.

Subleases

Under the ED, lessees that enter into subleases will need to apply the proposed lessor guidance to these transactions. When accounting for a sublease as a lessor, an entity will classify the sublease as Type A or B in accordance with the same criteria that a lessee uses for the classification (i.e., the nature of the underlying asset and the terms of the lease would be considered). However, the classification will be based on the underlying asset itself (rather than the sublessor’s ROU asset).

When a modification occurs, entities would account for the contract as a new contract when the modification becomes effective.

Example

Retailer A (head lease lessee) enters into an agreement to lease retail space — consisting of land and a building with a remaining economic useful life of 40 years — for a 10-year period. At the same time, Retailer A subleases a quarter of the retail space to another retailer (Optician B) for the entire 10-year period. In determining which lessor accounting model to apply to its sublease, Retailer A will base its evaluation of how to classify the lease on the underlying property (rather than on the ROU asset). In this case, because the sublease of 10 years is not for a major part of the remaining economic life of the property and the present value of the sublease payments does not represent substantially all of the fair value of the underlying property, A would account for the sublease in a manner similar to current lessor accounting for operating leases. Retailer A would continue to account for the head lease under the straight-line approach.

Modifications

The ED provides guidance on accounting for modifications to leases. Modifications include substantive changes to the lease contract, such as changes to the contractual lease term or contractual lease payments. When a modification occurs, entities would account for the contract as a new contract when the modification becomes effective. Further, the original ROU assets and lease liability would be derecognized and any difference would be recognized as a profit or loss.

Retailers would need to use judgment in determining whether a contract modification is substantive. In many cases, the derecognition of the ROU asset and the lease obligation may result in recognition of a gain when the modification becomes effective.

Challenges

Entities would encounter numerous complexities in implementing the ED, including:

- *Increased judgment* — Given the replacement of bright-line rules with a more principles-based approach, entities would have to increase their use of judgment (e.g., in determining lease classification, measuring lease payments, and determining lease term). Entities would 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 would need to summarize, validate, and analyze detailed data from individual leases to implement the proposed 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 would 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 on an ongoing basis. An entity should investigate these changes well before it implements a final 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 proposed changes could affect many key financial statement measures tied to the balance sheet (e.g., leverage ratios) and income statement (e.g., EBITDA). Companies should proactively assess the impact of the accounting changes on contracts with terms linked to financial metrics, such as debt arrangements, earn-outs, and compensation arrangements.
- *Taxes* — Tax departments would 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, state apportionment, or non-U.S. taxes) and changes in deferred tax positions related to book/tax differences in accounting for leases.

Thinking Ahead

The boards have requested feedback on many of the core elements of the ED. Companies in the retail and distribution industry are encouraged to play an active role in the standard-setting process. Comments on the ED are due by September 13, 2013.

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