

# Spotlight

## Lease accounting

### Transformational Change

Considering the impact of the proposed new lease accounting guidance on lessees in Manufacturing Industry

#### Highlights

- *The FASB and IASB are moving forward with a lease accounting overhaul that will bring substantially all leases onto the balance sheet and change income statement recognition*
- *The proposed changes will impact key financial metrics*
- *Creating a catalog of all leasing arrangements will be critical to evaluating the overall impact of the new standard*
- *Changing accounting standards will have far-reaching impacts on your organization's business processes, systems, and controls.*
- *Companies should begin now to prepare, in a measured way, for the upcoming business process changes.*

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# Background

## A process will be required for the identification and assessment of all potential lease arrangements

Leasing is a widely used to secure access to an asset. It enables companies to use property, plant and equipment without making large initial cash outlays. It provides flexibility, enabling lessees to address the issue of obsolescence. Sometimes, leasing is the only way to obtain the use of an asset that is not available for purchase.

Currently, lessees account for leases either as operating or as capital leases, depending on “bright-line” tests. Operating leases appeal to many companies because they provide nearly the same risks and rewards as outright ownership but do not result in debt on the balance sheet. Further, instead of recognizing front-loaded expense from financing of an asset purchase, operating lease expense is recorded on a straight-line basis.

### *Rationale for the change*

Critics say that it is difficult to compare financial statements of companies that buy assets with those that lease equivalent assets because current accounting rules do not portray the true economics of a lease.

As standard-setting boards push for change, various constituents appear to agree that for greater transparency, future lease commitments should be reported on a lessee's balance sheet.

### *Where we stand today*

On May 16, 2013, the FASB and IASB issued a revised *Leases* exposure draft (ED) that represents an overhaul of lease accounting rules. There is a 120 day comment period from issuance date of the ED. Companies interested in providing comments should do so by September 13, 2013.

The ED requires lessees to capitalize all leases that extend for more than one year on the balance sheet. Income statement recognition will depend on the nature of the leased asset. Leases of property will be presumed to apply a straight line lease expense pattern, similar to current operating leases (Type B). In contrast, leases of non-property (e.g., equipment) will be presumed to apply a front loaded expense profile with the expense allocated between interest and amortization (Type A).

### *The potential consequences*

The proposed changes will affect metrics such as EBITDA, net income and cash flows from operations. These in turn will likely affect loan covenants, credit ratings, and other external measures of financial strength. These impacts may spur companies to reassess lease-versus-buy decisions.

Lessees will need to consider business process changes in multiple areas, including finance and accounting, IT, procurement, tax, treasury, legal, operations, corporate real estate and HR. The following discussion highlights steps that companies should consider for the impact of the ED.

### *Step 1: Do I have a lease?*

#### **The analysis**

The analysis starts with determining if a contract meets the definition of a lease. This generally means that the customer receives the right to control an identified asset for a period of time in exchange for consideration.

The assessment of whether an arrangement contains a lease is similar to existing guidance. However, some changes are proposed which will affect current practice.

Although this analysis is required today as well, many entities do not separate the “embedded” operating lease because the accounting for an operating lease generally has a similar impact on the financial statements as that of a service/supply arrangement. However, this analysis will take on incremental significance because leases, other than short term leases, will be recognized on the balance sheet, and certain leases will recognize a front-loaded, rather than straight-line expense.

#### **The process**

Entities will need to inventory their contracts for leases, catalogue the identified leases, and identify lease and non-lease elements in multi-element arrangements. There is no grandfathering of existing arrangements.

### *Step 2: How do I initially measure the lease?*

#### **The analysis**

When the asset becomes available to the lessee for its intended use a lease liability and right-of-use asset will be recorded on the

**Depending upon the nature of the leased assets, the income statement will have a mix of front loaded and straight line expense from leases; ongoing volatility in financial statements may also result from required reassessments**

lessee's balance sheet unless the arrangement qualifies for the short-term exception.

The lease liability will be the present value of the lease payments to be made during the lease term. The discount rate used in determining the liability will be the rate the lessor charges or, if this rate is not available, the company's incremental borrowing rate.

The right-of-use asset will be equal to the lease liability plus any initial direct costs, such as commissions or legal fees.

### **The process**

Entities will need to gather data about its leases such as property type, lease term, renewal options and lease payments data to determine amounts to be recorded on the balance sheet and income statement.

### **Step 3: How do I model the expense?**

#### **The analysis**

The expense recognition pattern will depend upon the leased asset.

Leases requiring front-loaded expense recognition (generally non-property) will recognize interest and amortization expense. Interest expense will be recognized by unwinding the present value "discount" on the lease liability; amortization expense will be recognized against the right-of-use asset, typically on straight-line basis. Both will be shown separately in the income statement.

Leases meeting the criteria for straight line lease expense (typically property) will recognize periodic operating expense based on average lease payments during the lease term. This expense will comprise of the unwinding of the discount on the lease liability, consistent with the front loaded expense approach. However, to obtain the overall straight-line recognition pattern, it will be offset by a back-end loaded amortization of the right-of-use-asset.

#### **The process**

A different process will be needed to classify a lease as front-loaded or straight line lease compared to the existing process of classification as an operating or capital lease.

### **Step 4: How do I identify and unbundle lease components?**

Some entities may lease a bundle of assets instead of a single asset (e.g., land and building; or land, building and equipment; etc.). The question then is should the lease be separated into its individual elements?

The ED introduces the concept of components. An identified asset is a separate lease component only if (a) the lessee can benefit from use of the asset on its own or with other readily available resources; and (b) the asset is not dependent on or highly interrelated with other underlying assets in the contract; otherwise, the identified asset will be part of another lease component.

Each identified separable lease component (e.g., building, equipment, etc.) will be accounted for as a separate lease. Within the manufacturing industry, if a lease component contains multiple assets the nature of the primary asset in that component will determine if a front-loaded or straight line income statement approach applies.

### **The process**

A process will be needed to identify lease components in a contract and the primary asset in a multi-asset component before a lease can be classified as a front-loaded or straight line lease. This will be different from the existing process of fragmenting a lease for classification as an operating or capital lease.

### **Step 5: What are the ongoing requirements?**

#### **The analysis**

Periodic reassessment will be required under the ED, since lease renewal periods and index based rents will need to be reassessed and the related estimates tried up as facts and circumstances change. These reassessments may produce significant financial statement volatility; so the current "set it and forget it" accounting will no longer be feasible.

#### **The process**

Lease accounting will become more complex, requiring attention on an ongoing basis. Companies will need to put a process in place to monitor contractual changes and to update management judgments relating to contingent payments and renewals.

### **Developing a roadmap to implementation**

Based on the above analysis, companies will need to sketch out a roadmap and develop a plan to implement the new requirements.

Management will need to identify internal and external users of information who will be affected by the leasing changes and develop a communication strategy to help them understand transition - before, during and after the new standard is adopted.

Management may also want to revisit lease/buy processes and strategies.

# Analysis

**A lease of a factory may end up being treated as lease of equipment. This would have significant income statement implications**

**Lease extension options and lease term will need to be monitored and reassessed, from a practical perspective, every reporting period**

## ***A new model for fragmenting an arrangement into multiple leases and classifying the leases***

The following example illustrates how an entity in the manufacturing sector would identify separate lease components in a contract and the primary asset within one lease component that conveys the right to use more than one asset to the lessee. This analysis can become very judgmental and practical application may be hard.

### **The facts**

A steel sheet manufacturer leases a factory in an industrial town.

The factory has a special furnace to smelt the ore as well as an item of heavy machinery to manufacture the steel sheets from the smelted ore.

The lessor does not lease or sell the heavy machinery separately, but other suppliers do.

The factory is tailored for use only with the specialized furnace. The manufacturer leased the factory to get access to this furnace. However, the factory is not tailored for use only with the machinery, and the machinery could be used for a different manufacturing process within another factory.

### **The analysis**

#### ***Fragmenting the contract into lease components***

The contract contains two lease components—a lease of the manufacturing building (together with the land on which the building is situated and the customized furnace) and a lease of an item of heavy machinery.

The item of heavy machinery is neither dependent on, nor highly interrelated with, the manufacturing building and vice versa; that is, both the manufacturing building (land, building, and furnace) and the heavy machinery could be used for other purposes together with other assets. Accordingly, the manufacturer can benefit from use of the manufacturing building (land, building, and furnace) together with other resources that are readily available to it. The manufacturer also can benefit from use of the machinery together with other resources that are readily available to it.

#### ***Classifying a lease component based on the primary asset***

The primary asset in the manufacturing building is the furnace because it is the predominant asset for which the lessee has contracted for the right to use. The main purpose of the building (and the land on which the building is situated) is to facilitate the lessee obtaining benefits from use of the furnace. The land and building would have little, if any, use or value to the lessee without the furnace.

Based on the above analysis, since equipment (i.e., furnace) is the primary asset, lessee will apply a front loaded expense profile with the expense allocated between interest and amortization (Type A).

#### ***Determining the lease term may not be that simple***

### **The facts**

Assume the same facts as in the example above except that the manufacturer leases the factory for 5 years with two renewal options each for 5 years.

### **The analysis**

Based on the fact pattern above, given the unique nature of the furnace, the manufacturer may determine it has significant economic incentive to renew the factory lease for at least one renewal period. Therefore, the manufacturer may initially conclude at lease commencement that the lease term is 10 years (5 years non-cancellable base term plus 5 years from the exercise of 1 renewal option).

The manufacturer will have to revisit this assumption, from a practical perspective, every reporting period and true up as facts and circumstances change. For example, if 4 years into the lease, a key supplier contract is cancelled, the manufacturer may conclude that there is no longer a significant economic incentive to exercise the first renewal option.

These reassessments and the consequential true-ups may produce significant financial statement volatility.



**Ongoing re-assessment and remeasurement requirements will increase application complexity**

***Index based payments may still be problematic***

**The facts**

Assume the same facts as in the example above except that the manufacturer will pay \$1,000,000 in rent per year which is consistent with market rates for this location. From the second year onwards, at the beginning of each year, the monthly rent will increase by an amount consistent with the increase in CPI during the prior year. Once the rent increases based on an increase in CPI, it cannot decrease. The lessee will also pay additional rent calculated based on 1% of sales, if total sales for the year exceed a certain specified significant threshold.

**The analysis**

At the commencement date, the manufacturer will measure the lease liability on the basis of annual fixed payments of \$1,000,000 per month. The manufacturer is required to make payments of at least \$1,000,000 per month, regardless of the level of sales from the property or increase in CPI. Hence, these payments are in-substance fixed lease payments.

At the end of the first year of the lease, if there is an increase in CPI, the manufacturer will calculate the payments for the second year, adjusted to the change in CPI. Because the lease payments are variable payments that depend on an index, the manufacturer will adjust the lease liability to reflect the increase in CPI at the end of the reporting period, i.e., the lease liability now reflects increased payments for the remaining term of the lease. The manufacturer will need to carry out this adjustment at the end of each reporting period.

Since all of the remeasurement relates to future periods, the manufacturer will adjust the carrying amount of the right-of-use asset.

The manufacturer does not reassess the discount rate because a change in variable lease payments that depend on an index does not require the discount rate to be reassessed.

The payments based on the percentage of sales will not be included in the calculation of the lease liability and asset as they are performance based and not based on a rate or an index.



# Next Steps

**Pervasive impacts will require a well-planned, but measured approach without "boiling the ocean"**

Historically, many lessees have not needed robust systems and controls for their leases. A process was needed to initially classify a lease as operating or capital, and once the lease was classified the accounts payable or fixed asset systems generally sufficed.

Under the ED, the initial balance sheet recognition and the subsequent reassessment of lease term, payment estimates and support for management assumptions may require significant changes to existing processes and internal controls. Monitoring changes, evaluating the estimates and updating the balances may also require more personnel resources than those needed under current accounting rules.

Prior to adoption, management will need to catalogue existing contracts and gather data about payments, renewal options and the length of the arrangements.

Depending on issues like the number of leases, the inception dates, and the availability of records, the process of gathering and analyzing the information could take considerable time and effort. In many cases, original records may be difficult to find or may not be available. Other factors that had not been a focus before, such as embedded leases, will need to be identified and recorded.

Entities should plan to evaluate their systems and controls to ensure they have the appropriate infrastructure in place prior to the effective date of the new model. This includes assessing the ability of systems and processes to report on multiple bases which may include dual reporting under old GAAP and new GAAP (on a prospective basis)

Companies may need to invest in new information systems, including ones that capture and catalog relevant information and support reassessing lease term and payment estimates at each reporting period.

We recommend considering these and other issues now, so organizations will be ready to capture dual-reporting values on a prospective basis as soon as the new standards are finalized and implemented.

Additionally, assessing the current state of your leasing systems and processes now can benefit your existing accounting

and reporting. Tools such as the GAAP Accelerator® are available to help with the current state assessment and gathering information about leases.

## Systems and data

### Leveraging extended timeline for implementation

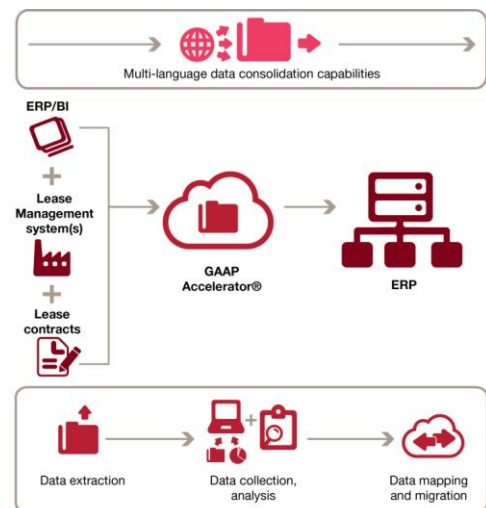
- Systems vendors may need to enhance their business systems to meet new requirements; some may before others
- Focus on gathering data in advance of transition date
- Will ease pain of system implementation in the future
- Will enable streamlining

### GAAP Accelerator® provides:

- Consistent framework
- Standardized data format
- Robust information gathering capabilities (in multiple languages)
- Lease information repository for both contracts and data
- Controlled review and sign-off

### Data gathering will facilitate:

- Data gap identification
- Process improvement from lease inception to reporting
- Add-on validation, analytics and modeling capabilities once data is centralized
- Availability of complete, accurate data can be easily migrated to a longer term solution in the future



# Questions & Answers

## Here are some frequently asked questions

**Q:** What is the process for transitioning to this new guidance?

**A:** Issuance of a final standard is unlikely before 2014 and is not likely to be effective before 2017. The transition approach will be either “modified retrospective” or full retrospective. Preparers will need to apply the guidance to all leases existing as of the beginning of the earliest comparative period presented (i.e., no grandfathering). Existing capital lease asset and liability balances will get carried forward. Some preparers are planning to maintain two sets of books as early as January 1, 2015.

**Q:** Will we need to develop an entirely new system to track and administer our leases?

**A:** Many lessees currently manage operating leases on spreadsheets or through accounts payable system. The ED will impose incremental accounting and disclosure requirements that will require extensive data capture. Most lessees may need to modify their information systems, processes, and internal controls to comply with the ED.

**Q:** Short term leases are eligible for scope-out from the ED. How is “short term” determined?

**A:** A lease is considered to be short term if the sum of the base lease term and all extension options available in the lease arrangement totals 12 months or less.

**Q:** The ED introduces the concepts of “insignificant”, “major part” and “substantially all.” How are they determined?

**A:** The ED does not define “insignificant”, “major part” and “substantially all” required to assess the exception criteria for classifying leases. Therefore, the analysis will likely be subjective and judgmental.

**Q:** Some leases include contingent rents. How are these rents considered in the ED?

**A:** Lease payments that are dependent on an index or rate, or are expected to be payable under residual value guarantees, will need to be included in the initial measurement of lease asset and liability. They will also need to be reassessed. However, variable payments based on usage or performance (e.g., number of miles a leased car is driven) are recognized in the period in which the obligation for those payments is incurred.

**Q:** What will be the accounting for build-to-suit transactions?

**A:** The proposed guidance would significantly change current accounting for build-to-suit leasing transactions in the US. A lessee will no longer be required to consider and then possibly recognize the leased asset as if it were the legal owner during the construction period. Instead, the right-of-use asset and lease liability will be measured as a lease at lease commencement date. If a lessee incurs costs prior to lease commencement, the lessee will recognize those amounts as prepayments and add them to the right-of-use asset at lease commencement

**Q:** How are lessors impacted?

**A:** Lessor guidance is changing to avoid inconsistencies with lessee accounting and to match up to the Boards’ proposed approach around the new revenue recognition guidance. Sales-type leases will likely continue to qualify as receivable and residual leases under the ED, while property leases classified as operating under the current rules will still qualify as operating leases under the ED. Leveraged lease accounting, however, will not survive.

**Q:** How and when should I start a program to manage change and meet compliance?

**A:** Although the effective date is not expected until 2017, companies should take advantage of the intervening period to ready themselves for the changes. This will allow companies to take a measured approach, typically starting with a current state assessment of people, processes, systems, data, governance and policy. Tools such as GAAP Accelerator® are available now to help.

**Q:** What other departments may be impacted by the new guidance?

**A:** Changes will impact well beyond the accounting department. For example, tax considerations will need to be assessed as there may be impacts relating to increased deferred tax liabilities from the new guidance. Additionally, human resources may be impacted as compensation metrics may be impacted by the new guidance. Based on the far reaching impacts of the guidance, management should consider the impacts early in their process.

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