Retail & Consumer

Lease accounting proposals

Thoughts for retailers on building counter-arguments

PricewaterhouseCoopers

Introduction

At the end of 2009 we issued a paper highlighting the significant impact that the proposed changes to lease accounting under US GAAP and IFRS would have on retailers' financial statements. Since the edition of that paper we have discussed the issues contained in it with many interested parties. Here are some of the arguments and points of view that have been expressed by our retail clients. These are particular concerns for preparers and should be considered carefully in the context of the forthcoming exposure draft. Retailers may want to give careful thought to these issues and consider developing a broader range of alternatives for consideration by the Boards. There are counter arguments against the positions described below that support the Boards' current thinking—but in the interest of space and focus we have deliberately made the debate in this paper one-sided.

How many assets—what is the unit of account?

The current proposals take the view that there is a single right-to-use asset which is contractually defined. This asset comprises current and potential future use as defined by the lease contract. The objective of the currently proposed measurement guidance is therefore to determine the cost of that single asset. Another view that was raised for consideration but has been rejected by the Boards is that each separable renewal period is a different asset for which the company has not yet taken delivery and thus for which it has no obligation. This should perhaps be reconsidered. The company may have taken delivery of an option to renew in signing the contract. In some geographies (e.g., France) where these renewal options can be proven to have a market value these values are already reflected in the key monies which would have been paid. In other geographies measuring the fair value of renewal options is likely to be impracticable—or the value is negligible.

What is the liability for optional renewals?

The current proposal would require including renewals to the extent they are more likely than not to be exercised. Many have argued that the lease obligations arising after a lease renewal do not meet the definition of a liability until the renewal option is exercised. There may be a concern that a measurement model that excludes lease renewal periods presents significant scope for abuse and might not reflect the underlying economics (see below). Experience has shown that wording designed solely to prevent abuse does not make for good accounting standards. A better approach might be to define a principle that attempts to reflect the economics and substance of a lease arrangement, possibly supported by well-worded implementation guidance.

A solution for the anti-abuse challenge

Leases have sometimes been tailored to achieve a desired accounting treatment. The Boards' overall objective is to ensure the assets and liabilities arising from lease transactions are better reflected in the financial statements, but there is clearly concern that the project will fail if loopholes are left open. Nevertheless, in their comment letters retailers may want to explore other ways of preventing abuse that would not at the same time adversely impact companies that have built real operating flexibility into their lease arrangements.

For example, would guidance on accounting for lease renewals based on an 'economic compulsion' to renew a lease be workable and allow the economics to be fairly reflected? There may also be other solutions available from other standards. The current IAS 17 refers to a continuation of a lease being 'reasonably certain'. Would such a wording be preferable? While lease renewals are not 'constructive obligations', a similar approach might be considered for lease renewals.

Recognition triggers for contingent rents/landlord's commission

Retailers may want to focus discussion on lease payments that are a percentage of takings rather than those adjusted for indices. In these arrangements, there is an obligation to pay only if there has been a sale. It could be argued that this is a true variable cost, with the landlord actually sharing the risk of the retailer's business, rather than the retailer sharing the landlord's risk of the real estate portfolio. Furthermore, many such arrangements are shop-in-shop leases, so separating the lease element from the administrative and service charges, as is suggested, may seem counterintuitive. For example, retailers would account for the obligation to pay for electricity when it is used but would accrue the landlord's commission many years earlier. Retailers may want to consider emphasizing these points to ensure the Boards have an appreciation for the practical challenge and related costs that would be imposed under the proposal.

The proposed model would require unreasonable levels of effort.

The proposals would require significant additional effort for retailers, as they would have to consider individually every lease in their portfolios. In some cases, these will run into the thousands. Arguments that good managers should know the details of the portfolio do in fact run counter to a key economic fact—the relatively low risk that short-term leases create. Because of this, management often does not closely monitor these leases. Decisions about lease extensions are often not major investment decisions. The proposed model would also require that preparers consider time periods many years beyond their usual planning cycle.

Would the proposed model give reliable information?

The level of judgment as to the likelihood of renewing leases and the amounts of contingent rent that may be payable will be highly significant. Also, there may be large variations between preparers. The amounts involved will also be highly significant, but given the level of judgment involved, will they be reliable? Retailers may wish to think about a disclosure regime that could be an alternative means of describing the operating and financial risk in the lease portfolio.

What does the investment community think?

At this stage we have had only limited interaction with the investment community, and, as users of financial statements, they are an influential voice. It is likely that while they will welcome any information that will help them predict future cashflows, they may not hold strong views on actual balance sheet treatments and may not be overly interested in any information which is not prepared as part of the company's usual planning processes. To the extent possible retailers will want to engage with the analysts and rating agencies that follow their companies to understand their information needs and factor this into their comment letters.

Concluding remarks

The views presented in this section do not necessarily represent those of the PricewaterhouseCoopers global network. They have been prepared solely to assist our retail clients in their thought processes and preparing comments on the proposals.

John Maxwell
Global Retail & Consumer Leader

David Mason
Chairman, Retail & Consumer Industry Accounting Group

pwc.com/r&c

PwC Retail & Consumer Industry Accounting Group

David Mason
Geneva
david.mason@ch.pwc.com
+41 58 792 9490

John Ellis
London
john.ellis@uk.pwc.com
+44 20 780 46241

John Ryan
Hong Kong
john.j.ryan@hk.pwc.com
+852 2289 2688

Julia Tabakova
Moscow
julia.tabakova@ru.pwc.com
+7 495 232 5468

James Geary
Florham Park
james.w.geary@us.pwc.com
+1 973 236 4497

Tony de Bell
Global ACS London
tony.m.debell@uk.pwc.com
+44 20 721 35336

Christine Bouvry
Paris
christine.bouvry@fr.pwc.com
+33 1 56 57 80 49

Sebastian Heintges
Dusseldorf
sebastian.heintges@de.pwc.com
+49 211 981 2873

Mark Tiberio
Florham Park
mark.tiberio@us.pwc.com
+1 704 344 7723

Alison Tait
Melbourne
alison.tait@au.pwc.com
+61 3 8603 2131