www.pwc.com/us/en/asset-management/real-estate

The overhaul of lease accounting
Catalyst for change in corporate real estate

Joint FASB/IASB Revised Exposure Draft

July 2013

Table of contents


Being distinctive

Executive summary

By some estimates, real estate leasing accounts for nearly two-thirds of all leasing activity. As part of our discussions with client and industry representatives on the changes that may be coming as a result of the proposed lease accounting standard, we are beginning to see senior management at many companies target their corporate real estate strategy and operations for major renovation and update. Their reasons for doing so are to prepare for the new requirements but also to be more nimble in the current economic climate.

For most companies, real estate represents one of their most significant costs. Yet the existing corporate real estate function may have been designed to support a very different operational structure compared to what exists today or one that was originally motivated by financing or tax considerations that no longer apply. The proposed changes to lease accounting may provide a catalyst for change to these operations that go well beyond what is required for the accounting change.

Proposed accounting change

The International Accounting Standards Board (IASB) and Financial Accounting Standards Board (FASB) recently issued Revised Exposure Drafts of a proposed accounting model that would radically transform lease accounting. These changes, if adopted in their current form, would affect almost every company including significant users of real estate. Under the proposed model, a lessee's rights and obligations under all leases (except short term leases)—existing and new—would be recognized on its balance sheet.

The Boards expect to issue final standards in mid-2014. The effective date, which has not yet been determined, is not expected to be before 2017. Upon adoption, prior comparative periods will be restated.

At a minimum, compliance with the proposed standard may require significant upgrades, replacements or overhauls of their legacy accounting systems, processes and controls. Importantly, the proposed standard will also have a significant impact on a company's operating results, financial ratios, and potentially their debt covenants. The scope of adoption issues are well beyond just financial accounting and many companies are already starting to plan for the coming changes.

For some companies, the proposed lease accounting standard will represent just another compliance exercise, but one likely to entail significant cost and complexity that will need to be managed. Expected costs are likely to include education of all key stakeholders, robust systems upgrades and implementation of new controls.

For others, the compliance exercise will serve as a much-needed catalyst for change in their overall corporate real estate strategies. Because the proposed model will eliminate the off-balance sheet accounting for operating leases, it will also eliminate some of the perceived accounting advantages of leasing. Thus, the proposed new

Overview of the proposed new lease standard

- The proposal will eliminate off-balance sheet accounting for leases; essentially all assets currently leased under operating leases (except short term leases) will be brought on balance sheet.
- Income statement "geography" and timing of recognition will change for all leases but more significantly for certain types of leases classified as "Type A." For Type A leases, straight-line rent expense will be replaced by interest expense (which will be greater in earlier years, like a mortgage) plus straight-line amortization of the leased asset, such that total expense will be front-end loaded. For Type B leases, rent expense will be replaced with a straight line "lease expense" comprised of interest expense computed on an effective interest method for the lease liability with the remainder comprised of amortization of the right of use asset.
- Financial performance ratios may no longer be useful for their historical purposes and other operating metrics may evolve as a result of the adoption of the new standard.
- The new lease assets and liabilities will be recognized based on the present value of payments to be made over the future term of the lease and will be carried at amortized cost.
- The lease term will include optional renewal periods that the lessee has a significant economic incentive to exercise and this may change upon reassessment (this is substantially different than today's "set it and forget it" model).
- Lease payments used to drive the initial value of the asset and liability will now include "contingent" amounts which are based on a rate or index (such as LIBOR or CPI) but will not include amounts based on out-put or performance (e.g., such as rents based on a percentage of a retailer's sales). Initially, one would use the rate or index at inception, but unlike today, such amounts could change upon reassessment which would be computed at the then applicable rate or index.
- Lease renewal periods and contingent rents will need to be continually reassessed, and the related estimates trued up as facts and circumstances change (again, substantially different than today's model which is largely "set-it and forget it").
- The proposed lease accounting model will require significant systems and process changes at adoption date and maintenance on an ongoing basis.
- Pre-existing leases are not expected to be grandfathered.
- The proposed accounting provides for either full retrospective or modified retrospective adoption, which may not yield the same results. Companies may need to evaluate under both transition methods to see which one they would prefer to select.

standard, coupled with change from other current economic, tax and business issues, may be an impetus to overhaul their real estate strategies. Changes to strategy may include lease versus buy decisions and structuring of the lease terms and common lease provisions (e.g., CPI changed based or contingent rent based rather than fixed rent steps).

For many significant users of real estate (e.g., retail companies), managing investor and other user relations during the transition will be critical.

The issuance of the Revised Exposure Draft has created a significant buzz and analysts and shareholders may start raising questions about the potential impact. Traditional operating metrics such as EBITDA used as proxies for free cash flow may no longer be relevant and will likely need to be replaced. Longer term, the inherent volatility in the income statement and balance sheet, in addition to significant changes in presentation and metrics, will require thoughtful communication.

Because there will be no grandfathering of existing leases at the time of adoption, companies entering into leases of any signification duration today should consider the implications the new standard will have for these transactions in the future and potentially change their negotiation strategies. Many leasing strategies employed today inherently consider existing accounting bias that may no longer be beneficial under the new model. Further, lease accounting will no longer be "set-it and forget it" – it will require periodic reassessment which may be significant.

Significant impacts

The new model will have pervasive business and accounting impacts

- **All leases on balance sheet**. Lessees will recognize a right-of-use asset and a liability measured at the present value of future lease payments. Lessees may elect to exclude short-term leases (with maximum terms of less than a year), which can continue to be accounted for like operating leases today. Under the existing model, analysts and credit agencies may be *underestimating* the quantum liability when adding back "debt-like" items for operating leases.
- **Expense recognition patterns will change for certain leases**. The proposals provide for two different models for expense recognition – Type A (effectively a financing) and Type B (aggregate expense is straight line). Cash pay ments versus expense recognition may further diverge for Type A leases. Management reassessment of renewal options and certain contingent rents based on a rate or index may produce significant financial statement volatility.
- **Decision points and data needs will change**. Except for short term leases, operating leases are dead. Structuring consideration will change to focus on *liability and volatility reduction* as opposed to obtaining operating lease treatment. Data needs for ongoing reporting will change significantly.
- **Lease versus buy decisions should be revisited**. Possible complacency in lease-versus-buy decisions, based upon reliance on operating-lease treatment, should be addressed.
- **Transition**. While not expected to be effective before 2017, prior comparative periods presented would need to be restated and companies may want to do full restrospective adoption depending on their portfolio of leases. Industry-wide neglect of leasing software and systems may necessitate upgrades and enhancements, which will require a significant runway to adequately prepare for transition.
- **Asset recognition may change state tax liability**. Income apportionment among states may change, potentially attracting additional income to higher tax jurisdictions. State capital and net worth taxes will increase as a result of an increasing balance sheet. Timing of sales and use tax payments may accelerate and state property taxes may increase.

A detailed summary of the key provisions of the proposed new leasing standard have been provided in ***Appendix A*** as well as several practical examples in ***Appendix B*** and impact on common real estate provisions in ***Appendix C***.

Opportunity

The last several years have seen a host of changes facing corporate real estate organizations. From cost management to outsourcing, from systems changes to designing the workplace of the future, the role of the corporate real estate department has never been more complex. Nevertheless, the role of corporate real estate as a strategic function within the enterprise has often been overlooked. Simply put, many senior executives or boards of directors have not viewed their corporate real estate departments as a significant element in driving the success of an organization.

At best, corporate real estate departments are often viewed as a necessary, but largely administrative function or cost center, having little bearing on the overall success or failure of the company. However, if effectively addressed, corporate real estate can be a key or contributing driver in the success of many operations.

Preparing for the change

Some fundamental questions

As you assess your current corporate real estate strategy, there are a number of fundamental questions that should be asked, such as:

- Why does your company lease or own in particular situations?
- What are the alternatives to leasing?
- What are current market opportunities (e.g., lease rates/ purchase prices) and how would they affect your real estate strategy?
- How do taxes factor into your corporate real estate decisions?
- How does your company manage occupancy costs today?
- What is the potential impact of the proposed lease model on your company?
- What changes will your company need to make to manage the process?
- Do your company's existing systems have the capabilities necessary to apply the proposed lease standard?

The "stakeholders"

Corporate real estate activity affects a number of key functional areas and any reconsideration of your approach should include, at a minimum, members of each of the following key constituencies:

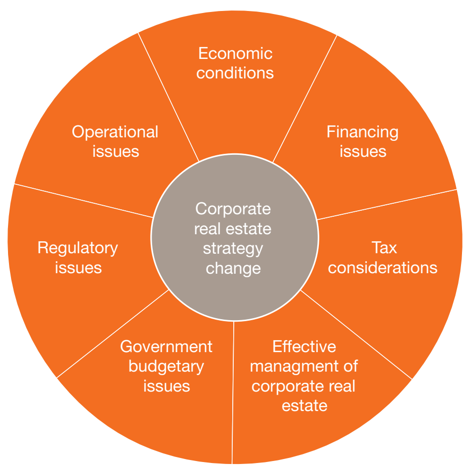
- Accounting/reporting
- Treasury
- Legal/regulatory
- Operations
- Tax planning and reporting
- Information/systems
- Human resources (e.g., impact on compensation agreements)

Each of these stakeholders will be impacted by the proposed accounting standard. Accordingly, many companies that are significant users of real estate are creating a "steering committee" comprised of individuals from each of these constituencies to help them consider the implications. A joint approach in the planning stages is vital to ensure unexpected implementation issues are identified early in the process.

Many companies quickly identify some of the more significant transition impacts such as the significant change in financial reporting or the impact on debt covenants. However, other less obvious impacts also exist for particular companies or industries. For example, recording significant additional assets may affect tax payments in some jurisdictions, while changes to key metrics may alter incentive compensation payments or earn-outs and perhaps even impact legal or regulatory capital. Additionally, the amount of time and effort associated with executing leases will increase as both sides of the transaction negotiate to achieve the most desirable accounting impact. Accordingly, it is essential for companies to seek broad participation in the process of identifying and addressing the potential impacts of the proposed lease accounting standard.

Factors that impact corporate real estate strategy

The proposed standard will be the catalyst for companies to take a fresh look at factors that influence corporate real estate strategy. Many of these factors drive the decision to lease a particular asset versus buying it.



The impact to corporate real estate strategy

- Reassess "lease-buy" decision criteria where buying is feasible
- Consider negotiation strategy around lease term – controlling space/economics versus accounting effect
- Consider pricing implications of option periods versus longer terms
- Consider common terms and modify where appropriate – what is the "new normal"? (e.g., should you increase or eliminate certain contingent rent provisions)
- Evaluate regulatory impact including regulatory capital, cost plus contracts, etc.
- Evaluate tax impact including federal, state, local and foreign taxes

Many companies are looking for a simple answer to the question, "how should we change our real estate strategy?" Unfortunately, the answer is, "it depends." As we will discuss further, the decisions around when and how to lease are affected by a large number of factors including needs to control particular assets, operational flexibility, availability of alternatives, common industry practices, tax and regulatory impacts and expectations of management. Careful consideration of the impact and the company's specific circumstances will be required. It is not a "one size fits all" evaluation for all companies or for different types of transactions. Rather, management should be armed with an understanding of the impacts of the proposed new model so they can create various strategies for major classes of transactions and then be able to apply those to specific situations as they arise.

Operational issues

A company's need for corporate real estate is driven in large part by both its current and planned physical requirements. Space needs can change dramatically over time with such changes driven by a variety of factors including growth/contraction plans, potential acquisitions, productivity improvements, and physical obsolescence of space. Further, local demographics may change needs for particular locations. These issues will vary significantly from company to company and by property type. The following examples help illustrate the diversity of potential issues based on a company's operations:

Example 1—Retail company

A retail company typically requires several different types of property for its operations including (i) store locations (ii) warehouse locations and (iii) key corporate offices in central business districts.

Example 2—Bank

Banks normally maintain a variety of property locations for their operations including (i) bank branches (ii) processing operations (often in fungible office space in suburban markets) and (iii) key corporate offices in central business districts.

Generally, a company is more likely to lease real estate when its long-term property needs are unclear, operational flexibility is highly desirable and expected access to acceptable alternatives is good. Leasing has also historically carried the added advantage of providing companies with a form of off-balance sheet financing (which will generally not exist under the new proposals).

Conversely, a company is more likely to buy when the company's long-term property needs are clear, the need for specific properties is expected to be stable and long-term, and/or there are concerns with respect to the availability of acceptable alternatives.

There are also many operational reasons why companies rent rather than own that may be unrelated to the accounting or even to the economics. One such reason frequently cited is that leasing allows tenants to avail themselves of professional property management. Does a bank, for example, want to maintain a staff of engineers, maintenance or other personnel necessary to address the day-to-day issues surrounding management of real estate? In these circumstances, we may begin to see an expansion of service options that may allow incentivized property management to be done on a contract basis.

Overriding operational considerations is often the impact of market practice or practical availability of property for purchase. Certain types of properties (e.g., retail store locations) may be unique and not generally available for purchase, whereas commercial office space may be more fungible and, in some cases, also more available for purchase.

With the loss of off-balance sheet accounting under the new proposed standards, companies that presently lease may instead opt to own. Companies with low leverage and high credit ratings may have a lower nominal cost of capital than traditional real estate lessors – which may create a capital arbitrage benefit for owning rather than leasing in certain cases. Perversely, under the proposed leasing standard, companies with a better credit profile and lower borrowing costs will also show more leverage as a result of the proposals (because of a lower discount rate) for the same lease relative to a company with a lesser credit and higher borrowing costs.

We have already begun to hear of increasing potential purchase transactions involving single-tenant office buildings. It is possible that condominiumization of certain property types may also increase as a result of the proposed lease model.

However, this trend will be affected by “why” the companies are leasing, as discussed previously. It is also likely to vary significantly by property type. For example, this is more likely to occur for longer dated leases in more physically static situations such as individual floors or blocks of floors in large office buildings or with single-tenant retail sites, both of which may be functionally independent. It is less likely to occur in relatively short or moderate duration leases with partial floors or in malls/strip centers which are not functionally independent and may frequently require reconfiguration of space to accommodate a different tenant mix.

Today, in many cases, companies “outsource” their corporate real estate lease administration because commercial real estate service providers offer this service on a cost effective basis. However, the additional information needed to account for leases under the proposed lease model may be sensitive to the company’s lease negotiating position. Companies may be hesitant to allow such service providers to have the necessary access to the information in order to prepare the required accounting documentation.

Economic issues

While some of economic turmoil from the 2008 financial crises has waned, there was a significant negative impact on property values, and in many cases, market rents declined dramatically. Not all of this has been reversed. Vacancy rates for some property types and in some markets are stabilizing, but not uniformly across all property type or markets. Further, many property owners continue to struggle with declining cash flow from operations, liquidity issues, high fit-out costs and to a lesser extent near term debt maturities. As a consequence, landlords may be interested in discussing asset sales and lease modifications—perhaps by trading a lower rent in exchange for a longer lease (i.e., so called “blend and extend” transactions).

Accordingly, the current environment presents both challenges and opportunities for users of corporate real estate. In certain cases, opportunities to buy assets at favorable prices may exist, while in other cases, negotiating rent concessions currently or through “blend and extend” type transactions may yield lower “all-in” occupancy costs. Although these market issues exist irrespective of the potential impact of the new lease accounting model, the impacts of the new lease accounting project focus a spotlight on these opportunities as companies consider the implications of the accounting proposals.

Financing issues

For many industries or individual companies, alternative financing options to leasing may be limited or too expensive. As a result, leasing, historically, may have been the only option available, or, it may have been cheaper than other sources of financing available to the company. In many cases, this will not change irrespective of the accounting ramifications.

However, depending upon the credit quality of the company, corporate real estate departments may now want to reconsider purchasing assets that were previously subject to a lease. When underwriting the amount and terms of a commercial mortgage to a property owner, lenders will consider factors such as debt yields, coverage ratios, loan-to-value, the length of lease terms, likelihood of renewal, and credit quality of the tenant or tenants occupying the property. In some cases, the property owner cannot effectively fund property improvements necessary for the current operation of the property. A corporate real estate user/tenant (lessee) may have a better credit profile and lower nominal cost of capital as compared to a particular property owner/landlord (lessor) or to the “average” credit in a pool of tenants at a site. If the tenant is committed to a longer term use of the property, such tenant may benefit from obtaining financing using its own credit rating versus the landlord’s which may be lower.

Tax considerations

Federal and state tax considerations often played a significant role in many corporate real estate strategic decisions. A clear understanding of the tax motivations and implications for both counterparties in a transaction is critical as these factors may significantly affect the pricing as well as the range of transactions the parties may be willing to consider. In addition, the economic issues affecting either side of a transaction may have radically changed since the decisions were first made. A company with net operating loss carryovers may be more willing to undertake substantial restructuring to accelerate tax benefits or utilize the loss carryovers before they expire. One with expiring capital loss carryovers may be seeking opportunities to generate gains. Tax sensitive transactions by entities with significant owned real estate are generating more interest once again—including sale-leasebacks, joint ventures, spin-offs and real estate investment trust (REIT) conversion transactions.

Even if taxes themselves will remain unchanged in a particular jurisdicition, significant deferred tax adjustments may need to be tracked as the related book amounts change.

Internationally, the proposed lease accounting model may have other impacts on the tax treatment of leasing transactions. In many jurisdictions outside the United States, tax accounting for leasing is often based on accounting used for book purposes. Given that there is no uniform leasing concept for tax purposes, the effect of the proposed lease accounting model will vary significantly, depending on the jurisdiction.

Items that may be impacted include the applicable depreciation rules, specific rules limiting the tax deductibility of interest (for example, thin capitalization rules, and percentage of earnings before interest, taxes, depreciation and amortization rules), existing transfer pricing agreements, sales/indirect taxes and existing leasing tax structures (in territory and cross-border). A reassessment of existing and proposed leasing structures should be performed to ensure continued tax benefits and management of tax risks.

Even where tax does not follow the proposed lease accounting model (like in the United States), management may see an increase in the challenges of managing and accounting for newly originated temporary differences impacting deferred taxes in the financial statements.

There also may be other types of local tax issues associated with the proposed lease standard, such as sales tax or property tax consequences. Companies may need to evaluate the unique tax provisions found in each jurisdiction to determine the various consequences to their particular case due to the proposed leasing standard.

Timely assessment and management of the potential tax impact will help optimize the tax position, by enabling entities to seek possible opportunities and/or reduce any tax exposures.

Regulatory issues

In some cases, the decision to lease was driven by regulatory issues particular to certain industries. For example, reimbursement rates paid on some government contracts are based on financial reporting. Today, for some contracts, a government will reimburse 100% of the cost of rent but does not reimburse for capital related items such as interest and amortization/depreciation of owned real estate. With the proposed elimination of the operating lease model (where “rent” is replaced by amortization and interest – presented as a single line “lease expense” for lease of Property), government contracts and/or reimbursement rules may need to be modified to ensure that the intended economics of the arrangement continue.

Since the standard is still in a proposal phase, additional regulatory effects may emerge when the standard is final and its effects are better understood. What is uncertain at this point is how regulatory agencies will react to the impacts this change will have on risk-based capital requirements and other key regulatory metrics. The effect of the change could be very significant to banks/broker dealers (see also “Intercompany Issues”) and other regulated entities whose capital ratios and/or other metrics are closely monitored and which would be adversely affected in many cases if computed under the proposed model. Historically, banking regulators have not provided much relief for the impacts of such accounting changes.

While the lessor operations of many banks will not be significantly affected, those with large leveraged lease portfolios and significant lessee activity (e.g., bank branches, headquarter buildings, processing centers and automated teller machine locations).

Intercompany issues

Many heavy corporate real estate users utilize a central real estate “holding entity” for owned and “leased in” property and then provide for intercompany charges to the consolidated subsidiaries. In some cases, the structures have been created (i) to take advantage of beneficial pricing (allowing companies to aggregate subsidiary needs to take bigger spaces), (ii) to obtain operating synergies and negotiate better terms and (iii) for operational ease (allowing corporations with multiple subsidiaries to be flexible in allocating space between these units). It also may be driven by tax considerations (e.g., private REITs with beneficial state tax impacts). In some cases, companies executed intercompany leases, but, in others, no formal arrangement existed and costs were allocated through an intercompany expense charge. Under the proposed lease standards, these intercompany transactions will need to be reflected on each consolidated subsidiary’s books and thereby affect them from a regulatory standpoint (e.g., subsidiary broker dealers may be inadequately capitalized). The documentation of the arrangement is likel y to be much more important since it will drive the value of assets and associated liabilities for entities reporting on a stand-alone basis.

Governance, budgetary issues and investment alternative issues

Some historical decisions to lease versus buy may have been driven by approval protocols and budgetary factors. For example, where a company is growing rapidly it might have been faster and more efficient to execute a lease of real estate rather than going through the process to approve the purchase of a capital asset. In addition, internal budgeting may have led to a leasing bias since the upfront cash outlay is much lower than a purchase. If the approval rules follow the new lease model, an operating lease may now need the same level of approval as an outright purchase.

In addition, some decisions to lease may have been driven by a company’s prior alternative investment options for available cash. Today, many companies are holding significant cash balances which are earning only nominal returns. In the near term using some of this cash to buy certain types of assets—especially ones which they expect to utilize for a substantial portion of their lives—instead of paying much higher implicit rates in leases would be accretive to earnings long term. However, because existing leasing activity under today’s operating leases may not be visible to corporate treasury departments, this alternative use of cash may not be in focus and these opportunities may be missed.

Managing corporate real estate

In many organizations today, the corporate real estate department is viewed as more of an administrative function or “cost center” rather than a part of a strategic function or a competitive advantage. Further, corporate real estate departments are frequently undermanned and often do not have the infrastructure or systems to effectively track and manage the real estate for which they are responsible. Additionally, in many cases the information necessary to make various decisions, estimates and periodic re-measurements has not previously been reported to the corporate real estate department on a timely basis (such as changing expectations of renewals).

Further, many companies that operate as a group of decentralized subsidiaries (either domestically or internationally) or ones which have grown larger through acquisition with significant legacy systems used in many places are often “balkanized” thus limiting management’s ability to understand and manage real estate on a company-wide or even country-wide basis. Such systems are neither optimal for a company’s current operations nor are they fully integrated into the larger enterprise-wide systems, including accounting and reporting. In addition, because of the length of a typical real estate lease, current management may not be aware of the original rationale for specific decisions, some of which may no longer exist due to changing circumstances. Changing this environment to a more centralized one may require significant cultural changes that may not be easy to accomplish.

In some cases, corporate real estate departments may have the responsibility for tracking the real estate but not enough resources and focus to (1) identify and manage excess capacity, (2) identify and seek reimbursement for overcharges for lease operating costs (e.g., Common Area Maintenance and bill back overcharges) and/or (3) minimize other cash real estate occupancy costs. Finally, for many companies, existing tracking systems are informal, incomplete or inaccurate. These "tracking systems" might be nothing more than a drawer for storing copies of leases, a notebook containing lease abstracts, spreadsheets and non-integrated or out-of-date software applications.

Few companies today track their owned real estate in a manual fashion. Yet, many companies are still accounting for their leases of corporate real estate using spreadsheets and accounts payable systems with no formal corporate real estate asset management system for these leased properties. Even for the more sophisticated corporate real estate groups that have asset management systems, these systems are often freestanding and utilized more for lease administration purposes, with no integration with the company's accounting systems.

Management of the accounting changes may be possible for some companies without significant upgrades or integration, but to do so may miss an excellent opportunity to automate a previously labor-intensive activity and free up employees for other more productive uses. Under the new proposals which will require ongoing re-evaluation, measurement and need to split and track non-lease items. This makes leasing a prime target for systems support and automation.

The new lease accounting model requires many judgments in its application and significant changes in the calculations prospectively (including new amortization schedules). From a long-term sustainability perspective (for companies with substantial leasing activities), spreadsheet based accounting will not be practical because of the significant maintenance required and resultant susceptibility to error. High-volume corporate real estate users will likely need new systems/processes to create a documentation trail of the judgments and changes in estimates made. The system will also need to be largely automated to make the necessary computational adjustments resulting from changes in estimates. Full integration into the company's control structure and accounting systems will be necessary as will the ability to create extensive quantitative disclosures that are mandated in the new accounting model.

Internal controls and processes

Many entities in the past have not needed robust processes and controls for leases other than those surrounding their initial classification. In addition, the existing lease accounting model (absent a modification or exercise of an extension) did not require leases to be periodically revisited. The proposed new standard would require that leases should be re-measured for changes in estimates (for example, for changes in expected lease term or for changes in future payments as a result of a change in an index such as CPI or interest rate on which future payments are based) and will require entities to design or redesign processes and controls to ensure proper management and accounting of all lease agreements.

Initial recording on balance sheet and annual reassessment of lease terms and payment estimates based on an index or rate may require significant and complex changes to existing processes and internal controls, including support for significant management assumptions. Monitoring and evaluating the estimates and updating the balances may also require more personnel resources than required by the current accounting.

Timely assessment and management of the impact on processes, controls and resource requirements will help reduce reporting risks. This includes the related areas of tenant improvements, impairment valuation and tax accounting.

IT and lease accounting systems

IT and lease accounting systems in the marketplace are based on the existing risks and rewards concept. They will need to be modified to the proposed right-of-use concept. Systems designed to meet the needs of this potential new standard do not currently exist – although some systems may capture some or all of the underlying data that may be needed to do the necessary computations. Development and implementation of suitable new modules or systems is likely to have a significant lead-time. Lessees will have to account for and manage lease agreements differently (including existing operating lease agreements). They may need to implement contract management systems for lease agreements and integrate these with existing accounting systems. Lessees will need to identify and implement IT and accounting solutions that meet their future needs. In addition, if a company also has significant subleases, additional complexities will arise, as the company will be applying both lessor and lessee accounting.

Lessees may expect lessors to provide them with the necessary information to comply with the proposed standard. However, lessors may not have, or may be unwilling to provide, data required by lessees. Consequently, lessees will need to capture such information themselves and may need to modify their systems accordingly.

Timely assessment and management of the impact on IT and lease accounting systems will help reduce business and reporting risks. We understand that some of the ERP systems providers are in the process of evaluating upgrades and solutions that will allow for an integration of the accounting for the new lease standard and potential controls thereon, however, such discussions are only at their conceptual and planning phases pending final accounting guidance.

Financial reporting and impact on ratios

The financial statements will require restatement for the effect of the changes. The effects of the proposed lease accounting model should be clearly communicated to analysts and other stakeholders in advance.

Ongoing accounting for leases may require incremental effort and resources as a result of an increase in the volume of leases recognized on balance sheet; there is also likely to be a need for regular reassessment of the lease term, contingent rentals based on an index or rate, residual value guarantees, or the impact of purchase options.

The impact of the change will not be restricted to external reporting. Internal reporting information, including financial budgets and forecasts, will also be affected.

The proposed lease model will change both balance sheet and income statement presentation. Leverage and capital ratios may suffer from the gross-up of balance sheets.

For "Type A leases" (including most equipment leases) – Rent expense for Type A leases will be replaced by depreciation and interest expense (with inherent Front loading). In addition, the expense recognition pattern will change significantly. This will negatively influence some performance measures, such as interest cover, but perversely improve others, such as EBIT/ EBITDA and cash flow from operations, all with no change in the underlying cash flows or business activity. In addition, continuous re-measurement will increase volatility in these key ratios. These ratios may no longer be useful for their historical purposes and other operating metrics may evolve as a result of the adoption of the new standard.

For Type B leases (including most property leases) – The total expense may be the same as today's operating lease accounting. However, that may not always be the case for example – (i) if the lease term (including more escalation periods) is different under the new model or (ii) if prior rent expense included amortization of deferred gains on qualified sale leasebacks which may no longer be deferred under the new model.

Timely assessment of the proposal's impact on covenants and financing agreements will enable management to start discussions with banks, rating agencies, financial analysts and other users of the entity's financial data. Entities anticipating capital market transactions should consider the effects on their leverage ratios. There is speculation that new metrics will be created for debt service coverage ratios that neutralize these effects, although it will likely take some time for these changes to take effect. Other agreements based on (entity-specific) key performance indicators will require reassessment and, potentially, adjustment (for example, compensation agreements). Companies in the process of negotiating new or existing agreements should seek provisions in the agreements that specify how changes in financial reporting impact financial covenants (i.e., whether covenant calculations are always based on then-current financial reporting or on financial reporting that was in effect when the agreements were signed).

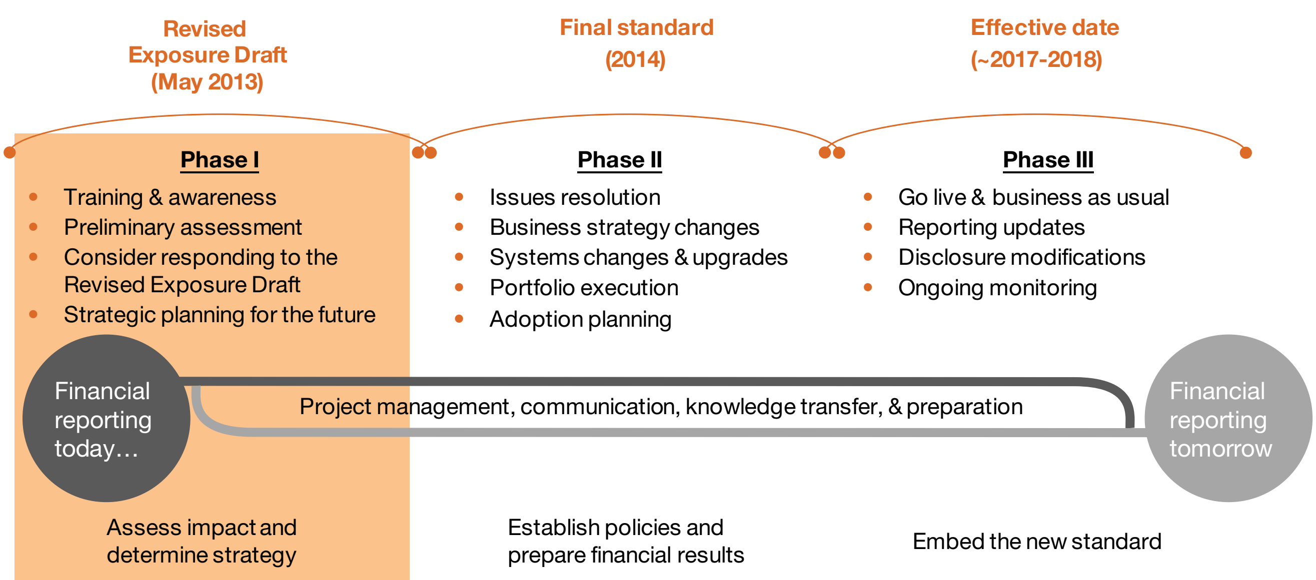
Next steps

The proposed lease standard is not expected to allow for grandfathering of existing leases (with the exception of existing capital leases, which effectively will be allowed to run their course). Accordingly, prior to adoption, management will need to catalogue existing leases and gather data about lease term, renewal options and payments in order to measure the amounts to be included on balance sheet. Gathering and analyzing the information could take considerable time and effort, depending on the number of leases, the inception dates and the availability of records. In many cases, original records may be difficult to find or may not be available. Other factors like embedded leases which had not been a focus before will need to be identified and recorded. In addition, companies with international operations may need to deal with leases written in different languages and with the potential impact of local statutes in applying the standard. For example, in France certain local statutes provide the lessee with an automatic rent controlled renewal option irrespective of whether one is contained in the lease agreement itself.

Given all of the above, the new standard will necessitate potentially significant cultural changes as well as significant operational ones. While the adoption of the new standard remains at least three years away, organizations are well advised to begin considering the impact of these changes now, and to put into motion the steps needed to prepare the organization for the change.

The chart below depicts a potential transition plan with respect to evaluating the effects of the proposed lease model. Incremental corporate real estate strategy and systems changes would be performed concurrently with this plan.

Proposed timeline



Preparing for the change

- ❑ Educate key business leaders about the issue.
- ❑ Create a cross functional "steering committee" to address standard and transition.
- ❑ Perform an inventory of your lease portfolio – understand what types of assets are leased and where the data resides.
- ❑ Identify contracts likely to include embedded leases.
- ❑ Consider modelling the transition impact on certain significant leases (or sample from a variety of lease types).
- ❑ Summarize existing systems and future needs.
- ❑ Evaluate sufficiency of existing control processes and potential gaps.
- ❑ Analyze potential income and other tax considerations (including federal, state and foreign taxes).
- ❑ Identify contracts affected by the change in accounting (e.g., financial covenants, compensation agreements, earn-outs, etc.), the potential implications and how terms should be modified in future.
- ❑ Identify regulatory issues affected by the change in accounting (e.g., regulatory capital implications and cost plus government contracts), the potential implications and how terms should be modified in future.
- ❑ Consider potential changes in real estate leasing strategy (e.g., lease/buy, shorter vs. longer leases, modify common terms, etc.).

The lease proposals will clearly have significant impact on many organizations. As discussed in this document, the proposals, if enacted, will necessitate changes in the technical accounting, operational processes, and systems of many companies. We also believe that they may cause many to reconsider how the corporate real estate role can become a strategic driver of success, thereby providing the "Catalyst for Change in Corporate Real Estate."

Beginning the process early would ensure that implementation of a future standard is orderly and well controlled and that data on new leases written before implementation of the changes is captured from the outset. In addition, it may allow entities to consider potential adoption and negotiation strategy changes for new leases and the potential renegotiation of existing agreements in order to reduce the impact at adoption.

Key takeaways on transition

Be strategic: Planning your transition will go much more smoothly if you have concrete data to work with. Modeling selected leases will give you relevant data to share with internal constituents. It will also help you understand what data you have, what data you need and how your leasing strategy may need to change to minimize the adverse accounting impact of the standard.

Manage market reaction: For many significant users of real estate (e.g., retail companies), managing investor and other user relations during the transition will be critical. The issuance of the Revised Exposure Draft has created a significant buzz and analysts and shareholders are likely to start raising questions about the potential impact. Traditional operating metrics such as EBITDA used as proxies for free cash flow may no longer be as relevant and in certain cases will likely need to be replaced. In part, this may depend on how combined lease, expense is treated for EBITDA purposes, i.e., similar to rent today or broken into its component pieces of interest and amortization. Longer term, the inherent volatility financial statement, in addition to significant changes in presentation and metrics, will require thoughtful communication.

Don't wait: In our discussions with clients, many expect adoption to take from 12-24 months. While the adoption timetable will vary by company, most believe adoption will be complex and time consuming. Targeted and measured steps today will help you understand the complexity and duration of the transition effort and more importantly, what steps you can take today to modify existing or planned leases to minimize the effort of complying with the new rules.

How can PwC help?

PwC has multi-disciplinary teams of specialists who can assist you with all aspects of your corporate real estate journey.

Real estate and accounting advisory

- Training, planning and implementation assistance with regard to new lease standard
- Analysis of needs and market trends
- Data collection and verification
- Analysis of, or assistance with, evaluating financial and strategic impact of new lease standard

Tax and transaction support

- Analysis of tax implications and structuring opportunities with respect to new lease standard
- Sale-leaseback transactions
- REIT spin-offs of corporate real estate to unlock shareholder value
- Federal and state tax planning transactions systems and processes

Systems and processes

- Process/control change consulting/implementation planning with respect to impact of new lease project
- Strategic information systems planning
- Gap analysis & system selection
- Technology integration & implementation

Operational effectiveness and cost containment

- Lease expense "audits" for potential recovery
- Process re-design & leading practices in corporate real estate
- Benchmarking and performance monitoring
- Spend analysis, strategic sourcing, outsourcing effectiveness
- Operational & organizational effectiveness

Valuation/market analysis

- Real estate and lease portfolio valuation
- Market studies
- Valuation analyses in conjunction with accounting requirements

Where to find additional information

If you would like further information on the proposed lease accounting model or assistance in determining how it might affect your business, please speak to your regular PwC contact. A list of PwC contacts has also been provided on the back cover of this publication.

Additional Information:

Appendix A: Detailed discussion of the revised exposure draft from a lessee's perspective

Appendix B: Detailed application examples

Appendix C: Impact on common real estate lease provisions on lessees

Authored by:

Tom Wilkin
Partner
Phone: 1-646-471-7090
Email: tom.wilkin@us.pwc.com

Lou DeFalco
Senior Manager
Phone: 1-312-298-3476
Email: louis.defalco@us.pwc.com

Appendix A: Detailed discussion of the revised exposure draft from a lessee's perspective

Status of the proposed new leasing standard

This Appendix summarizes the FASB and IASB's Revised Exposure Draft ("revised ED"), Leases, issued on May 16, 2013. The comment letter period ends on September 13, 2013. Depending on the feedback obtained from the comment letter process the Boards may redeliberate certain provisions to address concerns of constituents. Issuance of a final standard and determination of the effective date is unlikely before 2014. The adoption date has not been discussed, but it is unlikely to be earlier than 2017. The provisions of the revised ED are subject to change until a final standard is issued.

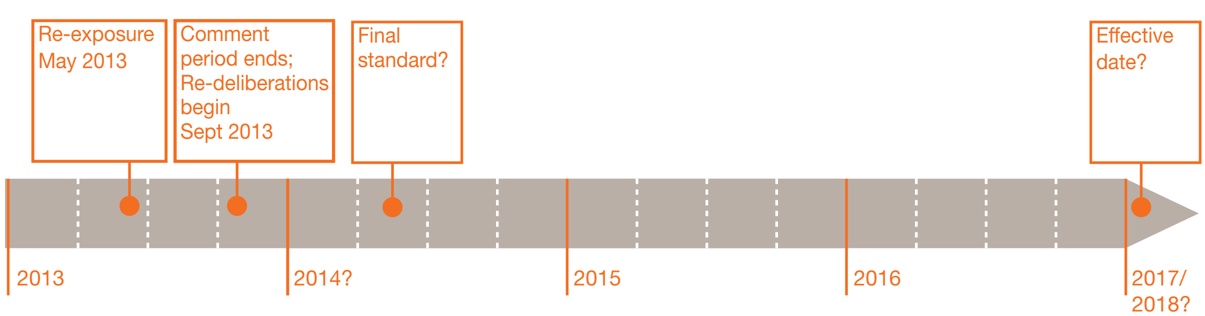
Background

Leasing is an important and widely used source of financing. It enables entities, from start-ups to multinationals, to acquire the right to use property, plant, and equipment without making large initial cash outlays. Lessees currently account for leases as operating leases or capital leases. Lease classification is based on complex rules. Though many operating leases provide nearly the same risks and rewards as outright ownership, neither the leased asset nor the obligation to pay for it is recorded on the balance sheet. Rather, rent expense is recorded on the income statement on a straight-line basis throughout the lease term under current GAAP. Many observers have long believed that the current lease model is not consistent with the conceptual framework, which provides the underpinnings for accounting rules. They argue that current guidance allows lessees to structure lease transactions to result in operating lease classification, resulting in off-balance sheet treatment. Critics also point out that the current standards permit something as illogical, for example, as a commercial airline company avoiding recognition of airplanes on its balance sheet.

As part of their global convergence process, the Boards have been working to create a single, comparable, worldwide leasing standard. The project was intended to build on previous work contained in the 1999/2000 white paper entitled "G4+1 Special Report, *Leases: Implementation of a New Approach*." The Boards issued a joint discussion paper in March 2009, which included possible changes to lease accounting. The initial exposure draft ("initial ED") published by the boards in August 2010 was a follow up to a discussion paper published in March, 2009. In early 2011, the boards began redeliberations to address concerns raised in the initial comment letter process. Because of the significant changes agreed to in redeliberations, in mid-2011, the Boards announced they would reexpose the standard. Redeliberations lasted for more than two years and involved several reversals along the way. After substantively completing redeliberations, it took almost a year to issue the revised ED. The boards issued the long awaited revised ED on May 16, 2013 with a 120-day comment period (comments are due on September 13, 2013). While there is no effective date contained in the revised ED, it is unlikely to be prior to 2017.

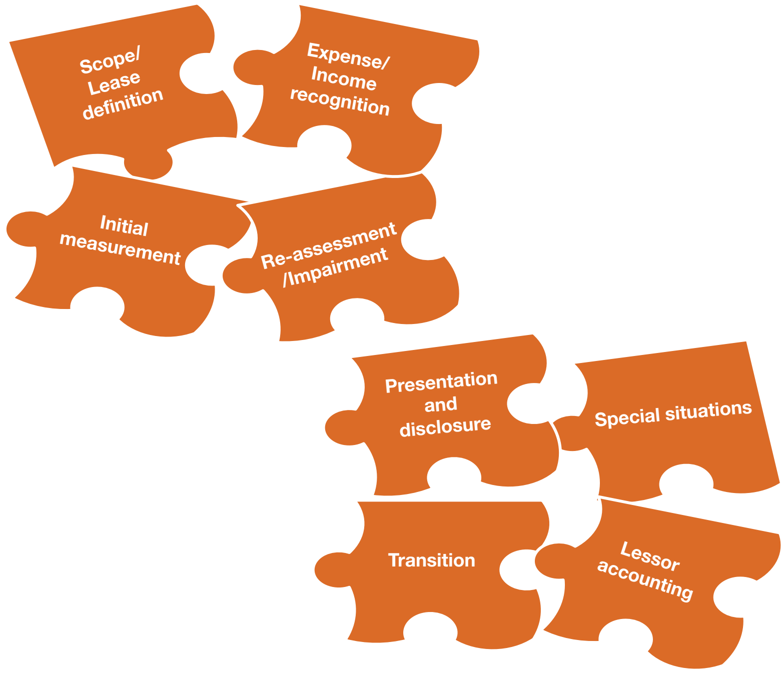
The timeline

The project timeline and reasonable reaction time periods for tenants/landlords to evaluate potential impacts are as follows:



The leases puzzle

The revised ED proposes changes to both lessee and lessor accounting. Lessors and lessees will have to apply most of the proposed standard's scope, concepts, definitions and judgments similarly. However, the proposed standard is likely to impact lessees' financial statements significantly more than lessors. Accordingly, while many of the descriptions in this Appendix also apply to lessors, the Appendix is written principally for real estate lessees, with only a high level overview of lessor considerations. This Appendix puts together the pieces of the puzzle to understanding the proposed model for lease accounting, with an emphasis on lessee accounting.



Scope and definition of a lease

Scope

The proposals in the revised ED would be applicable to all leases, with the exception of the following:

- Leases of intangible or biological assets; and
- Leases to explore for or use minerals, oil, natural gas and similar nonregenerative resources.

Definition of a lease: general concepts

The proposal defines a lease as "a contract that conveys the right to use an asset (the underlying asset) for a period of time in exchange for consideration." The legal form does not matter—a lease can be embedded in a larger arrangement such as a service contract and may need to be broken out and accounted for separately from the other elements of the contract. This requires assessing when:

- The fulfillment of the contract depends on the use of an **identified asset**; and
- The contract conveys the **right to control** the use of the identified asset for a period of time in exchange for consideration.

PwC observation: There is likely to be a greater focus on identifying whether an arrangement is or contains a lease, or several leases. Although many contracts are written legally as leases, other contracts contain the characteristics of lease but are not identified as such. In addition, certain arrangements may contain embedded operating leases. Currently, lessees often do not separate the embedded lease from the contract because the accounting for an operating lease and a service/supply arrangement has generally been similar, i.e., there is no recognition on the balance sheet and straight-line expense is recognized over the contract term. Because of the need to recognize virtually all leases on the balance sheet, and the potentially different income/expense recognition patterns, lessees will likely need to identify and separately account for embedded leases. If the contract includes both a lease and a service (or other non-lease executory components), contract consideration will need to be allocated to the components.

Separating components of a contract

After determining that a contract contains more than one leased asset, an entity would then need to determine which components (asset or group of assets) are subject to evaluation under the guidance in the revised ED.

An asset is evaluated and accounted for separately if both of the following criteria are met:

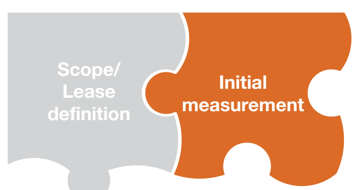
- The lessee can benefit from the use of the asset either on its own or together with other resources that are readily available to the lessee. Resources that are readily available are goods or services that are leased or sold separately or resources that the lessee has already obtained. These resources can be obtained from either the lessor or another supplier.
- The underlying asset is neither dependent on nor highly interrelated with other underlying assets in the contract.

A group of assets that must be used together would not meet the above criteria and would be accounted for as a single component.

Some components may have the characteristics of both property and non-property, e.g., a building with an electrical generator. In such cases, the entities would determine whether to apply the guidance applicable to property or non-property on the basis of the "primary asset" in the component. The primary asset would be the predominant asset for which the lessee has contracted the right to use. The primary asset will determine which classification model would be used for expense/income statement recognition. The presumptions used to determine income statement classification differ for property and non-property leases as explained in further detail in the expense/income statement recognition section of this Appendix.

PwC observation: Under the proposal, it would not be uncommon for a single lease agreement to contain multiple components. For example, a master lease of 300 laptop computers would likely result in 300 distinct lease components, i.e., 300 separate units of account. However, the income statement presentation would be the same for each component since each one has the same primary asset type for classification purposes.

A lease that contains a bundle of assets, e.g., land, building, integral equipment, and furniture, requires judgment to determine the number of lease components and the primary asset for each component. In this example, there could be three components (land/building, integral equipment, and furniture) or there could be two components (land/building/integral equipment and furniture). Once the components are identified, the pattern of expense recognition is dependent on the nature of the primary asset in each component.



Initial measurement

General concepts

One of the most significant impacts of the proposed standard will be the impact on the lessee's balance sheet. At the commencement date (the date on which the lessor makes the underlying asset available to the lessee), a lessee would be required to record:

- **A lease liability equal** to the present value of the lease payments to be made during the lease term, discounted using the rate that the lessor charges the lessee. If this rate is not available, the payments would be discounted using the lessee's incremental borrowing rate; and
- **A right-of-use asset** measured at the initial measurement amount of the lease liability, plus any lease payments made to the lessor at or before the commencement date (less any lease incentives received from the lessor), and any initial direct costs.

PwC observation: A core principle of the project has been that lease contracts give rise to assets and liabilities that must be recognized on the balance sheets of both lessees and lessors. Measuring the right-of-use asset and lease liability at the commencement date rather than the inception date would simplify today's guidance, especially in build-to-suit leasing transactions.

Short-term leases—Policy election

Lessees would have the ability to elect to account for leases that have a maximum possible term of 12 months or less (including any options to renew or extend), in a manner similar to today's accounting for operating leases. Rent-free periods would also be considered when determining if the lease is short-term. Lessees would make an accounting policy choice to follow the simplified short-term lease guidance on an asset class basis, i.e., it would need to be consistently applied to all assets in that class. A different policy may be applied to different asset classes.

PwC observation: This simplification for short-term leases will alleviate the burden of identifying and tracking short-term leases at each reporting period and may alleviate the need to determine if certain short-term contracts include an embedded lease.

Since different elections may be made for each asset class, entities may elect to apply the new guidance to individually significant leased assets, e.g., drilling rigs, but then elect to apply the simplification to insignificant short-term leases, such as a short-term auto lease or a standard 1 year apartment lease.

Calculating the initial lease liability and right-of-use asset

In order to calculate the lease liability and the right-of-use asset ("ROU asset") a lessee would perform the four steps described below. See also Example 1 in Appendix B.

Step 1) Determine the lease term

The lease term is the non-cancellable term of the lease plus any options to extend or terminate when a significant economic incentive to exercise exists. A lease is cancellable when the party evaluating its right to terminate the lease can do so without permission from the other party and with no more than an insignificant penalty.

An entity should consider all contract-based, asset-based, entity-based, and market-based factors together in assessing whether a lessee has a significant economic incentive to exercise an option. The assessment will often require the consideration of a combination of factors since the stated indicators are often interrelated.

As detailed in the proposal, the factors that a lessee should consider when assessing whether the threshold of significant economic incentive has been met are:

- Explicit contractual terms that could affect whether the lessee exercises the option when compared to market rates, such as the amount of lease payments in any optional period (discounted, market, or fixed rate);
- The existence or amount of any variable lease payments or other contingent payments under termination penalties or residual value guarantees;
- The terms and conditions of any options that are exercisable after initial optional periods, e.g., the impact of a fixed-price purchase option that is only exercisable at the end of an extension period;
- Leasehold improvements that are expected to have significant economic value to the lessee when the option to extend or to purchase the asset becomes exercisable but which would have no value if the lease were not extended. This may be because the lessee has to walk away from the leasehold improvements when the lease ends. Where the value of those leasehold improvements is significant, the lessee may be compelled to exercise the option to permit its continued use of those leasehold improvements, creating an economic incentive to exercise;
- Costs associated with returning the underlying asset to a contractually specified condition or location, e.g., the acceleration of an asset retirement obligation; and
- The importance of the underlying asset to the lessee's operations considering, for example, whether the underlying asset is a specialized asset or the unique location of the underlying asset make it highly likely that the extension options will be exercised, e.g., so called "mission critical" assets.

PwC observation: One of the primary reasons for initially including many more extension options under the original exposure draft using a "more likely than not threshold," and not limiting the accounting to the non-cancellable lease term, was to limit the potential for structuring opportunities. For example, a 10-year lease of property could be structured with a one year non-cancellable term and nine, one year renewal options. With the requirement to consider the costs attendant with leaving after year one, it will be much harder to structure around a desired outcome either initially, or as those incentives change over the lease term. In practice, structuring a short non-cancellable initial term is costly, and perhaps impractical, as the lessor would charge a significant premium to compensate for the uncertainty regarding the lease term and to ensure it recovers its investment in tenant specific improvements.

In reassessing the threshold for including extension options from the initial ED, the boards made a practical compromise that is less complex and more operational while still providing reasonable protection against structuring concerns. The threshold is relatively consistent with today's consideration of renewal terms, i.e., when they are "reasonably certain" of being exercised, but still represents an ongoing requirement rather than today's "set it and forget it" model.

Step 2) Identify the lease payments

The table below details what would be included or excluded from the definition of lease payments:

Included	• Fixed payments, less any lease incentives receivable from the lessor. • Variable payments that are initially based on a rate or an index at lease commencement (these payments are subsequently re-measured based on changes in the rate or index). • “Disguised” or “in-substance” fixed lease payments. • Any portion of residual value guarantees that are expected to be paid, except for amounts payable under guarantees provided by an unrelated third party for lessees. While the lessees’ liability includes only the portion of the guarantee they are expected to pay. The exercise price of a purchase option if the lessee has a significant economic incentive to exercise that purchase option, e.g., a bargain purchase option. • “Term option penalties” should be included in a manner that is consistent with the accounting for options to extend or terminate a lease. For example, if a lessee would be required to pay a penalty only if it does not renew the lease and the renewal period is excluded from the lease term, then that penalty should be included in the recognized lease payments.
Excluded	• Variable lease payments that are usage or performance-based, e.g., based on the number of miles a leased car is driven, unless the variable lease payments are “disguised” or in-substance fixed lease payments. • “Term option penalties” should be excluded in a manner that is consistent with the accounting for options to extend or terminate a lease. For example, if a lessee would be required to pay a penalty only if it does not renew the lease and the renewal period is **included** in the lease term, then that penalty should be excluded from the recognized lease payments. • Non-lease components lessees would allocate payments between lease and non-lease components based on their relative observable standalone purchase prices. If the purchase price of one component is observable, the residual method can be used to determine the price of components with no observable purchase prices. However, when there are no observable prices for any of the components, lessees must account for the entire contract as a lease.

Lease and non-lease component

Lessees would allocate payments between lease and non-lease components. Depending on the type of lease, this allocation may require significant judgment.

The following types of leases are common with respect to real estate:

- **Net lease**: These types of leases are common for a retail/industrial property and a single-tenant property where the tenant is billed by the lessor for executory costs incurred (typically on a pro rata basis for multi-tenant properties) or such costs are paid directly by the tenant.
- **"Modified gross" or "base year" lease**: These leases are common for office property where the tenant's rent is set during the first year of the lease, i.e., the "base year," which includes executory costs (on a pro rata basis for multitenant leases). In subsequent years, the tenant pays additional amounts for executory costs to the extent they exceed the tenant's pro rata share of the aggregate of those expenses in the "base year."
- **Gross lease**: The quoted base rent includes all executory costs. In many cases, especially for real estate, a tenant neither knows nor cares what these executory costs are – its focus is solely on the all-in costs of occupancy.

PwC observation: Separating non-lease elements will desirable for lessees since including them would increase the measured asset and liability. However, depending on the type of lease, this may require some effort and judgement.

In some cases, the determination of lease and non-lease components will be relatively straightforward. as they are either already separately billed (net leases) of are included in the lease at stated a ggregate amounts plus additional billed esclations over that amount (i.e., modified gross/base year leases).

Gross leases have historically been very simple. However, with the new requirements under the revised ED, judgment will be needed to allocate payments between the lease and non-lease components. We recommend that a lessee obtain the amounts being billed for these services from the lessor or make estimates of these amounts using market-based information.

Variable lease payments

The revised ED changed the proposals to generally include in the measurement of lease assets and lease liabilities only variable lease payments that either depend on an index or a rate or are in-substance fixed payments, rather than requiring the inclusion of an estimate of all variable lease payments.

Variable lease payments based on a rate or index would initially be measured using the index or rate at lease commencement. For example, leases with payments based on LIBOR would use the LIBOR spot rate on the lease commencement date to measure all lease payments.

Leases with payments that change based on a consumer price index (CPI) would not use the expected rate of change in that index. Thus, a lease with fixed payment increases of 2% per annum as a proxy for inflation would include such adjustments in the initial measurement, while a lease with rental increases based on changes to CPI (even though it may be expected to increase at the same rate of 2% per annum) would not. In the latter case, subsequent changes to the index would result in an adjustment to the asset and liability once the actual increase is known. The adjustment would consider all future payments subject to the escalation.

PwC observation: The proposal strikes a balance between the complexity of including contingencies and the concern over structuring opportunities if all contingencies were excluded. The elimination of the requirement to estimate future changes in variable payments using a probability-weighted approach, as proposed in the initial ED, would improve operationality of the standard. However, there will still be significant complexity related to the treatment of variable lease payments upon the re-assessment of lease payments (see the re-assessment section of this Appendix.

However, ariable lease payments that are usage or performance-based, e.g., percentage rent, are not included in lease payments, unless the variable lease payments are "disguised" or in-substance fixed lease payments. Expenses related to variable lease payments would be recognized in the period in which the obligation for those payments is incurred.

PwC observation: Determining whether a contingent payment is a "disguised" or an in-substance fixed lease payment would require significant judgment. The proposal includes examples of in-substance fixed payments to clarify the principle. The examples provided in the revised ED, however, each involve transactions in which the lessee would be required to make significant payments in the event the contingency requiring the variable payment does not occur. The boards also discussed the fact that payments associated with certain arrangements with only variable lease payments would not be considered in-substance fixed payments. Examples include lease payments based solely on a percentage of sales, e.g., a retail store, or based on output, e.g., wind or solar farms.

However, careful consideration would need to be given to these arrangements, particularly when such payments are inconsistent with norms for the asset or industry. If the terms of the agreement include payments that are virtually certain, these may require inclusion.

Step 3) Determine the appropriate discount rate

The implicit rate is the rate that the lessor charges the lessee. Lessors price the lease based on a variety of factors, typically taking into account the nature and expected residual value of the asset, duration, payment terms, credit risk and other relevant factors, e.g., inflation. Cash value and expected residual are necessary to determine the implicit rate.

The lessee may not know or be able to calculate the rate implicit in the lease. For example, the lessee may not know the expected residual value of the asset at the end of the lease, or may not know the lessor's tax considerations. Accordingly, absent knowledge of the implicit rate, the lessee should use its incremental borrowing rate at the lease commencement date. The lessee's incremental borrowing rate is the rate of interest that a lessee would have to pay to borrow over a similar term, payment profile and security, the funds necessary to obtain an asset of a similar value to the right of use asset at lease commencement.

PwC observation: Lessees are not obligated to seek out the rate the lessor is charging in the lease. The rate the lessor is charging is more likely to be identified in equipment leases, particularly when the lease contains a residual value guarantee, or when the equipment may also be purchased outright. When determining an implicit rate, a lessee should not make blanket assumptions for different type of arrangements. For example, it would not be reasonable to assume the discount rate for a 10-year lease of generic office space in New York is the same as a 20-year lease of a unique industrial asset in a remote location in Russia. For real estate leases with rents based on cost per square foot, the lessee rarely knows the implicit rate that the lessor is charging because it is typically not relevant to the negotiations.

Nonpublic entities may elect an accounting policy to use a risk-free discount rate with a term comparable to that of the lease term.

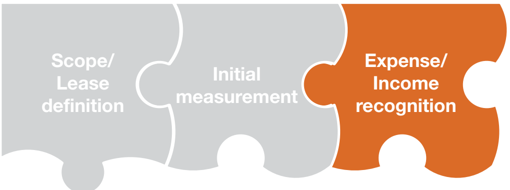
PwC observation: Private companies with no third party debt, and group entities where lease arrangements are executed by different subsidiaries, may find determining the incremental borrowing rate more challenging. We have heard from many preparers that they believe more guidance should be provided on how to assess the appropriate discount rate in these and similar circumstances. As noted above, private companies can elect to use the risk-free discount rate. However, if this rate is used, it will cause the lease liability and right-of-use asset to be higher as compared to when the incremental borrowing rate is used.

Step 4) Identify the additional elements of the right-of-use asset

In addition to the lease liability amount, the right-of-use asset includes any lease payments made to the lessor at or before the commencement date (less any incentives received from the lessor), and any initial direct costs (net of any reimbursements by the lessor).

Initial direct costs are defined as costs that are directly attributable to negotiating and arranging a lease that would not have been incurred had the lease transaction not been entered into, e.g., commissions, legal fees, payments made to existing tenants to obtain the asset for lease, preparing/processing lease documents and negotiating the lease terms.

Prior to lease commencement, lease payments made to the lessor at or before lease commencement, less any cash lease incentives received from the lessor, would be recognized by the lessee as prepaid assets.



Expense recognition

General concepts

Determining the lease type

At the commencement date, the lessor and lessee would be required to classify a lease as either Type A or Type B. This classification would not be re-assessed after the commencement date unless there is a contract modification.

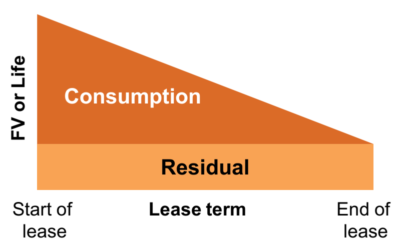
After much debate, the boards observed that most leases contain an element of financing merely as a result of the fact that they provide for payments over time. However, certain types of leases are inherently more consistent with financing arrangements because the value of asset is largely "used up" by the lessee during its usage period (referred to as "consumption"). The boards discussed various single model methods of accounting for this "consumption of the asset" but ultimately concluded that such models would be overly complex in application. Accordingly, the proposal includes a dual model for expense/income recognition based on the nature of the leased asset and the lessee's presumed "consumption" of that asset.

Under the dual model – virtually all leases will be recognized on the balance sheet; however, there is a distinction in the expense recognition pattern, with a front-loaded financing recognition pattern for some leases (the "Type A") and a straight-line pattern (the "Type B") for others. The determination of which approach to apply is based on a "principle" of consumption (illustrated below) with a practical expedient based on the nature (property or non-property) of the underlying asset. In trying to simplify the application, the boards considered broad types of assets and whether they would generally be considered to be consumed in a fashion that would significant affect pricing (and therefore more like a financing). After much discussion, they concluded that most equipment leases would likely be consumed to a degree whereas property leases would not. Accordingly, they created practical expedients where by leases other than property are presumed to be Type A leases while leases of property are presumed to be Type B leases.

Property is defined in the proposal as "land or a building, or part of a building, or both." As illustrated below, leases for other than property are presumed to be Type A, while property leases are presumed to be Type B.

Consumption based principle

Other than property (Type A)



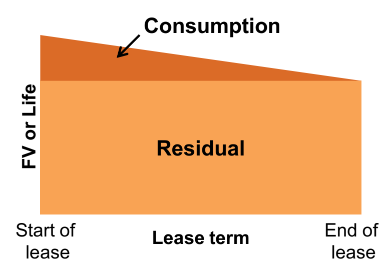
Pricing

Lease payments designed to provide return on and of (i.e. principal) lessor's investment down to residual

Presumption

Asset consumed

Property (Type B)



Pricing

Lease payments designed predominantly to provide return on investment

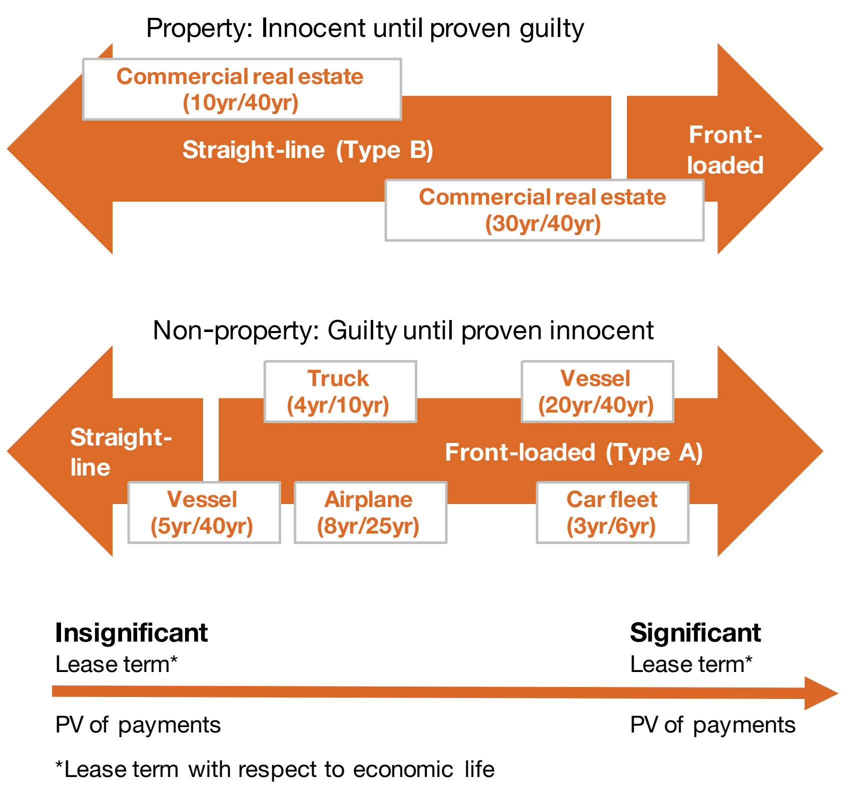
Presumption

Asset not consumed

The principle depicted in the illustration above is based on a presumption by asset type. In order to reduce cost and complexity in applying the principle, the boards created a "practical expedient" under which the presumptive treatment of property and other than property would likely result in what the boards perceived to be the appropriate classification of most leases of those broad categories. However, the presumption can be overcome in some circumstances. See the table below for factors to overcome the presumption.

Asset type	Presumption	The presumption is overcome if the following factors exist:
Non-property	Type A	• The lease term is an insignificant portion of the underlying asset's economic life; or • The present value of the fixed lease payments is insignificant relative to the fair value of the underlying asset.
Property	Type B	• The lease term is for the major part of the underlying asset's economic life; or • The present value of the fixed lease payments accounts for substantially all of the fair value of the underlying asset.

The following illustration depicts the dual model as discussed above. In determining type which approach to apply, significant judgment would be required to determine what constitutes "major," "substantially all" and "insignificant."



PwC observation: While the creation of Type B lease accounting had been welcome news to many real estate lessees and lessors, the decision to introduce a new dividing line into the model is likely to continue to generate significant interest and debate, given that some of the project's objectives were to have a single model to apply to all leases and to remove the existing "bright-lines" between operating and capital leases.

When evaluating the practical expedient, it is unclear whether the intent was to use qualitative and/or quantitative (e.g., 90%, 10%) thresholds. For example, when assessing long-term land leases, e.g., those greater than 25 years, a quantitative analysis would likely indicate the lessee is paying for "substantially all" of the fair value of the underlying asset and would imply that Type A classification is appropriate. However, this would be inconsistent with the underlying concept of consumption as well as current accounting.

Under US GAAP today, "integral equipment" is considered "real estate" and is subject to the scope of various real estate-related accounting standards. This could include telecommunication tower lessors, who view their business as similar to other lessors of multi-tenant property (such as office buildings or other commercial property types). Accordingly, many US constituents would like to view "integral equipment" as "property" for purposes of determining which model to apply. The concept of integral equipment does not exist internationally, but the boards' discussed this issue as part of re-deliberations on the revised exposure draft.

The boards did not replace or expand the definition of property to encompass the more expansive US concept. Instead, the boards decided to provide the application guidance for those leased assets that have multiple components by suggesting that lessees and lessors would need to determine the "primary asset" involved in the leasing transaction when evaluating the dividing line.

There has been some discussion at the IFRIC on these issues, however, no changes have been proposed. The IASB may consider an amendment to IAS 40 to clarify these issues.

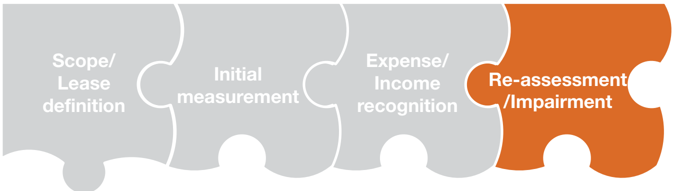
PwC observation: The narrow definition of "property" rather than "real estate" could be significant to many lessees. It may introduce some application difficulties and may produce results that certain lessees and lessors do not believe will faithfully represent the economics of their leasing transactions. While this item could impact both lessees and lessors, it will be particularly concerning for certain lessors due to the complexities involved in applying the receivable and residual approach to multi-tenant assets, e.g., cell towers.

Lessee expense recognition

The following tables detail the dual expense recognition model for lessees under the revised ED:

Type A lease (presumed for leases of assets other than property)	
Interest expense	• Recognize interest expense by unwinding the present value "discount" on the lease liability using a constant rate of interest. Interest expense will be reported separately in the income statement.
Amortization of ROU asset	• Recognize amortization expense on a straight-line basis (unless another systematic basis is more representative of the pattern in which the lessee expects to consume the benefits). Amortization will be shown separately in the income statement.

Type B lease (presumed for leases of property)	
Single lease expense	The expense recognition pattern for Type B leases is determined in a manner that is similar to the accounting for operating leases under current guidance. Rent expense is reflected as a single line item on the income statement. Straight line expense recognition is created by adjusting the allocation of the expense between the portion attributed to amortization of the discount and amortization of the right-of-use asset as follows: • **Lease liability**: Amortization of the discount is calculated in the same manner as that for a Type A lease. • **Right-of-use asset**: Asset amortization is a balancing figure, calculated as the difference between the straight-line expense and the amortization of the discount on the lease liability.
See Example 2 in Appendix B for a detailed example of lessee expense recognition.	



Re-assessment/ impairment

General concepts

Lease liability re-assessment

According to the revised ED, a lessee will re-measure the lease liability to reflect any changes in the following:

- Lease term, as a result of either (1) a change in the assessment of whether the lessee has a significant economic incentive to exercise an existing contractual option to extend the lease (other than changes in market conditions), or (2) the lessee either irrevocably electing to exercise an extension option that was not included in the original lease term or not exercise an option that was included in the original lease term;
- Relevant factors that result in the lessee having or no longer having a significant economic incentive to exercise an option to purchase the underlying asset;
- Variable lease payments based on a change in the index or rate that has already occurred which will be used to determine lease payments for future periods; and
- Amounts expected to be payable under a residual value guarantee.

The discount rate is re-assessed when there is a change in the lease payment due to changes in:

- Lease term;
- Relevant factors that result in the lessee having or no longer have a significant economic incentive to exercise an option to extend the lease or purchase the underlying asset; or
- Referenced interest rates, if variable lease payments are determined using those rates.

PwC observation: Current accounting has no reassessment requirement. One of the largest complaints about the original ED was it complexity, significant judgement and potential volatility. Much of that complexity came as a result of the broad reassessment requirements – in many cases based on very subjective information. While still containing requirements to reassess, the revised ED significantly reduces the subjectivity of the judgments and thereby the expected frequency of changes. Further, in practice, it will more closely align the change in the accounting to an actual event/ decision.

As noted above, a change in the lease term requires the discount rate to be re-assessed. This could lead to volatility and complexity in the accounting.

A lessee would determine the revised discount rate at the date of the re-assessment using the rate that the lessor charges the lessee at that date, if known, or the lessee's incremental borrowing rate at that date on the basis of the remaining lease term.

Changes in the measurement of the lease liability because of a re-assessment would be recorded as an adjustment to the right-of-use asset unless it relates to the following two changes (for which measurement changes would be recognized in the income statement):

- Changes in an index or a rate used for variable lease payments that are attributable to the current or prior periods; or
- If the carrying amount of the right-of-use asset is reduced to zero.

Re-assessing lease classification

Lease classification would be re-assessed only when there is a substantive contract modification. The modified contract would be accounted for as a new contract at the date that the modifications become effective.

Examples of a substantive contract modification include changes to the contractual lease term or to the amount of contractual lease payments that were not part of the original terms and conditions of the lease.

PwC observation: As noted above, the boards decided that even though the lease term can change after lease commencement, lease classification, i.e., whether Type A or Type B, should not be re-assessed. The boards compared this situation to current accounting where, absent a modification or actual renewal, lessees and lessors would not re-assess lease classification for changes in circumstances.

Lease term re-assessment

The lease term would be reassessed if either of the following occur:

- A change in a relevant factor that causes the lessee to either have or no longer have a significant economic incentive to exercise an option or terminate the lease; or

- The lessee either elects to exercise an option even though the entity had previously determined that the lessee did not have a significant economic incentive to do so or does not elect to exercise an option even though the entity had previously determined that the lessee had a significant economic incentive to do so.

Assume that a lessee is leasing a building under a ten-year lease that includes a five-year renewal option. At lease commencement, the lessee concludes that it does not have a significant economic incentive to exercise the extension option. The lease is classified as a Type B lease. Four years into the initial lease term, the lessee significantly renovates the building which results in significant additional leasehold improvements which are expected to have substantial remaining value at the end of the original lease term. As a result of the renovation, the lessee concludes that it has an economic incentive to exercise the extension option because of the value of the improvements that would be lost in the event of non-renewal. Therefore, the lessee would re-assess the lease term and adjust the lease liability and right-of-use asset. However, the lessee would not re-assess the lease classification due to this event, i.e., Type A or Type B.

PwC observation: The revised exposure draft does not clearly address when the lease term would be reassessed. For example, in the above situation in which, subsequent to commencement, the tenant in a property lease makes a significant improvement to the property. It is currently not clear when the lease term should be reassessed: when the lessee commits to renovate, or when renovation activities begin. The timing of this change would affect balance sheet measurement and can affect expense recognition patters under either Type A or Type B leases (the latter if there are additional escalations in the added lease term).

A change in market rents, in isolation, would not cause an entity to re-assess whether there is a significant economic incentive to exercise the option and re-assess the lease term.

For both a Type A and Type B lease, the lessee would re-measure the lease liability and right-of-use asset by calculating the present value of the remaining lease payments over the revised term using the discount rate at the re-assessment date. The revised lease payments would reflect the change in amounts payable under purchase options or termination penalties.

For a Type A lease, a lessee would revise the interest expense prospectively based on the interest rate selected at the re-assessment date. Amortization expense would be determined by calculating a new straight-line amortization based on the revised asset value and lease term.

For a Type B lease, a lessee would revise the straight-line expense as follows:

- Adjust the initial total lease costs for the change in undiscounted lease payments that arose due to the re-assessment;
- Subtract straight-line expense already recognized for the lease from the amount calculated in 1) above; and
- Divide the amount calculated in 2) above by the remaining periods in the lease terms.

See Example 3 in Appendix B for a detailed example of re-assessment based on a change in lease term.

Re-assessment of purchase options would follow the same accounting as discussed above for renewal options. A lessee would determine the revised lease payments on the basis of the new lease term or to reflect the change in amounts payable under the purchase options.

PwC observation: The requirement to re-assess the lease term is a significant change from the "set it and forget it" model used today. From a practical perspective, changes as a result of a re-assessment will likely be more aligned with the timing of actual business decisions. However, the requirement to re-assess requires judgment. The systems and processes that would need to be developed and maintained to continually monitor the need for re-assessment may add significantly to the cost of implementation, particularly for those entities with a significant portfolio of lease contracts.

Variable lease payment re-assessment

Re-assessing lease payments based on a rate or index would require lessees to re-measure their right-of-use asset and lease liability, each time rates and indices change, which may be as often as each reporting period. Lessees would account for this change in profit and loss when it relates to the current accounting period and as an adjustment to the right-of-use asset when it relates to future periods.

See Example 4 in Appendix B for a detailed example of re-assessment based on changes in an index.

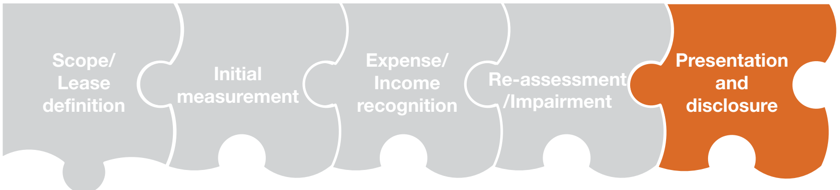
Residual value guarantee re-assessment

Lessees would re-assess the amounts payable under a residual value guarantee when events or circumstances indicate that there has been a significant change in the amounts expected to be paid.

Impairment

Lessees would follow existing guidance on impairment of long-lived assets with respect to its right-of-use assets.

PwC observation: A right-of-use asset accounted for as a Type B lease would have a higher risk of impairment due to the fact that amortization is slower than that for comparable Type A assets. This is because amortization expense for a right-of-use asset in a Type B lease is back-end loaded. If there is an impairment charge for this type of leased asset, it is unlikely to result in a corresponding change to the value of the recorded liability absent a modification to the terms or a reassessment of options to renew, i.e., incentives no longer support inclusion in the measurement of the asset or liability.



Presentation and disclosure

Presentation

The table below details the presentation requirements for lessees

Lessee presentation requirements		
Financial statement	**Type A lease**	**Type B lease**
Statement of financial position	• Right-of-use assets and lease liabilities would either be presented separately or separately disclosed within the notes (including disclosure of where it is recorded on the balance sheet). • The right-of-use asset would be required to be included in the same line as similar owned assets.	• The requirements are the same as Type A. However Type A and Type B components would be presented/disclosed separately.
Statement of comprehensive income	• Amortization expense on right-of-use assets and interest expense on lease liabilities would be presented separately.	• Amortization expense on the right-of-use assets and interest expense on lease liabilities would be combined in a single line item.
Statement of cash flows	• Each lease payment would have a principal and interest component. • Principal payments would be classified as financing activities. • Interest payments would be classified in accordance with ASC 230, *Statement of Cash Flows*. • Variable lease payments and short-term lease payments not included in the lease liability would be classified within operating activities.	• All cash lease payments would be classified as operating activities.

PwC observation: **Statement of financial position**: We expect most lessees will present the right-of-use asset within property, plant, and equipment. However for financial institutions, it is not clear how regulators will view the right-of-use asset for purposes of determining minimum regulatory capital requirements. If regulators view the right-of-use asset as an intangible, it may not be considered an asset included in the denominator of Tier One leverage ratios and would be subject to a higher risk weighting for the risk-based capital ratios.

The changed profile of the balance sheet and related income statement effects could have implications for state and local tax apportionment as well as franchise taxes, property taxes and foreign taxes.

Statements of comprehensive income and of cash flows: Due to the variety of changes to the statements of comprehensive income and cash flows, i.e., interest expense, amortization expense, etc., lessees with Type A leases will need to assess the potential impact on covenants, compensation agreements, and other contracts. Such an assessment may require significant time. As such, we suggest companies begin the process well in advance of the effective date.

The boards have not specifically discussed how variable lease payments not considered minimum lease payments, e.g., payments based on sales, should be presented in the income statement for a Type B lease. However, we anticipate that these payments would be reflected as an operating cost in the period to which they pertain (similar to the approach under today's guidance), with disclosure in the notes to the financial statements.

Disclosure

The table below summarizes the more significant disclosure requirements included in the proposed guidance. Entities should carefully consider the level of detail necessary to satisfy the disclosure objective and how much emphasis to place on each of the various requirements. Entities can aggregate or disaggregate disclosures so that useful information is not obscured by either the inclusion of a large amount of insignificant detail or the aggregation of items that have different characteristics.

Topic	Lessee
Nature of the lease	• A general description of the lease. • Variable lease payment information. • The details of extension/termination options including which options are included/excluded from the right-of-use asset. • A residual value guarantee. • Restrictions or covenants imposed by the lease. • Sub-lease information.
Lease that have not yet commenced	• Significant rights and obligations created by the lease prior to lease commencement.
Significant assumptions and judgments	Information about: • The determination of whether the contract contains a lease; • The allocation of the consideration in a contract between lease and non-lease components; and • The determination of the discount rate.
Reconciliation of opening and closing balances of the lease liability (for lessees)/lease receivable (for lessors)	• Liabilities created due to lease commencement or extension. • Liabilities extinguished due to leases termination. • Re-measurement relating to a change in an index or a rate used to determine lease payments. • Unwinding of the discount. • Cash paid. • Foreign currency effects. • Effects of business combinations. • Other useful information. • The above would be required to be disclosed separately for Type A and Type B leases. Additionally, a non-public entity would be able to elect not to provide any of these disclosures.
Maturity analysis	• Maturity analysis of the lease liability by providing the annual undiscounted cash flows for the first five years of the lease and a total for the remaining years. • Maturity analysis of commitments for non-lease components related to a lease by providing the annual undiscounted cash flows for the first five years of the lease and a total for the remaining years.
Other	• Costs recognized in the period relating to variable lease payments not included in the lease liability. • The acquisition of right-of-use assets in exchange for lease liabilities, arising from both Type A and Type B leases, as a supplemental non-cash transactions disclosure. • Related party lease transactions.

PwC observation: Although some changes have been made to the disclosures required in the revised ED as compared to the original ED, the proposed disclosures are extensive, specifically the requirements to provide a number of reconciliations of balance sheet, income statement, and cash flow statement activity. It may also be difficult for users to put together various disclosures in order to obtain decision-useful information about an entity's lease activities.

Transition

General concepts

Lessors and lessees would recognize and measure all leases (except those short-term leases where the election is made to retain existing accounting treatment) that exist at the date of the initial application date. The date of initial application is the start of the earliest comparative period presented in the financial statements in which the lessee first applies the guidance in the revised ED. The revised ED allows a modified retrospective and full retrospective approach to transition.

Lessors and lessees would need to determine the lease classification in order to calculate the transition adjustment. All available evidence would be used to classify the lease.

The boards decided not to provide relief for leases outstanding at the initial application date but that expire prior to the effective date of the new standard. Additionally, there are no provisions to grandfather existing arrangements. The definition of a lease will be applied retrospectively. That is, any contracts in place as of the initial application date that are determined to be leases under the proposals in the revised ED would follow the new rules. Additionally, there is no transition relief for leases that have less than 12 months remaining at the initial application date unless the lease is truly a short-term lease as defined in the revised ED. For example, if at the adoption date a lessee has 6 months left in a 5 year lease, the lessee would need to account for that lease in accordance with the proposed guidance and could not apply the simplified accounting allowed for a short-term lease.

PwC observation: The lack of grandfathering for existing leases will mean that extensive data-gathering will be required. For each lease, a process will need to be established to capture information about lease term, renewal options, and fixed and contingent payments. The information required under the revised ED will typically exceed that needed under current accounting. Depending on the number of leases, their commencement dates, and the records available, gathering and analyzing the information could take considerable time and effort. Beginning the process early will help to ensure that implementation of the final standard is orderly and well controlled. Companies should also be cognizant of the proposed model when negotiating lease contracts between now and the effective date of a final standard.

Full retrospective approach

Both lessors and lessees would be able to elect to apply the guidance in the revised ED to each outstanding lease as of its commencement date. Applying this guidance would result in a cumulative catch up entry being booked to equity.

Modified retrospective approach

Existing capital leases, direct financing leases, and sale-type leases

No adjustments to existing assets and liabilities would be required. Lessors and lessees would retain existing carrying amounts at the beginning of the earliest comparative period presented.

Entities would subsequently measure the lease assets and lease liabilities in accordance with the guidance for a Type A lease, i.e., interest and amortization approach/receivable and residual approach. However, the entity would not apply the re-assessment requirements, e.g., lease term/variable payment based on index included in the revised ED.

Existing operating leases

For leases classified as Type A, the lease liability and right-of-use asset would be recorded as described below, with the difference between the two amounts recorded in retained earnings on the initial application date. Additionally, any pre-paid or accrued rent on the balance sheet as of the initial application date would be eliminated and added to or subtracted from the initial measurement of the right-of-use asset.

For a Type B lease, lessees would calculate the lease liability in the same manner as a Type A lease. The right-of-use asset would equal the lease liability, however any pre-paid or accrued rent on the balance sheet on the initial application date, would be removed and a corresponding adjustment made to the right-of-use asset. There would be no impact to retained earnings.

Type A	
Lease liability	Measure at the present value of the remaining lease payments using the rate at the effective date. Non-public entities are permitted to use a risk-free discount rate with a term comparable to that of the lease term as an accounting policy election for all leases.
Right-of-use asset	Measure based on the applicable proportion of the lease liability at the commencement date. This amount is calculated as follows: 1. Calculate the average of the remaining lease payments as of the effective date. 2. Assume that average payment is paid evenly over the entire lease term from the lease commencement date and calculate the present value of those payments. The discount rate at the effective date is used to present value the payments. 3. Calculate the pro-rata amount that should be attributed to the remaining lease term as follows: *Amount calculated in 2) above times remaining lease term divided by the total lease term*

PwC observation: When a lessee has an existing operating lease and applies the modified retrospective transition approach to a Type A lease, there will be lease expense recorded as an adjustment directly to retained earnings upon transition due to the difference in the way the lease liability and right-of-use asset are calculated. This adjustment is necessary due to the initial front loading that occurs in the earlier years of the lease. This is expected to provide lessees with higher total profits over the remaining term of the lease than would be the case under the existing operating lease accounting model, or under a full retrospective approach at transition, or for a Type B lease.

PwC observation: A lessee could record a different straight-line expense on a Type B lease after transition compared to the previous operating lease accounting. This is because the lease asset and liability recorded at the initial application date could reflect a different lease term and different lease payments, than those used to record straight line expense previously.

All evidence available (including hindsight) can be used to determine the lease term at transition. For example, if a lessee exercised a renewal option prior to the effective date of the new guidance, it could assume exercise of the renewal period at the initial application date without having to determine whether there was a significant economic incentive to extend the term of the lease at that time.

As noted above, the lessee would use its incremental borrowing rate on the effective date, rather than at the lease commencement date, to initially measure the liability to make lease payments. In selecting the discount rate, a separate discount rate would not be needed for each individual lease; rather a discount rate could be determined based on a portfolio of leases, requiring some stratification of leases with reasonably similar characteristics, most likely considering remaining lease term and similarity of payment profile.

PwC observation: **Deferred taxes**: Preparers will need to consider the deferred tax implications that will arise on transition as a result of changes that will be made to both the balance sheet and income statement presentation. Deferred tax adjustments, especially for Type A leases, could be significant.

Discount rate: When selecting the discount rate to be applied to a portfolio of leases, a wide variety of factors must be considered to determine whether leased assets have similar characteristics. For example, a lessee has an office building located in New York City and a manufacturing facility located outside of the United States. Both leases have a 20-year term. Due to many factors such as different market values, etc., it would be unlikely that a lessee could utilize the same discount rate for both assets.

Lessor accounting considerations

General concepts

Similar to lessee accounting, the boards are proposing that lessors apply two approaches to accounting for leases. After considerable debate, the boards concluded that the classification criteria should be the same for lessors as it is for lessees for determining Type A or Type B leases.

Issues in how to classify leases are likely to mirror those for lessees. These include determining what is "significant," "substantially all" and "insignificant," how broadly the term "property" should be defined, and application of the guidance to arrangements involving multiple assets and/or services.

Similar questions to those facing lessees would also exist in applying the rebuttable presumption for property when assessing a long-term land leases, e.g., those greater than 25 years. The present value of the lease payments required under the lease would likely represent substantially all of the fair value of land. If so, the practical expedients in the proposals would indicate that the Type A "receivable and residual approach" is appropriate—a surprising result given the underlying principle of consumption that is supposed to be at the heart of the classification requirements.

Type A lease	Type B lease
The lessor would apply the receivable and residual approach. Under this approach, the lessor will: • Derecognize the carrying amount of the portion of the asset subject to the lease; • Recognize a receivable measured as the present value of the remaining lease payments, discounted at the implicit rate plus any initial direct costs; and • Recognize a residual asset measured as the present value of the amount the lessor expects to derive from the leased asset at the end of the lease term (discounted using the implicit rate) plus the present value of expected variable lease payment less any deferred profit. Under the receivable and residual approach, profit is recognized at lease commencement on the portion of the underlying asset conveyed to the lessee via a right-of-use. This profit would be measured as the difference between the present value of the lease receivable and a proportionate amount of the cost basis of the underlying asset. Any profit on the portion of the underlying asset retained by the lessor (related to the lessor's residual interest in the leased asset) would be deferred and only recognized when the residual asset is sold or re-leased.	The lessor will apply an approach similar to existing operating lease accounting. Under this approach: • The underlying leased asset remains on the balance sheet of the lessor. • No lease receivable or gain/loss is recorded at lease commencement. • Rental revenue is recognized on a straight-line basis or another systematic basis if that basis is more representative of the pattern in which income is earned from the underlying asset over the terms of the respective leases. • The leased asset continues to be depreciated based on its estimated useful life. • Unbilled rents receivable represent the cumulative amount by which straight-line rental revenue exceeds rents currently billed in accordance with the lease agreement.

PwC observation: We expect many respondents to the revised ED to question how the boards have set the dividing lines. For example, they may question whether:

- Consistency with the revenue recognition proposals, e.g., when license revenue is recognized, would be preferable
- A property/non-property distinction is appropriate, e.g., the economics of multi-tenant non-property leases, such as satellites and telecommunication towers, which have many characteristic in common with property but have a different classification presumption. Further, applying the Type A "Receivable and Residual Approach" to portions of multitenant assets will be extremely complex and cumbersome
- A dividing line based on the lessor's business model would better reflect the economics
- It is appropriate for the leased asset in a Type B lease (or at least a portion of it) to appear on both the lessee and lessor's balance sheets

Special situations

General

There are a number of special situations addressed by the revised ED that would be expected to have broad-based relevance, including:

- Subleasing
- Foreign exchange rate implications
- Leases in a business combination
- Sale and leaseback transactions
- Related party leases

Subleases

Subleases would be accounted for as two separate transactions. That is, a sublessor would utilize lessee accounting on the head lease and lessor accounting on the sublease. When classifying a sublease, an entity would evaluate the sublease with reference to the underlying asset, e.g., the property, plant, or equipment that is the subject of the lease, rather than the right-of-use asset.

PwC observation: Lessees should be mindful that head leases and subleases may be classified differently. For example, there could be situations in which the head lease is classified as a Type A lease and the sublease is classified as a Type B lease, depending on the provisions of the two leases.

Foreign exchange rate implications

When leases are denominated in a foreign currency that is not the entity's functional currency, the impact of changes in the exchange rate related to lease liabilities and right-of-use assets should be recognized in the income statement, consistent with existing guidance for monetary assets and liabilities.

When leases are denominated in the functional currency of a reporting entity and that reporting entity's functional currency is different than the parent's reporting currency, the impact of changes in the exchange rates related to lease liabilities and assets should be part of the cumulative translation adjustment, consistent with existing guidance.

PwC observation: Some respondents to the original ED questioned whether exchange rate differences should result in an adjustment to the right-of-use asset and the liability to make lease payments. However, the boards decided the accounting should be consistent with how foreign exchange differences would be measured for an asset acquisition that is financed with debt in a non-functional currency.

Leases in a business combinations

General concepts

The acquirer would classify leases on the basis of the contractual terms and conditions at the commencement date of the lease, i.e., the acquiree's commencement date. If the contractual terms and conditions of a lease are modified in connection with the acquisition, and result in a substantive change to the original lease, the lease would be considered a new lease and classified based on the terms and conditions at the commencement date of the new lease, which might be the acquisition date.

If the acquiree is a lessee with Type A and/or Type B leases, the acquirer would recognize liabilities to make lease payments and right-of-use assets. The acquirer would measure the liability as the present value of future lease payments as if the acquired lease were a new lease at the acquisition date. The lessee's right-of-use asset recognized at the acquisition date should be the same amount as the liability adjusted for any off-market terms in the lease contract or any other intangible asset associated with the lease.

If the acquiree is a lessor with Type A leases, the acquirer should similarly recognize a receivable and a residual asset. The acquirer should measure the receivable at the present value of future lease payments at the acquisition date as if the acquired lease were a new lease as of the acquisition. The residual asset would be recorded as the difference between the fair value of the underlying asset at the acquisition date and the carrying value for the receivable asset.

If the acquiree is a lessor of a Type B lease, the acquirer would take into account the terms and conditions of the lease in measuring the acquisition date fair value of the underlying asset, such as a building, that is subject to the lease. The acquirer would not recognize a separate asset or liability if the terms of the lease are either favorable or unfavorable when compared with market terms nor would it ascribe value to in-place lease intangibles or lease customer relationships.

PwC observation: The proposed accounting for an acquirer obtaining a Type B lease as a lessor clearly represents a significant change for prospective transactions that today would have a significant lease intangible associated with above/ below market terms, in-place lease values and customer tenant relationships.

For Type A leases, not allocating to lease intangibles is consistent with acquiring financial assets, i.e., the receivable, and inherently does not apply to the residual asset. However, it is not clear that the same holds true in a Type B lease when the acquirer is acquiring a non-financial asset/ business. Inherently, the value of the leased item as encumbered by the lease is different than unencumbered by the lease, e.g., the value of a building that is 100% leased, even at market rents, is worth more than a vacant building.

The acquirer would not recognize assets or liabilities at the acquisition date for leases that, at that date, have a remaining maximum possible term under the contract of twelve months or less.

PwC observation: This could result in substantial off-market long-term leased assets that happen to be less than a year from termination at acquisition date not being recognized.

Transition

A lessee with existing assets or liabilities recorded in accordance with IFRS 3R, *Business Combinations*, relating to favorable or unfavorable terms of an operating lease acquired as part of a business combination, would derecognize the asset or liability, and record a corresponding adjustment to the carrying amount of the right-of-use asset.

A lessor of Type B leases would not derecognize such existing assets and liabilities. However, a lessor of Type A leases would derecognize the assets and liabilities and record a corresponding adjustment to equity at the beginning of the earliest comparative period presented.

Sale-leaseback transactions

General concepts

In a sale-leaseback transaction, the sale would be recognized pursuant to the revenue recognition guidance, while the leaseback would be subject to the revised ED. Entities would apply the control criteria in the proposed revenue recognition standard to determine whether a sale has occurred. If a sale has not occurred, the entire transaction would be accounted for, by both lessee and lessor, as a financing. When consideration received does not equal the fair value of the asset sold, the assets, liabilities, gains or losses recognized should be adjusted to reflect current market rentals.

Not a purchase and sale

If the transferee does not obtain control of the underlying asset pursuant to the revenue recognition guidance, the transferor would not derecognize the transferred asset and would recognize any payments received as a financial liability. Conversely, the transferee would not recognize the transferred asset but would recognize the amounts paid as a receivable.

The existence of a leaseback does not, in isolation, prevent the transferee from obtaining control of the underlying asset. However, if the leaseback provides the transferor with the ability to direct the use of and obtain substantially all of the remaining benefits from the underlying asset, then the transferee does not obtain control of the underlying asset and the transfer is not a sale. The transferor is considered to have the ability to direct the use of and obtain substantially all of the remaining benefits from the asset if the following conditions are met:

- The lease term is for the major part of the remaining economic life of the asset; or
- The present value of the lease payments accounts for substantially all of the fair value of the asset.

Sale-leaseback transactions are fairly common for lessors of both property and non-property assets, and the boards' decision to align the sale criteria with the proposed revenue recognition standard may result in more transactions qualifying as a sale.

PwC observation: The decision on how to evaluate sale-leasebacks fundamentally requires a separate evaluation of the sale from the leaseback. It may be appropriate to recognize the full gain on sale immediately. In longer duration leasebacks, some have argued that the seller/lessee retains a significant portion of the right-of-use the asset and fundamentally only the residual asset was sold, e.g., the sale of a building and subsequent lease-back of 30 of the 40 floors. In these cases, many believe only the portion of the gain relating to the sale of the residual asset, i.e., 10 floors should be recognized.

Transition of sale-leaseback

The transition requirements for historical sale-leaseback transactions will depend on how the lease was originally accounted for.

- **Sale/capital lease**: The existing lease accounting will be allowed to run its course without any transition adjustments if the sale-leaseback transaction resulted in the seller/lessee accounting for the lease as a capital lease. The deferred gain or loss that was previously recognized in respect to the sale-leaseback transaction will continue to be amortized.
- **Sale/operating lease**: Both the seller/lessee and buyer/lessor would re-evaluate the sale transaction on transition in accordance with the proposed revenue recognition guidance. If the sale conditions are met, then the seller/lessee would measure the right-of-use asset and lease liability under the revised ED. Upon initial application, any deferred gain on that date from a qualified sale leaseback would be recorded through retained earnings as part of transition.

PwC observation: Under current accounting guidance, buyer/lessors typically account for sale and leaseback transactions as a purchase and lease, without evaluating whether they have obtained control of the underlying asset. However, upon transition, buyer/lessors are required to re-assess all existing transactions in which the lessor accounted for its lease as an operating lease. This is to determine whether the buyer/lessor must re-characterize its investment in the property as a loan. For some lessors this could require significant effort and could result in significant transition adjustment to retained earnings.

Related party leases

All leases, including related party leases, are subject to the recognition and measurement requirements based on the legally enforceable terms and conditions of the lease.

The FASB, however, acknowledged that some related party transactions may not be documented and the terms may not be at arm's length. Lessees and lessors will be required to understand the economic substance of the transaction in order to apply the provisions of the proposals.

Related party leases are subject to the existing disclosure requirements.

The path forward

The revised ED will have a 120-day comment period with comments due on September 13, 2013. The boards are expected to issue the final standard in 2014.

The effective date will be set after the boards consider feedback received on the revised exposure draft.

Appendix B: Detailed application examples

Example 1: Lessee initial measurement

Background

On 01/01/20x0, ABC Co. ("lessee") enters into a contract to lease property to be used as a retail store from XYZ Landlord Co. ("lessor").

Key terms of the lease contract	
Lease commencement date	01/01/x0
Initial lease term	5 years
Extension option	3 years
Annual contractual payments in the initial term	$115,000 (includes $15,000 per year for executory costs)
Annual lease payments in the extension period	$110,000 (excluding executory costs)
Payment date	12/31 at the end of each year
Initial direct costs	$10,000
Discount rate	The lessee does not know the discount rate implicit in the lease. The lessee's incremental borrowing rate would be 5% for a five year term or 5.75% for an eight year term.
Lease increase based on changes in the Consumer Price Index ("CPI")	The annual lease payment increases in line with the annual increase in the CPI. The payment is based on the CPI at the beginning of the year. For example, the payment due on 12/31/x0 is based on the CPI at 01/01/x0. The CPI at lease commencement is 120.
Variable payment based on sales	An additional lease payment of 1% of the annual retail store sales in excess of $1.0 million is due 90 days after the end of each lease year.

Issue

How should the lessee initially measure the lease liability and right-of-use asset?

Analysis

In order to calculate the initial lease liability and right-of-use-asset ("ROU asset"), the lessee will:

Step 1) Determine the lease term	Based on conditions that exist at the commencement date, the lessee determines that it does not have a significant economic incentive to exercise the extension option; therefore the lease term is five years.
Step 2) Identify the lease payments	The annual contractual payment is $115,000. However, $15,000 of each annual payment is allocated to the executory costs and is excluded from the measurement of the lease liability. Therefore, the payments included in the initial measurement of the lease liability are $100,000 due on 12/31 of each year. The variable payments based on sales are excluded because they are based on performance. Additional payments based on changes in CPI are initially calculated using the index at inception, which would yield no additional payments. At the contract's rent reset date, changes in CPI since inception or the most recent previous reset date will need to be reflected in the right of use asset and liability.
Step 3) Determine the discount rate	Since the lessee does not know the interest rate implicit in the lease agreement, the lessee will use its incremental borrowing rate for similar terms as in the lease (amount, duration, and collateral) which is 5%.
Step 4) Identify the additional elements of the right-of-use asset	The lessee paid initial direct costs of $10,000.

Calculation of the initial lease liability and right-of-use asset

Based on the amounts above, the amounts recorded on the balance sheet on 01/01/20x0 are as follows:

Lease liability is $432,948 and is calculated as follows:

Payments made at the end of each year						
Year	1	2	3	4	5	Total
Payment	$100,000	$100,000	$100,000	$100,000	$100,000	$500,000
Discount	(4,762)	(9,297)	(13,616)	(17,730)	(21,647)	(67,052)
Present value	$95,238	$90,703	$86,384	$82,270	$78,353	**$432,948**

Right-of-use asset is $442,948 and is calculated as follows:

	Amount
Lease liability	$432,948
Initial direct costs	10,000
Total right-of-use asset	**$442,948**

Example 2: Lessee expense recognition

Background

Assume the same facts as in Example 1 for initial measurement.

Issue

How should the lessee recognize expense?

Analysis

This is a lease of property, so the presumption under the proposed standard is that this will be a Type B lease. However, to highlight the differences between the two models, we show both Type A and Type B expense recognition.

Type A

Interest expense: The table below details the interest expense calculation for each year.

Year	Remaining cash payments	Discount	Liability beginning balance	Interest expense	Lease payment	Liability ending balance
1	$500,000	$67,052	$432,948	**$21,647**	$100,000	$354,595
2	400,000	45,405	354,595	**17,730**	100,000	272,325
3	300,000	27,675	272,325	**13,616**	100,000	185,941
4	200,000	14,059	185,941	**9,297**	100,000	95,238
5	100,000	4,762	95,238	**4,762**	100,000	–

Amortization expense: The lessee has concluded that a straight-line amortization pattern best represents the pattern in which it will consume the asset. Therefore, the annual amortization is as follows:

Year	1	2	3	4	5
Beginning balance	$442,948	$354,358	$265,769	$177,179	$88,590
Annual amortization	**88,590**	**88,590**	**88,590**	**88,590**	**88,590**
Ending balance	$354,358	$265,769	$177,179	$88,590	$ –

Total annual interest and amortization expense based on the CPI at lease commencement is as follows:

Expense type			
Year	Interest	Amortization	Total
1	$21,647	$88,590	**$110,237**
2	17,730	88,590	**106,319**
3	13,616	88,590	**102,206**
4	9,297	88,590	**97,887**
5	4,762	88,590	**93,351**
Total	$67,052	$442,948	**$510,000**

Variable payments: Variable lease payments based on a percentage of sales will be expensed in the period incurred. The lease liability must be re-measured each period for the change in the CPI. See Example 4 for an illustration.

Executory costs: These costs are generally recognized as incurred.

Type B

For a Type B lease, a lessee will show a single lease expense on the statement of comprehensive income. The lease expense will be the straight-line amount of the lease costs calculated as follows:

	Lease cost (a)	Lease term (b)	Straight-line expense (a)/(b)
Lease payments	$500,000	5	$100,000
Initial direct cost	10,000	5	2,000
Total lease cost	$510,000		**$102,000**

However, the single lease expense must be allocated between amortization of the lease liability and the right-of-use asset, as follows:

Lease liability: The lease liability is subsequently measured in the same manner as the Type A lease. Therefore, the interest component of the straight-line expense will equal the interest expense calculated as for a Type A lease, above.

Right-of-use asset: The right-of-use asset "amortization" is computed as the balancing figure between straight-line expense and "interest" expense computed using the effective interest method as follows.

Year	Asset beginning balance	"Interest" component (d)	Straight-line expense (e)	"Amortization" component (e) – (d)	Asset ending balance
1	$442,948	$21,647	$102,000	**$80,353**	$362,595
2	362,595	17,730	102,000	**84,270**	278,325
3	278,325	13,616	102,000	**88,384**	189,941
4	189,941	9,297	102,000	**92,703**	97,238
5	97,238	4,762	102,000	**97,238**	–

Variable payments: Variable lease payments based on a percentage of sales will be expensed in the period incurred. The lease liability must be re-measured each period for the change in the CPI. See Example 4 for an illustration.

Example 3: Lessee lease term re-assessment

Background

Assume the same facts as in Examples 1 and 2 for initial and subsequent measurement. As noted in Example 1, the lessee did not have a significant economic incentive to exercise the 3-year extension option at the lease commencement date. However, assume that on December 31, 20x2 (the last day of year 3 of the lease), the lessee installed unique tenant improvements into the retail store with an estimated 5-year economic life. The lessee determined that it will only recover the cost of the improvements if it exercises the extension option, creating an economic incentive to extend.

The lessee's incremental borrowing rate based on the revised term of the lease is 6% on December 31, 20x2 (based on the incremental borrowing rate of the lessee using market interest rates at the time of the reassessment). This rate differs from the equivalent rate calculated at inception.

Issue

How should the lessee account for the change in lease term?

Analysis

This is a lease of property, so the presumption under the proposed standard is that this will be a Type B lease. However, to highlight the differences between the two models, we show both Type A and Type B expense recognition.

Type A

The lessee must re-assess the lease term when it determines that there is a significant economic incentive to exercise the extension option. In this example, it is December 31, 20x2 or the end of year 3 of the lease.

Calculate the adjustment to the lease liability and the right-of-use asset: The lease liability is re-measured based on the present value of the remaining future lease payments for the new term using the revised discount rate of 6%. The new term is now eight years in aggregate with five years remaining, i.e., the remaining two years in the initial term plus the three years in the extension period. The re-assessment occurred at the end of year 3, so the next payment occurs at the end of year 4. The revised lease liability is $445,026 at the end of year 3, determined as follows:

Payments made at the end of each year						
Year	4	5	6	7	8	Total
Payment	$100,000	$100,000	$110,000	$110,000	$110,000	$530,000
Discount	5,660	11,000	17,642	22,870	27,802	84,974
Present value	$94,340	$89,000	$92,358	$87,130	$82,198	**$445,026**

The adjustment is calculated as follows:

	Amount
Revised liability balance per above	$445,026
Liability balance at the end of year 3 (see Example 2 for this balance)	185,941
Adjustment	**$259,085**

The adjustment is recorded as follows:

Journal entry	Debit	Credit
Right-of-use asset	$259,085	
Lease liability		**$259,085**

Expense recognition: The interest and amortization expense will change based on the revised term and discount rate, as shown below.

Interest expense: The interest expense would be updated to reflect the revised discount rate and lease term.

Year	Remaining cash payments	Discount	Liability beginning balance	Interest expense	Lease payment	Liability ending balance
4	$530,000	$84,974	$445,026	**$26,702**	$100,000	$371,728
5	430,000	58,272	371,728	**22,304**	100,000	294,031
6	330,000	35,969	294,031	**17,642**	110,000	201,673
7	220,000	18,327	201,673	**12,100**	110,000	103,774
8	110,000	6,226	103,774	**6,226**	110,000	(0)

Amortization expense: The revised straight-line amortization is as follows:

Component	Amount
Original asset balance at the end of year 3 (see Example 2 for this amount)	$177,179
Adjustment calculated above	$259,085
Total revised balance	**$436,264**
Revised remaining lease term	5
Annual amortization	**$87,253**

The balance of the right-of-use asset at each period end is as follows:

Year	4	5	6	7	8
Beginning balance	$436,264	$349,011	$261,758	$174,506	$87,253
Annual amortization	87,253	87,253	87,253	87,253	87,253
Ending balance	**$349,011**	**$261,758**	**$174,506**	**$87,253**	**$ –**

Type B

The lessee must re-assess the lease term when it determines that there is a significant economic incentive to exercise the extension option. In this Example, it is December 31, 20x2 or the end of year 3 of the lease.

Calculate the adjustment to the lease liability and the right-of-use asset: The adjustment to the lease liability and the right-of-use asset is the same as in a Type A lease discussed above. Therefore, the revised lease liability is $445,026. The revised right-of-use asset is calculated as shown to the right.

	Amount
Right of use asset at the end of year 3 (see Example 2 for this balance)	$189,941
Adjustment per above	259,085
Re-measured right-of-use asset balance	**$449,026**

Recalculate the straight-line expense: The single lease expense will change based on the revised term, as shown to the right. The lessee must first adjust the total lease costs for the change in undiscounted lease payments that arose due to the change in the lease term.

	Amount
Initial lease payments	$500,000
Initial direct costs	10,000
Additional lease payments in the extension period	330,000
Total revised lease costs	**$840,000**

Next, the lessee would recalculate the straight-line lease expense based on the revised total lease cost and term.

	Amount
Total revised lease costs per above	$840,000
Less lease costs already recognized	$306,000*
Adjusted lease costs	**$534,000**
Revised remaining lease term	5
Revised straight-line expense	**$106,800**

*Lease costs already recognized in this example are calculated as follows:

Initial annual straight-line lease expense	$102,000
Annual periods with expense recognized	3
Total lease costs already recognized	**$306,000**

Subsequent measurement: The lessee would subsequently measure the lease liability as in the Type A lease shown above. The lessee would subsequently measure the right-of-use asset as follows:

Year	Asset beginning balance	"Interest" expense	Straight-line expense	"Amortization" expense	Asset ending balance
4	$449,026	$26,702	$106,800	**$80,098**	$368,928
5	368,928	22,304	106,800	**84,496**	284,431
6	284,431	17,642	106,800	**89,158**	195,273
7	195,273	12,100	106,800	**94,700**	100,574
8	100,574	6,226	106,800	**100,574**	–

Example 4: Lessee re-assessment based on changes in an index

Background

Assume the same facts as in Example 1 and Example 2 for initial measurement and subsequent measurement. As noted in Example 1, the CPI at lease inception (01/01/x0) was 120 and the first annual payment due on 12/31/x0 was based on that CPI. The next annual payment is due on 12/31/x1 and the amount due is based on the CPI at 01/01/x1. The CPI at 01/01/x1 is 125.

Issue

How should the lessee account for the change in CPI?

Analysis

This is a lease of property, so the presumption under the proposed standard is that this will be a Type B lease. However, to highlight the differences between the two models, we show both Type A and Type B expense recognition.

Type A

Calculate the adjustment to the lease liability and the right-of-use asset: Calculate the future lease payments based on the new CPI of 125 as follows:

CPI at 01/01/x0	120
CPI at 01/01/x1	125
Change in index	5
% change	4%
Annual lease payment in prior year	$100,000
Revised annual lease payment based on % change in CPI	$104,000

Next, the lease liability is re-measured based on the present value of the revised future lease payments of $104,000. The discount rate of 5% used at lease commencement is still used to discount these payments. The revised lease liability at 01/01/x1 is $368,779 as calculated below.

Annual lease payment					
Year	2	3	4	5	Total
Revised payments	$104,000	$104,000	$104,000	$104,000	$416,000
Present value discount	4,952	9,669	14,161	18,439	47,221
Present value	$99,048	$94,331	$89,839	$85,561	**$368,779**

The adjustment is calculated as follows:

	Amount
Revised liability balance per above	$368,779
Liability balance at the end of year 1 (see Example 2 for this balance)	354,595
Adjustment	**$14,184**

The adjustment is recorded as follows:

Journal entry	Debit	Credit
Right-of-use asset	$14,184	
Lease liability		$14,184

Revise the expense recognition: The interest and amortization expenses will change based on the revised lease payments, as shown below.

Interest expense: The revised interest expense based on the change in CPI is as follows:

Year	Remaining cash payments	Discount	Liability beginning balance	Interest expense	Lease payment	Liability ending balance
2	$416,000	$47,221	$368,779	**$18,439**	$104,000	$283,218
3	312,000	28,782	283,218	**14,161**	104,000	193,379
4	208,000	14,621	193,379	**9,669**	104,000	99,048
5	104,000	4,952	99,048	**4,952**	104,000	–

Amortization expense: The revised straight-line amortization is as follows:

	Amount
Original asset balance at the end of year 1 (see Example 2 for this amount)	$354,358
Adjustment calculated above	$14,184
Total revised balance	**$368,542**
Revised remaining lease term	4
Annual amortization	**$92,135**

The balance of the right-of-use asset at each period end is as follows:

Year	2	3	4	5
Beginning balance	$368,542	$276,406	$184,271	$92,135
Annual amortization	92,135	92,135	92,135	92,135
Ending balance	**$276,406**	**$184,271**	**$92,135**	**$–**

Type B

Calculate the adjustment to the lease liability and the right-of-use asset: The adjustment to the lease liability and the right-of-use asset is the same as in a Type A lease discussed above. Therefore, the revised lease liability is $368,779. The revised right-of-use asset is as follows:

Component	Amount
Right of use asset at the end of year 1 (see Example 2 for this balance)	$362,595
Adjustment per above	14,184
Revised right-of-use asset balance	**$376,779**

Recalculate the straight-line expense: The single lease expense will change based on the revised payments as shown to the right. The lessee must first adjust the initial total lease costs for the change in undiscounted lease payments that arose due to the change in CPI.

	Amount
Initial lease payments	$500,000
Initial direct costs	10,000
Additional lease payment based on increased CPI ($4,000 annual increase x 4 years)	16,000
Total revised lease costs	**$526,000**

Next, the lessee would recalculate the straight-line lease expense based on the revised total lease cost.

	Amount
Total revised lease costs per above	$526,000
Less lease costs already recognized	$102,000*
Adjusted lease costs	**$424,000**
Revised remaining lease term	4
Revised straight-line expense	**$106,000**

*Lease costs already recognized in this example are calculated as follows:

Initial annual straight-line lease expense (See Example 3)	$102,000
Annual periods with expense recognized	1
Total lease costs already recognized	**$102,000**

Subsequent measurement: The lessee would subsequently measure the lease liability in the same manner as the Type A lease shown above. The lessee would subsequently measure the right of use asset as follows:

Year	Asset beginning balance	"Interest" expense	Straight-line expense	"Amortization" expense	Asset ending balance
2	$376,779	$18,439	$106,000	**$87,561**	$289,218
3	289,218	14,161	106,000	**91,839**	197,379
4	197,379	9,669	106,000	**96,331**	101,048
5	101,048	4,952	106,000	**101,048**	–

Appendix C: Impact on common real estate lease provisions

Note the discussions below apply to typical "Type B" property leases. Most property leases will be classified as "Type B." However, certain types of leases (such as longer duration leases including land leases, single tenant property, "anchor" or large block CBD office space) could be classified as "Type A" leases.

Terms	Example	Existing accounting	New accounting
Co-tenancy clauses	There are various types of co-tenancy clauses. One example is for "key tenants" whom other tenants believe are critical to the successful operation of the location. If a key tenant departs, the property owner has time to cure the issue but until cured, rent may be reduced.	Reflect any reductions in period they occur but do not project them in considering minimum lease payments.	Reflect any reductions in period they occur but do not project them in adjusting the lease liability or right of use asset unless they represent a permanent reduction.
CPI escalations	Office tenant has a rent escalation each anniversary date based on the change in the published Consumer Price Index.	Treated as contingent rent which is not included in "minimum lease payments" used for straight line rent purpose but rather the expense is recognized in each annual period based on actual increase in that period.	As the lease payments are variable payments that depend on an index, office tenant would be required to adjust the lease liability to reflect the new CPI rate when the rate changes and not in the initial measurement of the lease liability or right to use asset. Also, the tenant would 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 adjustment to the lease liability at the time of the CPI change is the difference between the present value of the revised and the original lease payments discounted using the rate determined at the commencement date. A corresponding adjustment is made to the right to use asset. In most cases, the expense recognition for property leases will be similar to today with expense being similar to cash.
Free rent periods	Retail tenant given six-month free rent period in connection with 10-year lease.	Current lease model would apply a "straight line rent" method whereby expense is reflected based on a mathematical average of the aggregate minimum lease payments over the period from commencement of the lease through end of lease term. This model does not compensate for the economic impacts of the timing of payment.	The new model would have no cash out-flows in the present value calculation for first six months. As a result, initially the right of use asset and lease obligation would increase over the free rent period as the obligation is accreted using a constant effective yield with interest being added to the balance during the free rent period (i.e., like a negative amortizing loan). However, the expense recognition would result in a straight-line expense for most Type B property lease.
Lease inducement	Property owner pays tenant $1.0 million to enter into a lease that may be used for any purpose.	Treated as negative rent payment and reduction in minimum lease payments to be reflected using straight-line method over lease term.	Treated as reduction in lease obligation and, therefore, as a reduction in the asset at inception. The net straight line expense over the lease term would be reduced.

Terms	Example	Existing accounting	New accounting
Lease allowance	Property owner pays tenant $1.0 million for part or all of the improvements to the leased property.	If the tenant allowance is for improvements considered tenant assets, the accounting is the same as described under “lease inducement” below. If the tenant allowance is for improvements considered to be property owner assets, the payment is treated as a reimbursement for the cost of a lessor asset with no additional accounting over the lease term.	The accounting for a tenant allowance for improvements considered tenant assets is the same as described under “lease inducement” below. There is no change from existing accounting for a tenant allowance for improvements considered to be property owner assets.
Lease allowance	Property owner pays tenant $1.0 million for part or all of the improvements to the leased property.	If the tenant allowance is for improvements considered tenant assets, the accounting is the same as described under “lease inducement” below. If the tenant allowance is for improvements considered to be property owner assets, the payment is treated as a reimbursement for the cost of a lessor asset with no additional accounting over the lease term.	The accounting for a tenant allowance for improvements considered tenant assets is the same as described under “lease inducement” below. There is no change from existing accounting for a tenant allowance for improvements considered to be property owner assets.
Percentage rent	Retail tenant pays Retail tenant pays additional rent of 4% of annual sales at the location in excess of $10.0 million.	Treated as contingent rent which is not included in “minimum lease payments” used for straight line rent purpose but rather the expense is recognized based on actual sales when it becomes probable annual sales will exceed $10.0 million.	At the commencement date, the retail tenant would measure the lease assets and liabilities without including the variable lease payments determined as a percentage of sales in the measurement of the lease liability or right to use asset. The additional contingent rent would be recognized and measured consistent with today’s model.
Perpetual leases	In some jurisdictions, by statute the tenant may have the right to renew the lease indefinitely. For example, in France, many retail leases are automatically renewable by the tenant in three-year increments.	Today these are straight-lined for each three-year period.	At the commencement date, judgment will be required to determine the lease term based on whether or not the tenant has significant economic incentive to renew. In addition to looking at the amount the lease payments in the renewal period are relative to current market rates, consideration will need to be given to significant leasehold improvements that are expected to have significant economic value for the lessee when the option to extend becomes exercisable, asset retirement obligations and the importance of the underlying asset to the tenant’s operations. Furthermore, except for market factors, a tenant would need to reassess the lease term if there is any significant change in relevant factors. Therefore a significant amount of improvements performed by a tenant prior to expiration may be indicative of an extension in the lease term prior to execution of a formal extension.

Terms	Example	Existing accounting	New accounting
Prepaid rent	Lessee prepays a significant amount of rent at the inception of the lease.	Rent recognized over the term of the lease on a straight-line basis.	The new model would reduce any cash out-flows in the present value calculation by the amount of prepaid rent received. As a result, initially the right of use asset and lease obligation would be lower than if no rent were prepaid. However, the expense recognition would still result in a straight-line expense with the prepaid amount getting amortized on a straight-line basis.
Security deposit	At the beginning of the lease term, tenant pays property owner $1 million, which is approximately two months of rent due under the lease agreement. The amount protects the property owner from a default by the tenant or damage to the leased property caused by the tenant and is refundable if neither occurs.	Treated as a liability by the property owner and as an asset by the tenant until returned to the tenant or used by the property owner in the event of default or damage to the leased property.	Same as existing accounting.
Tenant Improvements (Lessee assets)	At the beginning of the lease term, tenant pays to improve the space.	Treated as separate asset amortized over the lesser of the life of the improvement or the assumed term of the lease.	Treated as separate asset amortized over the lesser of the life of the improvement or the assumed term of the lease. However, under the proposed model, the lease term may now be longer if option periods are included (for example, as result of a reassessment).There should be consistent assumptions between amortization period and lease term.

Contact us

PwC is ready to serve you. For more information, please contact any of the following PwC real estate professionals:

Global real estate and consulting contacts

Global Real Estate Industry Leader	Kees Hage	kees.hage@lu.pwc.com	+352 49 48 48 2059
Global Leasing Project Co-ordinator	Jay Tahtah	jay.tahtah@nl.pwc.com	+31 (0) 88 792 39 45
Global ACS – Real Estate/Leasing	Tom Wilkin	tom.wilkin@us.pwc.com	+1 646 471 7090

Real estate industry contacts

Brazil	Joao Santos	joao.santos@br.pwc.com	+55 11 3674 2224
Canada	Lori-Ann Beausoleil	lori-ann.beausoleil@ca.pwc.com	+1 416 687 8617
Germany	Uwe Stoschek	uwe.stoschek@de.pwc.com	+49 30 2636 5286
Hong Kong	Kwok Kay So	kwokkay.so@hk.pwc.com	+852 2289 3789
Luxemburg	Kees Hage	kees.hage@lu.pwc.com	+352 49 48 48 2059
United Kingdom	Craig Hughes	craig.hughes@uk.pwc.com	+44 20 721 24183
USA	Byron Carlock	byron.carlock.jr@us.pwc.com	+1 214 754 7580
USA	Mike Herman	mike.herman@us.pwc.com	+1 317 940 7090

Accounting advisory contacts – Leasing

Australia	Paul Brunner	paul.brunner@au.pwc.com	+61 (2) 8266 4664
Belgium	Elena Shibkova	elena.shibkova@be.pwc.com	+32 2 7109644
Brasil	Maikel Van Zaanen	maikel.van.x.zaanen@br.pwc.com	+55 11 3674 3561
Canada	Marcie Beggs	marcie.beggs@ca.pwc.com	+1 416 815 5285
China	Dora Cheung	dora.cheung@cn.pwc.com	+ 86 (10) 6533 7070
Finland	Timo Ihamäki	timo.ihamaki@fi.pwc.com	+358 50 585 7177
France	Alexandra Aubry	alexandra.aubry@fr.pwc.com	+ 33 1565 76936
Germany	Sylvia Leuchtenstern	sylvia.leuchtenstern@de.pwc.com	+49 89 5790 5538
Hong Kong	Shelley So	shelley.so@hk.pwc.com	+(852) 2289 2955
Ireland	Ronan Doyle	ronan.doyle@ie.pwc.com	+353 (0) 1 792 6559
Italy	Matteo Strada	matteo.strada@it.pwc.com	+39 02 7785 355
Norway	Teresa Trapan	teresa.trapani@no.pwc.com	+47 95 26 0000
Poland	Radomil Maslak	radomil.maslak@pl.pwc.com	+48 22 523 4223
Russia	Lena Asadova	l.asadova@ru.pwc.com	+7 495 9676313
Singapore	Senthilnathan Sampath	senthilnathan.sampath@sg.pwc.com	+65 6236 7074
South Africa	Elizabeth Schoonees	elizabeth.schoonees@za.pwc.com	+27 (11) 797 4137
Spain	Isaac Freites Asencion	isaac.freites.asencion@es.pwc.com	+34 915 685 919
Sweden	Anna Smeds	anna.smeds@se.pwc.com	+ 46 8 555 338 43
Switzerland	Silke Ruenaufer	silke.ruenaufer@ch.pwc.com	+41 (0) 58 792 2103
United Kingdom	Christopher Biggs	christopher.r.biggs@uk.pwc.com	+44 20 7804 4778
USA	Ashima Jain	ashima.jain@us.pwc.com	+1 408 817 5008
USA	Tom Kirtland	thomas.kirtland@us.pwc.com	+1 646 471 7345