10 Minutes
on lease accounting

pwc

June 2013

How the new proposal could change your financials

Highlights

There are many valid business reasons to lease, and most companies lease assets. The new proposal could have a significant impact on your financial statements.

Leases will have new P&L presentation and recognition patterns. The impact varies depending on the nature of leased assets and the significance to your financial statements.

Consider whether your leases are property or non-property—the dividing lines could make a difference to your P&L.

The changes go beyond accounting, affecting the entire business. Prepare systems, processes, and resources now. Impact could be felt in 2015.

Lease accounting is back in the spotlight. After years of discussion, the IASB* and FASB* (the Boards) recently issued a new exposure draft, bringing changes that could echo through your business.

Leases allow companies to use property or equipment with payments made over time, and there has been debate whether the future payment obligations are debt. Today, payments due under operating leases aren't reflected on the balance sheet. But the Boards' new proposal requires that almost all leases be reflected on the balance sheet, with both an asset and obligation—similar to capital leases today. And the proposal creates two methods for profit & loss statement (P&L) recognition.

If you lease, no matter your company's size or industry, your balance sheet will look different. Your P&L could, too. A more debt-laden balance sheet may prompt you to renegotiate current agreements; reshape how you weigh lease-buy decisions; and limit your company's ability to take on other debt. While further debate is expected, companies may need to begin planning now—particularly since the proposal requires retroactive restatement.

Where the business could feel the impact:

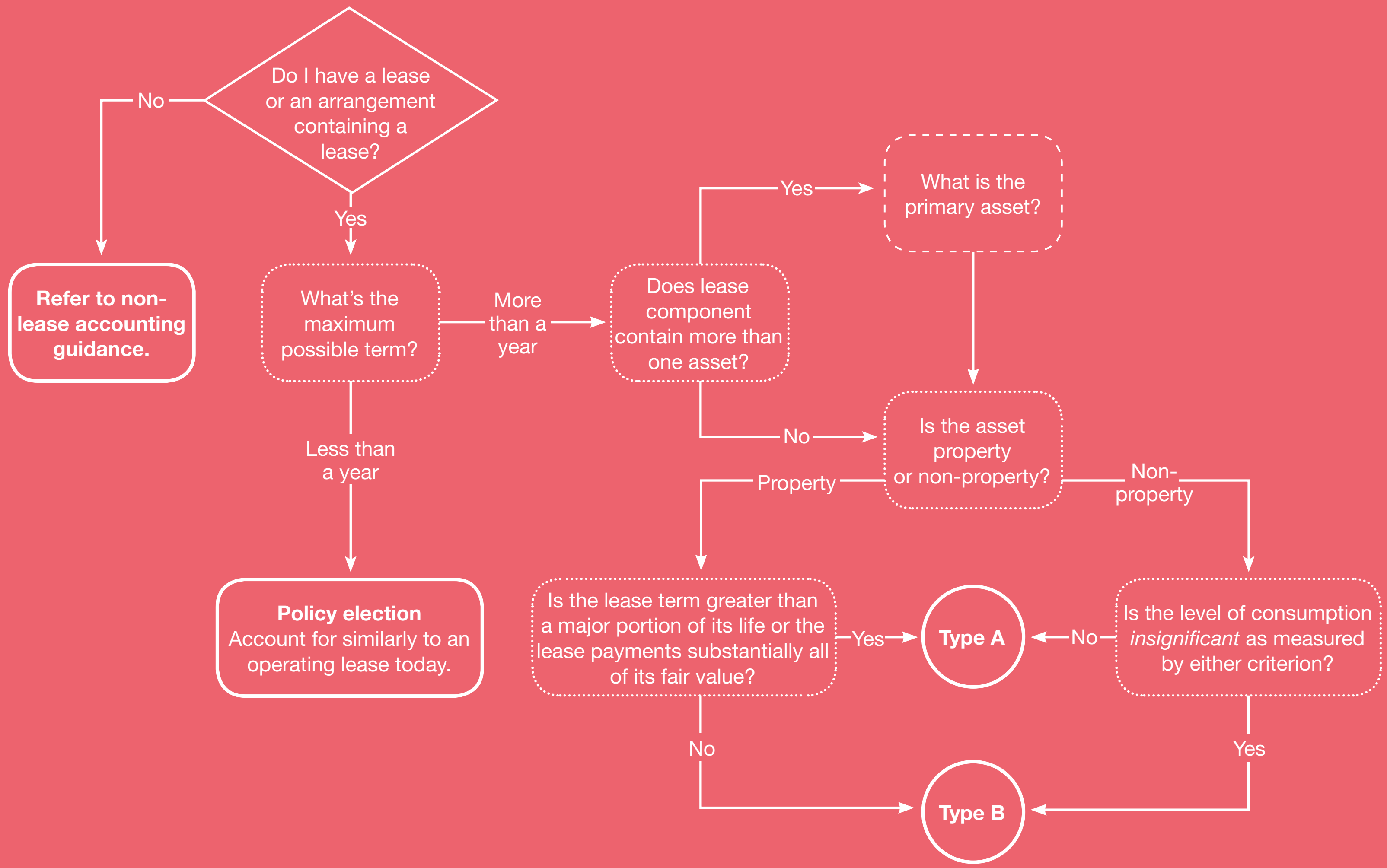
1. **Treasury.** Today, some companies may have operating leases, which keep debt off the balance sheet. But soon, the impact of having leased assets, the related liabilities, and the associated impacts on the P&L could merit reassessing lease-buy decisions.
2. **Operations.** Pre-existing leases won't be grandfathered and all leases will be reassessed, so companies will need to consider the impact of current and future arrangements. You may need new processes, systems, and controls to account for current and future agreements.
3. **Tax.** Proposed changes are not expected to impact tax classifications in the US. However, proposed changes to the balance sheet and the P&L could have implications for state and local tax apportionment or in foreign jurisdictions, impacting cash taxes.
4. **Regulatory compliance.** For example, new assets and liabilities could affect banks' capital sufficiency ratios. How regulators respond to changes may have operational implications.

* IASB International Accounting Standards Board;
FASB Financial Accounting Standards Board.

At a glance

What the proposed rules mean for your financial statements

How lease expense is recognized—either as a financing (Type A) or a straight-line expense (Type B)—depends on certain factors.*



*For simplicity, this chart provides a high-level overview of the requirements and does not cover multiple leased components.

01

New rules to reckon with—if you lease it

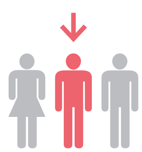
How is a lease defined?

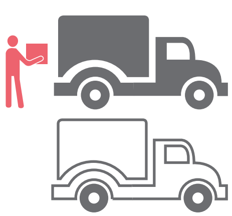
An asset must be identified and the company must have the right to control the asset. Consider:

1. Does the contract allow the use of a physical asset?

2. Can the asset be substituted?

3. Are you responsible for the business decisions relating to the asset (e.g., when and how the asset is operated)?





4. How dependent are the associated services that the asset provides?

Before diving into the lease proposal, you'll need to consider whether you have a lease or just a service agreement. You'll need to consider whether leases are contained in a larger service agreement, such as if a company uses a third-party data center.

If your company has more than a few leasing agreements, it may be quite a task. Evaluating this now could save you time later.

Per the proposal, a lease must involve *an identified asset*. When an arrangement depends on the use of an asset, it needn't be specified in the contract.

If the asset is identified, you would then consider *who's in control of the asset*. In a lease, the party that can direct and benefit from use of the asset controls the asset.

Sometimes this analysis is straightforward: Assume a delivery company executes a contract with a vehicle manufacturer to use a fleet of trucks for a period of time. The agreement identifies the trucks and allows the delivery company to control how and when the trucks are used. This arrangement is a lease.

In contrast, assume a business hires a third-party service to deliver a parcel. It has no control over a particular truck, can't control the route, and shares the benefit of the truck with other customers. This is not a lease.

Not all assessments are this clear-cut; in some cases, the line between a lease contract and a service contract is blurry. Complications could include:

- **Substitution rights.** Leases don't always identify an asset or, if they do, they often permit asset swaps during the lease term. Contractual definitions aren't the end to the analysis. You also need to consider whether rights are substantive. You will also want to consider the costs (employee time, re-leasing, remarketing costs, etc).

- **Customizing.** Usually, the more customized the asset, the higher the switching costs. Customization may involve installation or integration of the equipment at the customer site, as well as modifications to the physical asset (company branding, physical configuration). How long did the initial customization take? What were the costs? How significant were they relative to rents or the asset's value?

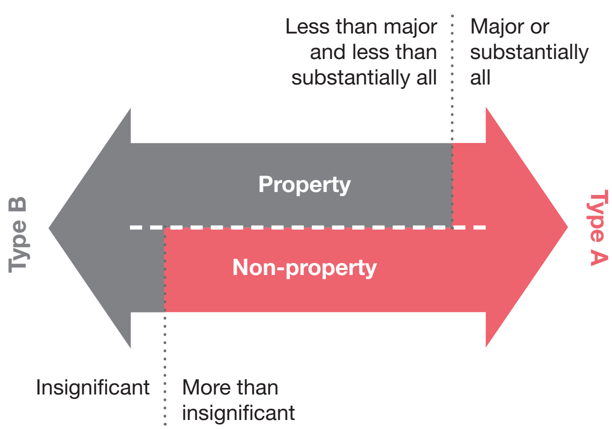
- **Decision making.** What decision making is enough to indicate control? For a vessel or aircraft, is control about the cargo? The destination? Or is it about who operates the asset?

- **Service agreements.** For example, a company that outsources the IT for its back office must consider whether its service agreement includes equipment leases, like computers or printers. If so, the leases must be split out and accounted for separately.

The big picture: How your financial statements will change

Bye-bye bright lines

The proposal creates presumptions based on asset type that can be overcome based on lease term or payments compared to the asset's economic life or its fair value, respectively.



If you lease assets, your financial statements will be affected. The proposal aims for transparency and a clearer view of companies' total "debt." At a minimum, you'll want to understand how lease obligations could change your business's financial picture.

1. What's on the balance sheet

Under existing standards, leases are either *operating* or *capital*. Today, distinguishing between the two is based on bright-line tests, which allow one to manage contractual terms to achieve a desired accounting outcome. Those that fall under operating stay off the books and are treated as merely operating expenses.

Under the proposal, bright lines are gone. Virtually all leases will be capitalized on the balance sheet and measured based on the payments required over the lease term. However, leases with a maximum term of 12 months or less (including all possible renewal periods) do not need to be reflected on the balance sheet.

Depending on the size and extent of your leases, the balance sheet could look very different, with recognition of virtually all leases. This will lead to higher liabilities.

2. Two types of P&L patterns

The proposal includes two possible P&L recognition patterns—a front-loaded recognition pattern typical of a financing (Type A); and a straight-line pattern (Type B) where the expense is spread evenly through the lease term.

3. Reporting with the asset in mind

The two new approaches place consumption of the underlying asset at the heart, instead of the four existing bright-line tests. This represents an important shift: Now, the nature of the underlying asset matters in financial reporting. So look at *what's* being leased and *how* it's being used.

Leases of property (land and buildings) will be presumed to qualify for Type B expense recognition. Type A would apply only if:

- the lease is for the major part of the asset's remaining economic life, or
- the present value of payments accounts for substantially all of the asset's fair value.

For all non-property assets, the Type A recognition pattern applies. Type B is only permitted when:

- the lease is for an insignificant part of the economic life of the underlying asset, or
- the present value of future lease payments is insignificant relative to the asset's fair value.

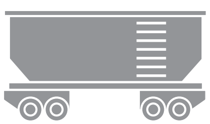
The presumptions above seem to follow the Boards' notion that most non-property leases are Type A, since an outright purchase is typically an option. This is often not an option for property leases.

03

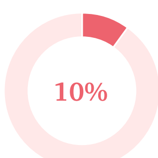
Drawing new dividing lines

Non-property: Two criteria for insignificance

Leased assets such as a railcar would qualify for Type B P&L recognition if its economic life ***or*** economic value is considered *insignificant.*

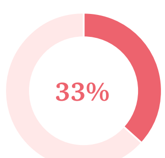


Economic life	Economic value
30 years Economic life	$40,000 Fair value
3 years Lease term duration	$420 Monthly payment



Percent of asset's life

Insignificant?
Type B



Percent of asset's fair value

More than insignificant
Type A

Property or equipment? Defining leases as one or the other is critical—and possibly complex—under the new proposal.

Time to rethink definitions

Many non-property leases are *operating* today and will likely be Type A tomorrow.

You might presume that all structures affixed to land are property. But that isn't the case, as the Boards defined property narrowly—land, buildings, or part of a building.

An additional wrinkle is that some contract components include characteristics of both. Assume a company executes an agreement to acquire electricity from the owner of a power plant. Assuming the arrangement is a lease, it's plausible that the turbine—not the building—is the primary asset. If so, the entire component would be evaluated as non-property.

Since equipment typically results in P&L recognition similar to other debt financing, the expense would be Type A. Similarly, leases involving land through which pipelines run or on which cell towers are located may actually require treatment as equipment, not property.

The significance of *insignificance*

The threshold for equipment to qualify for Type B recognition—insignificant consumption—is well below the standards used today to classify leases as operating or capital. As such, most equipment leases will follow the front-loaded Type A financing model. This front-loaded recognition pattern will have a big impact when the asset is expensive—for example, an aircraft—or when the aggregate leases are significant to your financial statements.

Insignificant won't be defined—it will be subject to interpretation. Companies must use their own judgment to determine the level of consumption needed to overcome the presumption.

Be careful interpreting this: With two P&L options, the potential for error remains. And picking the incorrect one could misrepresent your P&L for that particular lease.

This decision is especially difficult to make if your equipment leases fall on the border of insignificant (e.g., a 3-year lease of a railcar that has an economic life in the 25- to 35-year range). It's likely that economic life will be the focus. This is because shorter-term leases generally attract higher relative payments to compensate for the higher relative costs (both initial as well as in the event of non-renewal).

04

Don’t wait for finalizing—prepare now to lessen impact

Accounting for change

How financial statements may look different compared to today’s operating lease treatment.

	Type A	Type B
Balance sheet		
Assets	▲	▲
Liabilities	▲	▲
P&L statement		
Lease expense	▼	●
Amortization/Interest expense	▲	●
Cash flow statement		
Cash from operations	▲	●
Cash from finance	▼	●

▲ Goes up ▼ Goes down ● No change

Companies should voice their views on the new proposal. Submit your comments to the FASB by September 13, 2013. Before rules kick in, here are six steps to consider.

1. Get every function on board

- Educate your company leaders about potential impact.
- Anticipate the resources needed to support the transition and ongoing compliance: IT, HR, tax, procurement, operations, treasury, and investor relations.

2. Break into the filing cabinets

- Do you know everything you lease?
- Look at your agreements to see if they fall under the guidelines. Do an inventory of lease contracts and embedded leases. Prepare for the changes in accounting treatment for some arrangements.
- Gather data on lease terms, renewal options, and payments. If your company has global operations, you probably have leases in different languages, drafted under different legal standards.
- Evaluate your leasing strategy for changes (e.g., lease-buy, shorter vs. longer terms, variable payments, or asset substitution clauses).
- Examine agreements thoroughly. In a multi-asset lease, you need to identify and account for each component as a separate lease.

3. Assess the potential impact

- Create a model of the transition’s impact on significant leases or on a sample of leases to understand the impact of the proposal.

4. Examine potential regulatory and tax implications

- See how recorded amounts might impact regulatory issues. For example, if regulators treat leased assets like intangibles, a bank may see its capital sufficiency ratios fall. Other examples may include government contracts that reimburse using cost or cost-plus models.
- Examine the impact on cash taxes—for example, how changes may impact state and local tax apportionment or cash taxes in foreign jurisdictions.

5. Manage the transition

- Check to see if you need to design, implement, and test new systems. Recognition of assets and liabilities on the balance sheet and frequent reassessment of terms and payments could require complex changes to existing processes and controls.
- Revisit strategy decisions, like executing new agreements or amending existing agreements.

6. Reassess agreements

- Plan to periodically re-evaluate leases and consider what monitoring and tracking is needed. Ongoing compliance costs are likely to be higher than today.

Upcoming 10Minutes topics

Managing tax uncertainty through operational effectiveness

The tax function is an overlooked area for improvement. It is frequently bogged down by rigidity and antiquated systems, and unprepared for change. Even worse, its antiquated systems represent a hidden source of risk to the company. The tax function is ripe for systemic change, similar to how Lean, Six Sigma, and enterprise resource planning have transformed other company functions. The result: improved risk management, forecasting, analytical abilities—even cash savings.

Getting eco-efficiency right

Nearly half (48%) of global CEOs in our *16th Annual Global CEO Survey* say they plan to support eco-efficiency in the coming year by reducing environmental impacts. But chances are good these efforts will stall. Projects that are both cost-effective and good for the environment may never get off the ground. In this 10Minutes we'll look at current approaches for making the business case for environmental initiatives, give examples of indirect benefits, and show how intangibles can be factored into your decisions.

How PwC can help

To have a deeper discussion about how changes in lease accounting may impact your business, please contact:

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