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Leases

Lease accounting convergence brings a new view

Background

The lease accounting rules as we currently know them are changing as a result of ongoing accounting convergence efforts between the International Accounting Standards Board (IASB) and the U.S. Financial Accounting Standards Board (FASB) (collectively, the "Boards"). In August 2010, the Boards issued an exposure draft (ED) proposing to establish a new accounting model for both lessees and lessors and to fundamentally change how leases are recorded in a company's financial statements.

The proposed lease model in the ED is expected to affect companies across various industries and in a variety of ways.

On the basis of feedback received from comment letters, roundtables, and outreach sessions, the Boards have made significant changes to the proposals in the ED and, therefore, have decided to re-expose the proposed lease accounting guidance for comment. While the exact timing of the re-exposure expected in the second half of 2012 and the issuance of a final standard later in 2013 is still to be determined, based on deliberations to date there are some fundamental aspects we know now with some degree of certainty.

What's changing?

The proposed lease model in the ED is expected to affect companies across various industries and in a variety of ways.

- Many companies are likely to face technical accounting challenges in applying a new accounting standard as well as needing to address a number of process and technology issues.
- For lessees, the new approach would eliminate the operating lease accounting model and replace it with a "right-of-use" model, in which a lessee would recognize an asset representing its right to use a leased item during the lease term as well as a liability for the lessee's obligation to pay rentals.
- For lessors, after further deliberations, the Boards tentatively decided that a single lessor accounting model, the "receivable and residual" method, should apply to all leases, with exceptions for short-term leases and leases of investment property. The proposed single model employs a receivable and residual approach that is similar to the derecognition model proposed in the ED and eliminates the performance obligation model proposed in the ED.

This publication highlights some of the common key implementation challenges that may lie ahead as well as how Deloitte can help companies evaluate and ultimately implement this new lease accounting guidance.

Main principles of the proposed lease model

The proposed model represents a significant change from past accounting practice. Historically, companies distinguished between (1) leases of an operating nature and (2) capital/finance leases. This distinction and the key differences in accounting outcomes for operating and capital/finance leases oftentimes presented considerable challenges (and transaction structuring opportunities, particularly for U.S. GAAP entities, given the bright-line tests involved in the determination of the nature of individual lease contracts under U.S. accounting rules).

Balance sheet presentation would be affected since all leases would now be recorded on the lessee's balance sheet.

Under the proposed model, all leases are essentially treated the same for lessees and in a manner more akin to the traditional capital/finance lease model. The following is a short summary of the key concepts and the Boards' tentative decisions to date:

- Balance sheet presentation would be affected since all leases would now be recorded on the lessee's balance sheet.
- Lessees would recognize a "right-of-use" asset and a related liability for their obligation to make rental payments. The ED proposes that lessees would subsequently amortize the right-of-use asset on a systematic basis and would record the obligation to make rental payments at amortized cost by using the effective interest method. In response to feedback received on the pattern of accelerated expense recognition in the proposed approach, the Boards are currently deliberating three alternative approaches for the subsequent measurement of the right-of-use asset and obligation to make lease payments.
- Based on the Boards' tentative decisions, lessors would follow a single model and derecognize the underlying asset and recognize:
  - A lease receivable measured at the present value of lease payments
  - A residual asset measured on an allocated-cost basis
  - Day one profit if reasonably assured
- Short-term leases with a maximum term of 12 months or less (including potential renewal periods) may be afforded simplified requirements under the proposed model.
- The Boards have tentatively decided that renewal options would be included in the lease term if there is a significant economic incentive for an entity to renew. Entities should consider contract-based, asset-based, market-based, and entity-based factors when assessing whether there is a significant economic incentive to renew. This is a departure from the ED which proposed the lease term to be defined as the "longest possible term that is more likely than not to occur" (including potential renewal periods).
- The Boards have tentatively decided that variable lease payments (or contingent rentals) should not be included in the measurement of a lessee's lease liability and a lessor's lease receivable unless the variable lease payments are (1) structured in such a way that they are in-substance fixed lease payments (commonly referred to as "disguised minimum lease payments"), (2) the portion of a residual value guarantee expected to be paid by a lessee, or (3) based on an index or rate derived payment. This a departure from the ED which proposed contingent rents, such as a percentage of retail sales rent, would be recognized and measured under an expected-outcomes approach.
- The Boards have tentatively decided that reassessment of the lease term would be required when relevant factors change significantly (i.e., lessee would have or no longer have significant economic incentive to renew). Market-based factors would not be considered during reassessment.

Why should companies care now?

Although the Boards still may change elements of the ED as proposed, certain aspects of the proposed model are likely to remain in the final accounting standards. In particular, the core concept of lessees recording all leases on the balance sheet as a "right-of-use" asset and the corresponding obligation to make lease rental payments is a key objective of the Boards that is likely to be incorporated into the final lease accounting rules.

Consequently, the impacts of the proposed model are likely to be felt throughout an organization. Identifying and evaluating those impacts can help ensure a smoother transition once a final standard is issued. Companies may wish to identify key impact areas now to understand how the new lease guidance may affect them, as well as to make informed decisions about how to manage both the transition and any internal changes necessary. Some potential impact areas are discussed below in further detail.

No more operating lease treatment

Since operating lease treatment will go away and lessees will be required to record all leases on the balance sheet, a company's assets and liabilities are expected to increase. Companies should consider how they will manage this transition, which may involve determining methods for computing gross asset and liability amounts and dealing with the additional internal controls and financial reporting impacts involved. The changing balance sheet amounts are likely to affect key financial ratios, which will likely have implications for existing and future debt covenant compliance.

Transition may require long lead times, particularly when system enhancements are needed or desired.

Capital/finance lease treatment will change

Even though leases would now be recorded on the lessee's balance sheet, differences from current capital/finance lease treatment are also expected, including:

- Disguised minimum lease payments and amounts expected to be payable under residual value guarantees would be recorded in the initial right-of-use asset and payments obligation.
- Lease term would include expected renewal options if there is significant economic incentive to exercise an option.
- Lease term would be reassessed over the life of the contract.
- Bifurcation of nonlease service components could be a key consideration because service elements, which may include operating expenses and property taxes for real estate, would not be included in the recorded balance sheet amounts and would still be recognized over the contract term.

Systems and processes may be affected

Current information technology systems and financial reporting-related processes may not be suitable for tracking and recording all lease arrangements.

Since recorded amounts on balance sheet will change for both lessees and lessors, companies should also consider revisiting and potentially enhancing internal controls over financial reporting for these balances.

Potential tax implications

The classification of leases for tax purposes has, in many cases, historically followed book treatment. The classification of leases under U.S. tax law is generally based on economic factors established by case law and Internal Revenue Service administrative rulings that require an independent analysis of specific facts and circumstances, particularly for complex transactions.

In addition to the issue of tax classification, the proposed accounting standard could have implications on the computation of taxable temporary differences, global tax planning, and multistate apportionment.

Operational decisions may be revisited

Different accounting outcomes, including income statement impacts, may influence a company's decision to lease or buy particular assets or to otherwise modify approaches to entering into different types of contracts (for instance, decisions to enter into shorter-term arrangements or to limit use of renewal options).

Transition challenges

The proposed model would apply to essentially all outstanding leases, with no "grandfathering" of existing arrangements. Transition may require long lead times, particularly when system enhancements are needed or desired, placing additional demands on companies' internal resources and related implementation planning.

Key implementation issues

As highlighted above, the proposed model changes how companies will account for leases. These changes may create implementation challenges as companies evaluate the adoption impacts to their organization and develop a course of action for implementing a new standard. Some potential key implementation issues are described in more detail below.

Complex calculations to compute right-of-use assets

The right-of-use asset recorded by the lessee is the sum of the net present value (NPV) of estimated future lease payments plus the recoverable initial direct costs incurred by the lessee attributable to arranging and negotiating the lease. Determining this NPV amount can be more complicated than it sounds because companies will need to exercise judgment in determining the applicable lease terms, including identifying disguised minimum lease payments and evaluating significant economic incentives to exercise renewal options.

Systems capabilities

Many companies currently have some system for capturing information on their existing lease contracts — even if it is just a spreadsheet used to determine minimum lease payments for current footnote disclosure purposes. Current systems (and especially spreadsheets) may not be designed to track all of the different lease terms and forward term and variable rent assumptions a company needs to accurately compute the right-of-use asset, or to manage an initial lease liability and its subsequent unwinding over time.

Compared with existing accounting standards, the proposed model increases the level of disclosure required.

Companies may decide to implement new or significantly enhanced lease contract management systems, along with enhancements to current accounting systems, to more closely integrate them with these new lease systems. Controls and processes may also need to be adapted to ensure compliance with the final standard

Reassessments

Under the proposed guidance, lessees would need to periodically reevaluate lease terms to determine whether evaluations of significant economic incentives to renew should be changed on the basis of new facts or circumstances. This could prove to be particularly challenging depending on the number of leases involved, the complexity of their individual lease payment terms, and the frequency with which these assumptions are required to be reassessed.

Service components

For leases that contain both service and lease components, companies will need to assess whether the service component is "distinct" and whether payments can be allocated between the lease and the distinct service component. The distinction between rentals and services is often blurred and, therefore, judgment may be required.

Distinct service components would continue to be accounted for as executory contracts and would not be included as part of the lease asset and liability.

Subleases

An entity that subleases a leased asset to a third party would need to consider both lessee and lessor accounting models, which adds an extra layer of complexity. A company's volume of sublease activity may drive the need to develop different accounting policies and require different information systems functionality.

Sublease accounting under the proposed lessor models could also significantly affect a lessee's financial position and profit and loss.

Disclosures

Compared with existing accounting standards, the proposed model increases the level of disclosure required, including both qualitative and quantitative financial information about lease contracts and the key judgments made in applying the standard to those contracts.
Disclosure of the proposed information could represent a considerable challenge to certain companies and is likely to require companies to institute system and internal process changes to capture and extract the relevant data.

What other types of arrangements need to be analyzed to determine how they will be impacted under the proposed model?

Key questions for companies to ask

As companies evaluate the potential impacts of adopting a new lease standard, their attention will most likely turn to areas outside of the finance and accounting function. The following are some hypothetical questions for companies to reflect on as they look beyond the technical accounting changes required by the proposed model.

- **Systems** — Are our current lease and other accounting systems able to capture all of the lease information needed in the computation of the amounts to be recorded on our balance sheet under this new guidance? If not, what are our plans to embed the needed system capabilities? How will existing real estate or equipment lease databases integrate with the enterprise system?
- **Financial statement impacts** — How will our financial statements change when all leases are included on the balance sheet as assets and liabilities? How will the replacement of operating lease expense with the amortization of the lease asset and liability affect our income statement? How will rental payments (lessee) and rental receipts (lessor) change the operating and financing sections of our cash flow statement? How will operating expenses and property taxes be carved out from gross real estate leases, if necessary?
- **Debt** — How will debt covenants be affected, and what does this mean for our existing and prospective debt agreements?
- **Nontraditional leases** — What other types of arrangements do companies need to analyze to determine how they will be affected under the proposed model (e.g., indefeasible rights of use, warehousing agreement, and power purchase agreements)?
- **Compensation** — How will employee compensation agreements with ties to financial performance metrics be affected by changes to our financial statements (e.g., bonuses or share-based payments based on existing performance measures)?
- **Project plan** — What plans do we need, and at what level of detail should they be, for us to effectively evaluate the large volume and diverse types of leases?
- **Tax** — Has the classification of our existing leases as a purchase or financing transaction been separately analyzed for tax purposes? How will our tax accounting methods and deferred tax position be affected by the recognition of additional lease assets and liabilities on the balance sheet?

  Will significant changes in the financial statement or statutory balance sheet arising from the new standard impact global tax planning, including distributable reserves, thin capitalization calculations applicable to intercompany financing arrangements, and transfer pricing?

  How will the new standard be incorporated into the basis for income tax reporting, particularly in those jurisdictions where the computation of taxable income is closely aligned with International Financial Reporting Standards (IFRS)-based statutory reporting? Will there be a significant impact on our multistate tax apportionment?
- **Investor education** — How will we educate stakeholders, including investors, analysts, and even regulators, about the changes that the new lease approach will have on our key performance measures (e.g., earnings before interest, taxes, depreciation, and amortization)?
- **Contracting** — What proactive steps can we take now in our contracting process to manage the impacts going forward and to potentially reduce our required transition efforts (e.g., factoring new accounting guidance into new lease contract negotiations and addressing debt covenant compliance, tax reporting, and investor education early in the process to avoid surprises later on)?
- **Commercial impacts** — How will bringing leases onto the balance sheet affect our (or our customers') lease-versus-buy analysis? Are there any practical benefits to entering into shorter-term leases to lessen the financial statement impact, or is it still commercially preferable to maintain longer lease terms? Will the accounting for renewal periods and contingent payments lead us to change the manner in which we structure our agreements?

What can Deloitte do to assist companies now?

There can be complex implementation challenges ahead as a result of the changes expected under the proposed leasing model. Deloitte can help you develop proactive yet measured approaches to help you navigate these challenges. Subject to customary independence limitations for our attest clients, we can help clients as described below.

Deloitte can support your company through this accounting transition.

Company action item	Potential next steps	Deloitte services
Develop a project plan	• **Create a detailed implementation roadmap** — Identify discrete work streams and phases and identify higher impact and long lead-time implementation issues.	• Help develop actionable roadmaps for implementing the new leasing standard.
Execute project plan work streams	• **Lease data aggregation** — Identify existing leases and gather information on inception date, lease term, renewal options, fixed payments, gross lease operating expenses and taxes, and contingent payments.	• Assist in surveying business units to identify and capture lease data and in performing preliminary impact analysis.
	• **Process and system complexity evaluation** — Assess whether systems and processes can capture relevant information and support reassessment of lease terms and payment estimates as of each reporting date.	• Support evaluation of impacts with technical subject matter experience in the new lease standard.
	• **Accounting and tax evaluation** — Develop policies and procedures for the recognition and subsequent measurement of the right-of-use asset and related liability for the reporting entity's obligation to make rental payments. Develop an accounting policy for immaterial leases. Evaluate the implications of the new accounting standard on income tax accounting and compliance as well as multistate income tax and global planning processes.	• Provide advice and recommendations on accounting policies.
	• **Future process and system development** — Evaluate future-state process and system requirements, including strategy and execution support. Identify key integration points with other finance systems.	• Perform a system-capabilities assessment and provide insights and observations on available information technology solutions, including vendor benchmarking.
	• **System selection** — Perform analysis to identify, evaluate, and select system solutions.	• Implement software solutions.
Establish program organization and readiness office	• **Establish a project management office (PMO)** — Establish a project governance structure to facilitate implementation activities for all converging standards. Develop preliminary training, workshops, and communication plans to educate key stakeholders.	• Provide insights and observations about creating a PMO to manage the implementation of new standards.
Coordinate convergence and IFRS considerations with other significant finance or information technology initiatives	• **Identify interdependencies** — Look for opportunities to integrate convergence considerations into other accounting and financial reporting transformation and simplification initiatives.	• Help identify additional integration and financial improvement opportunities.

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