

Issues and solutions for the retail and consumer goods industries

Lease accounting for retailers—the biggest-ever accounting change?



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Foreword

The Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) are currently overhauling their respective lease accounting standards. The proposed changes are significant and, as implied in the title to this article, promise to have a very significant impact on retailers' financial statements.

The proposed changes—which will essentially result in the capitalization of all leases—are causing some concern among retailers. Of particular concern is the treatment of contingent rental payments and lease renewal options.

Although the changes are likely to proceed, there is still time to voice your concerns. Our aim with this paper is to explain the details and highlight the impacts of the potential changes, so that you can consider the implications on your business, express your views to the Boards and start planning for the future.



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Introduction

Earlier this year the IASB and FASB published their discussion paper (DP) on accounting for leases. Much of the criticism of the current standard relates to the fact that the core assets of a business (e.g. aircraft/airlines) are not on the company's balance sheet, and that the assessment of contracts on the borderline between operating and finance leases involves significant amounts of time and effort and is often ignored by analysts. Few retailers are heavily involved in operating versus

finance lease issues since the leases are generally short term as compared to the underlying assets. It is the retail industry, however, that will probably be the most affected by the proposals, together with its high-street neighbours the restaurant industry.

This paper summarises the proposals and subsequent responses of retailers and then looks at the likely impact from the changes on retailers' balance sheets.

Key messages

- The new accounting proposals for leases will see operating leases included on balance sheets as "right-of-use" assets and a corresponding liability for the likely cash flows.
- The impact on the financial statements of almost all retailers will be significant.
- Key measures of performance, such as EBITDA and operating cash flows, will typically improve but with offsetting deterioration in interest cover and debt/equity ratios.
- A recent joint FASB/IASB meeting has discussed two of the most contentious elements of the proposals—contingent rents and renewal options.
- Retailers will be faced with a number of strategic and process-related challenges that merit early attention.



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Summary of the main points of the proposals

Accounting for leases has remained largely unchanged since 1982 when IAS 17 “Leases” was issued. Critics argue that the “all-or-nothing” approach due to the distinction between finance and operating leases results in very different accounting treatments for very similar arrangements. More significantly, many important cash-out obligations are not recorded as liabilities.

The discussion paper proposes a “right-of-use” approach that requires lessees to recognise an asset for its right to use the leased asset for the lease term and a corresponding liability for the committed cash outflows. Current operating lease accounting would be eliminated.

The “right” is measured at the present value of lease payments discounted at the lessee’s incremental borrowing rate. The duration to be taken into consideration is an area where the Boards have sought feedback. The current proposal is that the “most likely lease term” should be considered, requiring preparers to make regular assessments as to whether they will take up renewal options. This particular perspective of the standard is crucial for retailers who in many markets renew short-term contracts on multiple occasions.

Another area of specific interest is contingent rentals, which are often the norm for retail outlets and defined as a percentage of store revenues with or without an underlying base rent. The

Boards themselves are split on this issue, and the DP looks for comments. The current proposal in the DP is that contingent rents should be included in measuring the right-of-use asset. But while the IASB believes changes in estimates of the amount payable should be reflected as an adjustment to the right-of-use asset, the FASB believes such changes should be reflected in income.

Residual value guarantees would also be considered in determining the value of the right-of-use asset, but these are not common in the retail sector.

With regard to presentation the IASB and FASB currently have different views. Both agree that right-of-use assets should be presented separately from owned assets. The FASB proposes the liability should be presented separately from other financial liabilities, but the IASB does not.

The model proposed would significantly change financial statements and financial metrics for many retailers. Preparers should be especially cautious when finalising debt covenants and agreeing compensation targets. Balance sheets will be grossed up and the unwinding of the discount on the liability will result in higher interest expense in early years as compared to the current straight-line operating lease model. However EBITDA will probably increase as the rental costs will be replaced by right-of-use amortisation and interest expense.



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Summary of comment letters

An overview of the responses to the DP indicates that there were very few comment letters to these proposals from retailers.

Scope of lease accounting standard

The DP foresees that there are no scope exclusions for non-core asset leases and short-term leases.

Retailers have requested that the board exclude short-term leases from the standard and, in doing so, defined “short term” as one to three years. The arguments put forward are that such short-term leases generally do not result in a material impact on the income statement or balance sheet and that the cost and effort of determining the liability and tracking the amortisation and interest element would outweigh any benefits to be derived from their inclusion.

Approach to lessee accounting

Arguments against the recognition of the right-of-use asset centre on the transfer of risks and rewards. More powerful arguments were made against the recognition of the liability—highlighting that many elements (e.g., extensions and contingent rents) do not meet the definition of a liability.

The Boards tentatively reconfirmed their support for the right-of-use model for lease accounting during their October joint meeting but did not touch upon the more complex topics of extensions and contingent rents.

Initial measurement

Generally the approach of using the lessee’s incremental borrowing rate is supported as it is seen as easier to determine than the implicit interest rate in the lease and will reduce the burden of analysis. It was highlighted, however, that such an approach will result in inconsistent presentation between depreciation and interest expense among preparers, as short-term leases often do not specifically reflect the risk profile of the lessee.

Subsequent measurement

Retailers think that the lessee should not be required to revise its obligation to reflect changes in its incremental borrowing rate. The reevaluation of the obligation would create a substantial administrative burden for the lessee. It would also add further complexity for preparers, increase the room for volatility and be inconsistent with measuring other obligations on the balance sheet whose rates and terms are set and not subject to change unless there is a new agreement.

Leases with options

The Board’s tentative decision that the obligation to pay rentals must be consistent with the outcome the lessee determines is most likely is clearly an issue for retailers who maintain that it is very difficult to predict if and how often the lease will be renewed after the initial term ends. The alternatives proposed varied, but many retailers who responded wanted only to account for renewal options when they are certain to be exercised. However, there was a general consensus among retailers that an annual reassessment of the lease term would be an unreasonable burden on preparers who may have many thousands of leases.

Contingent rentals and residual value guarantees

Few if any retailers support the idea that contingent rentals be included in the calculation of the minimum lease payments. The arguments supporting this are both technical (respondents argue that future contingent lease payments do not meet the definition of a liability) and also cost driven (excessive amounts of work for what is effectively

only a balance sheet gross-up). There is also a consensus that should annual remeasurements be required, the effects of the change should be included in the value of the right-of-use asset.

If contingent rentals must be included in calculating the minimum lease payments, then there is consensus among the retailers that the obligation should be measured on the basis of the most likely rental payment.

Update of debate since the discussion paper was issued

The Boards have subsequently made the following tentative decisions related to accounting by lessees:

- The initial measurement should use the incremental borrowing rate, although the rate implicit in the lease might also be permissible. Initial direct costs would also be included. Initial measurement should be determined at lease inception.
- The obligation would not be remeasured for changes in the incremental borrowing rate.
- Under IFRS, companies could revalue under IAS 38 and, under both frameworks, impairment should be considered in accordance with existing guidelines.
- Rights to extend the lease are to be considered at initial recognition and reconsidered at every reporting date if there are changes in facts and circumstances.
- At initial recognition, optional renewals to extend the lease term would be included until their exercise is no longer probable.
- Contingent rentals should be included at initial recognition and valued using an expected outcome technique. They would be reassessed if new facts indicate there is a material change in the obligation.
- Changes in the amounts payable for contingent rents relating to current or prior periods should be recognised in profit or loss; other charges impact the value of the asset. A similar approach is required for residual value guarantees.
- Lessees should account for residual value guarantees in the same way as for contingent rental arrangements.
- Discount rates should not be revised when there are changes in expected lease terms and contingent rents.
- Simplified accounting proposed for short-term (“<12 months”) leases.
- Guidance will be provided on the key features of sale and purchase agreements (e.g. bargain purchase options), which will be excluded from the scope of the new standard.
- Substantial disclosures for lessees are proposed, particularly in relation to balance sheet roll forwards, judgments and estimates.
- Intermediate sub-lessors/lessees should account for each element of the arrangement in accordance with the guidance. Separate presentation is required.
- Sale and lease-back arrangements should be accounted for as such, rather than financing transactions.
- There will be no scope exclusion for long-term land leases.

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Quantitative analysis

An analysis of the 2008 financial statements of listed companies shows the dramatic effect this standard will have, especially on retail companies. The analysis uses the minimum lease payment disclosures as a proxy for the impact of the standard. The actual impact will be greater if the proposals on lease renewal options and contingent rents go forward as planned.

The tables below show the impact on debt, leverage and EBITDA across a selection of industries and sub-sectors and show median rather than average values in order to reduce the impact on the statistics of outlying companies with low debt and EBITDA figures.

	Increase in interest-bearing debt	Increase in leverage (percentage points)	Increase in EBITDA
Retail and trade	64%	42%	34%
Other services	16%	17%	13%
Professional services	28%	12%	20%
Transportation and warehousing	14%	9%	14%
Telecom	9%	8%	7%
Wholesale trade	13%	8%	11%
Accommodation	12%	6%	10%
Manufacturing	9%	5%	7%
Construction	3%	4%	6%
Entertainment	5%	4%	5%
Financial services	3%	2%	5%
Oil, gas and mining	3%	1%	2%
Utilities	0%	0%	3%
All companies	8%	4%	7%

Research performed by the Rotterdam School of Management, Erasmus University and PwC Netherlands.

The Retail and trade sample includes 109 companies, of which 54% are from America, 28% from Asia and

18% from Europe. The largest groups in the sample are in the subcategories general merchandise and food.

	Increase PPE in %	Increase LT debt in %	Equity ratio		Interest coverage		EBITDA		
			Before	After	Before	After	Before	After	Variance in %
Apparel	115%	86%	42.9%	37.8%	4.39	2.66	98	197	100.1%
Automotive dealer	35%	39%	24.9%	20.4%	1.67	1.54	147	211	42.9%
Building material	93%	173%	44.3%	33.7%	6.18	3.73	1,106	1,606	45.2%
Eating and drinking	65%	84%	40.6%	26.8%	3.84	2.96	148	243	64.7%
Food	43%	91%	37.8%	28.9%	5.11	3.28	363	375	3.3%
General merchandise	27%	43%	40.7%	36.2%	5.27	3.45	217	258	18.7%
Home furniture	51%	46%	40.0%	37.6%	3.81	1.39	133	191	43.8%
Other	52%	34%	35.0%	30.9%	2.30	1.91	183	210	24.4%
Total	51%	60%	38.1%	31.5%	4.03	2.57	182	258	41.3%

The analysis shows that the most affected subcategories are those for which traffic from passing trade is a key driver of success (apparel and food and beverage). These businesses are perhaps the least likely to invest in own property and ones that seek the flexibility of a relatively large number of outlets under operating leases. Building material suppliers that use large out-of-town purpose-built outlets on longer-term leases which are close to the finance/capital lease threshold are also heavily impacted.

Despite the enormous changes described above, total cash flows will in fact remain the same—unless and until companies start to acquire rather than rent properties. However, operating cash inflows will increase with an offsetting increase in financing cash outflows from the interest charges and investing cash outflows from the acquisition of rights over time.

Still time to comment?

It is more or less inevitable that this fundamental change to lease accounting will proceed although, as with all of the projects, the exact timeframe is difficult to predict. Current plans are for an exposure draft in the second quarter of 2010 with a standard a year later. Experience has shown that the earlier in the process opinions are voiced the greater the impact on the final standard, even though there will still be the opportunity to comment on the exposure draft once it is issued.

The financial statement impacts described in the previous section are already very significant for the retail industry. It is difficult to estimate the impact that the proposals to include anticipated renewals and contingent rents will have on the figures presented earlier. However, even if you assume only one renewal—the basic adjusting entries (Dr Asset; Cr Liability) will be more than double for many companies.

If a company has contingent rents on premium sites that it has no intention of vacating it may be forced into estimating revenues for that outlet into perpetuity. If any changes in this estimate become recorded in the income statement (as is proposed by the FASB)—then they will become a highly significant area of judgement and hence uncertainty in the financial statements.

Rental payments after an optional renewal, as well as ones contingent on revenue figures (landlords' commissions), do not meet the definition of a financial liability, and thus there are good arguments that these should be excluded.

To have any chance of impacting the final standard retail companies must not miss the opportunity to respond to the exposure draft when it is issued and also consider contacting the Boards in the meantime.



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What to comment on?

Since the first edition of this paper in December 2009 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. We should highlight that there are counter arguments against the positions described below and which 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.

Conclusion and next steps

If a standard becomes applicable from January 1, 2012 with retroactive application the challenges and questions for retail companies that will need to be addressed include:

- Can you accurately predict the impact the changes will have on the key KPI ratios you use to communicate with investors?
- Do you change the operating model—consider more use of franchise arrangements or reconsider the “lease-versus-buy” decisions?
- Do you have the systems necessary to capture, analyse and accumulate the necessary data from a portfolio of outlets that may run into the thousands?
- Do you need to redesign your approach to controlling capital expenditure?
- Do you need to revisit and subsequently renegotiate covenants included in loan arrangements— or even your underlying lease contracts—since lessor accounting is also likely to change?

As can be seen, the impacts of this project are highly significant. The answer to the question posed by our title is that it is probably the biggest-ever accounting change—especially for retailers—and there is much to be done in a short space of time.

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