

Retail & Distribution Spotlight

New Lease Accounting Model Taking Shape . . . but When?

In This Issue:

- Changes in Lease Accounting
- Challenges for Retail and Distribution Companies
- Thinking Ahead



The Bottom Line

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

- The FASB and IASB (the “boards”) proposed dramatic changes to current lease accounting with the issuance of an exposure draft (ED) in August 2010. The boards received over 750 comment letters in response and started redeliberating the proposal in January 2011.
- Retail and distribution companies provided feedback to the boards regarding the conceptual merits of the proposal but also expressed concerns about the subjectivity, operational complexity, and administrative burden.
- Despite many substantive adjustments made to the ED’s original proposals during redeliberations, current practice is expected to change significantly, and companies will need considerable time and resources to implement the final standard.
- The proposed provisions will notably 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 performing preliminary assessments of the potential impact on key financial measures and the related implications; companies are also beginning to identify the data, systems, and processes that will be essential to supporting a successful implementation.
- Although it is unknown whether the proposal will be reexposed, the boards’ recent decision to reexpose the revenue recognition proposal suggests that reexposure of the lease proposal is likely, which could push issuance of a final standard well into 2012.
- The proposal’s effective date is not likely to be earlier than 2015 but currently would require a form of retrospective application for companies that present comparative financial statements. A decision to reexpose the proposal would most likely influence a potential effective date.

Beyond the Bottom Line

To effectively plan for the significant changes ahead, retail and distribution companies should continue to monitor the boards' decisions, evaluate the significance of the industry-specific challenges to their business, and assess the requirements of an eventual implementation. The following discussion provides insight into each of these key areas.

Changes in Lease Accounting

Since the issuance of the original proposal, many retail and distribution companies provided feedback to the boards through comment letters and participation in roundtable meetings. On the basis of the feedback received from many industries, the boards are now considering significant adjustments to the proposed model. Key tentative 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 potentially recognize a lease on the balance sheet by using one of several proposed models. 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.

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. Although the definition of a specified asset is similar to that used in current practice, the revised definition of control could significantly reduce the number of arrangements subject to lease accounting in certain industries because it appears to remove the notion that an arrangement contains a lease simply because the purchaser obtains all but an insignificant amount of the output of an 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.

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 this simplified accounting would not require any form of balance sheet recognition for both lessees and lessors. The boards have 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.

Accounting for leases on the balance sheet will be a major change for retail and distribution companies.

Retail and distribution companies will have to think more critically about their lease strategies under the new standard.

Measurement of Lease Assets and Liabilities

Once it is determined that balance sheet recognition is required, the question becomes the amounts to be recognized. Critical to both lessee and lessor measurement 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 and to consider contract-based factors, asset-based factors, and entity-specific factors in both the initial and subsequent evaluation.

- Contract-based factors are 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).
- Asset-based factors are related to the characteristics of the underlying leased asset that could create a significant economic incentive to exercise an option (e.g., loss of leasehold improvements).
- Entity-specific factors include historical practice of the entity, management intent, and common industry practice.

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

The tentative decisions regarding the application of lease term, though notably different from the original proposal, may result in more renewal options being included in the recorded lease balances of lessees and lessors, particularly if intent and past practice are factors.

Variable Lease Payments

The ED proposed that an expected outcome approach be used to measure lease payments, including contingent rentals. However, the boards have tentatively decided that variable lease payments should only be included in the measurement of a recorded lease balance if they are (1) based on an index or rate, (2) deemed an in-substance minimum lease payment (i.e., the variability lacks substance), or (3) a portion of a residual value guarantee expected to be paid. Separately, the boards tentatively decided that lease incentives (i.e., up-front payments received from the lessor) would be reflected as a reduction of the right-to-use asset.

The general exclusion of variable lease payments from the recorded balances will notably decrease the subjectivity and complexity of the proposed rules. This decision is very significant to retail and distribution companies, whose leases often contain contingent rent provisions.

Nonlease Components

The ED proposed that lease accounting not apply to “distinct” service components of a contract. However, the boards have tentatively decided to eliminate this threshold and require that all nonlease components generally be separately accounted for, which would typically require the allocation of payments between lease components and nonlease components on the basis of their relative stand-alone purchase prices. For a lessee, if stand-alone prices are not available for at least one of the components, the entire contract would be accounted for as a lease.

Cost pass-through items, such as insurance, tax, and maintenance, in real estate leases will most likely be considered nonlease components, requiring separation from gross lease payments.

Recognition of Lease Income and Expense

Consistent with the overall objective of the lease project are proposed changes to create uniform accounting for leasing in the income statement. The effect of the proposals will 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. In 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.

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. A lessor that retains exposure to significant risks or benefits associated with the underlying asset during the expected term of the lease, or after the expected term of the lease by having the expectation or ability to generate significant returns by releasing or reselling the underlying asset, would apply the performance obligation approach; otherwise, the lessor would apply the derecognition approach.

- *Performance obligation approach* — The lessor should recognize and initially measure (1) lease assets as a receivable for the expected rental payments and (2) a corresponding liability as of the date of commencement of the lease. The lessor would recognize income as the performance obligation is reduced over the lease term in addition to recognizing interest income on the receivable.
- *Derecognition approach* — The lessor would recognize an asset for the right to receive rental payments, remove a portion of the carrying amount of the underlying asset from its statement of financial position, and reclassify it as a residual asset that represents the lessor's rights in the underlying asset that it did not transfer. In addition, the lessor may recognize up-front income and expense in profit or loss.

Since issuance of the ED, the boards have acknowledged the concerns raised regarding the proposed lessor accounting. The boards are currently exploring the possibility of a single lessor model under which all lessors would recognize a lease receivable and a residual asset for all leases.

Further deliberations on lessor accounting are anticipated and significant changes to the ED are expected. The outcome of these deliberations will be important to retail and distribution companies that sublease space to third parties.

Much of the feedback to the boards from retail and distribution companies reflected similar themes.

Challenges for Retail and Distribution Companies

Beyond the technical requirements, many broader implications of the proposed rules may present significant challenges to retail and distribution companies, including:

- *Overall lease decisions* — The proposed changes may affect the business decisions made and leasing strategies used by retail and distribution companies. For example, such companies may consider (1) owning assets instead of leasing them and (2) entering into reduced lease terms to create a desired effect on the financial statements.
- *Profit and loss impact* — The change to the recognition of lease expense and resultant higher interest expense in earlier periods will significantly affect retail and distribution companies. Because of this change, even if a retail and distribution company is doing well, the company's financial performance may be distorted. In addition, for those retail and distribution companies that are expanding, recognizing this expense up front will have a negative impact on their profit and loss and may hinder their ability to fund the expansion.
- *Debt covenant implications* — Retail and distribution companies are often party to debt arrangements that contain leverage-based covenants. Such covenants may require adjustment in response to the financial statement and financial ratio impact of lessees' recording of additional lease liabilities, potentially opening the door to a broader renegotiation of terms. To assess this impact, companies will need to perform a contract-by-contract analysis, and they may need to amend covenants to avoid violations.
- *Risk of reduced transparency and changes to financial statements* — The changes to the financial statements could be profound for retail and distribution companies, and, because the expansion of liabilities on the balance sheet could affect the valuation and credit rating of the company, investors will need to understand the impact on some of the key performance indicators. Retail and distribution companies will also need to (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. Companies that disclose EBITDA measures will see significant changes because rent expense will be replaced with amortization and interest.
- *Data requirements and administrative burden* — For retail and distribution companies to determine appropriate lessee and lessor treatment and support the required financial reporting changes, key data from individual leases will be required. The integrity and completeness of this detailed data will need to be aggregated and validated for companies to assess the proper accounting treatment, including determining any nonlease components, especially for retail and distribution companies with large portfolios of diverse leases. The preliminary experience of companies that have started planning for the proposals indicates that it can be challenging to track down contracts for all leases that companies have entered into on an entity-wide basis.
- *Technology issues* — Because of the level of detail that will be required related to the processing and storage of individual leases, retail and distribution companies with large portfolios of leases will need to consider assessing whether their current technology and systems have the capabilities to store large amounts of 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. Companies will need to evaluate loan approval and monitoring processes and models to assess the impact of the new standard.
- *Tax accounting* — The tax departments of retail and distribution 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.

There may be complex implementation challenges ahead as a result of the changes expected under the proposed model.

Tracking down individual lease contracts for leases that were previously accounted for as operating leases may be one of the biggest challenges.

Thinking Ahead

Given the reasons expressed by the boards for reexposing the revenue ED, it is likely they will decide to reexpose the lease ED, which could push the issuance of a final lease standard back to mid or late 2012. While the boards have still not voted on an effective date, a final standard may be effective as soon as January 1, 2015, in which case the new rules would be applied, upon adoption, to all leases outstanding as of January 1, 2013, for those companies that present comparative financial statements. However, a decision to reexpose the proposal and the ultimate timing of that process would most likely influence a potential effective date.

While the exact details of the proposed rules will be subject to ongoing refinement over the coming months, the broad requirements of lessee accounting have become well defined — and there are many things retail and distribution companies can do to begin preparing. Specifically, they can start to identify and evaluate the challenges introduced by the proposed rules, both in terms of adoption demands and broader business impacts. By planning early, retail and distribution companies can more effectively manage what promises to be, for many, a complex and resource-intensive implementation.

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