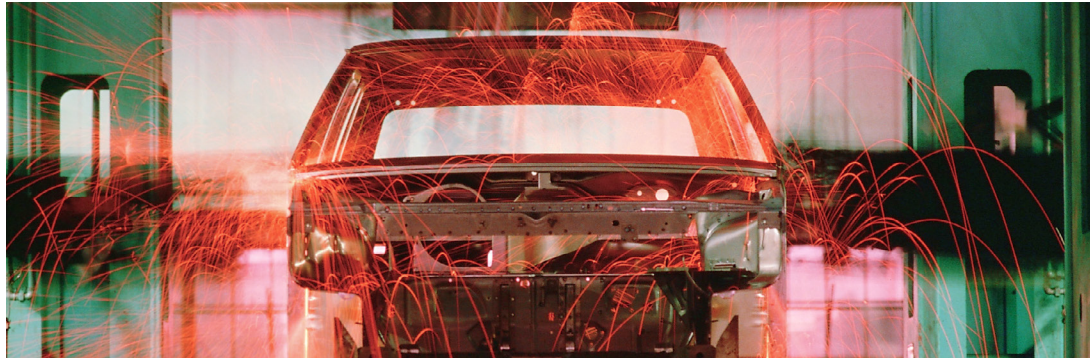


## Consumer & Industrial Products Spotlight

### Proposed Changes to Lessor Accounting: The Lessor of Two Evils?

#### In This Issue:

- Background
- Key Issues
- Other Items
- Challenges
- Thinking Ahead



#### The Bottom Line

- On May 16, 2013, the FASB and IASB issued a revised exposure draft (ED) on lease accounting. The proposal would significantly affect consumer and industrial products (C&IP) companies that lease products to customers.
- Under the proposal, leases of assets other than property (e.g., machinery or vehicles) that are currently treated by lessors as operating leases may no longer qualify for such accounting; rather, in such cases, lessors would generally use the receivable-and-residual approach.
- The new receivable-and-residual approach could influence (1) how a lessor reflects the underlying asset in its financial statements, (2) when the lessor recognizes income from the lease, and (3) the overall presentation of lease income in the lessor's statement of comprehensive income.
- Entities with large lease portfolios will need significant resources to meet the ED's implementation and reassessment requirements.
- Comments on the ED are due by September 13, 2013.

Entities with large lease portfolios will need significant resources to meet the ED's implementation and reassessment requirements.

# Beyond the Bottom Line

This *Consumer & Industrial Products Spotlight* provides insight into select aspects of the recently issued leases ED that are relevant to C&IP companies that lease products to customers. For a comprehensive overview of the ED, including changes to lessee accounting and illustrative examples, see Deloitte's May 17, 2013, [Heads Up](#).

## Background

The ED would significantly change lessor accounting by stipulating a two-model approach for lessors. While the ED retains the current concept of an operating lease for lessors, it introduces a new approach — the receivable-and-residual approach — under which a lessor would derecognize the underlying asset and would recognize in its place (1) a receivable for lease payments due and (2) a residual asset. Lessors would use these two approaches to account for all leases but would be allowed to exclude leases with a maximum possible lease term of 12 months or less, including any option to renew, from the ED's recognition, measurement, and presentation requirements.

Direct-finance, sales-type, and leveraged leases would typically be accounted for under the receivable-and-residual approach. Whether a lease that is currently an operating lease would remain so under the ED depends largely on whether the leased asset is property (defined as "[l]and or a building, or part of a building, or both") or an asset other than property. It is expected that lessors would generally account for leases of assets other than property (e.g., vehicle, equipment, and machinery leases) under the receivable-and-residual approach unless the lease term is relatively short. In contrast, the operating-lease approach would generally apply to leases of property unless the lease term is relatively long or the lease commences near the end of the asset's life.

The ED would significantly change lessor accounting by introducing a two-model approach for lessors.

Lessor Accounting — Comparison of Current U.S. GAAP With the ED		
Current U.S. GAAP	ED	Comparison
Operating Lease	Operating Lease	Generally similar
Direct-Finance Lease Sales-Type Lease Leveraged Lease	Receivable-and-Residual Lease	Generally similar, except that: <ul style="list-style-type: none"><li>• The receivable-and-residual approach requires that the receivable be presented separately from the residual asset.</li><li>• For sales-type leases, less profit would be recognized up front under the receivable-and-residual approach.</li><li>• Initial direct costs would be capitalized in the lease receivable under the receivable-and-residual approach.</li><li>• For leveraged leases, lease assets would be presented separately from third-party debt on the balance sheet under the receivable-and-residual approach; in addition, income smoothing would be eliminated.</li></ul>

## Key Issues

### Classification

In determining whether to use the receivable-and-residual or operating-lease approach for a particular lease, the lessor would consider the nature of the leased asset as well as the terms and conditions of the lease, as explained in the table below:

Lease of Assets Other Than Property	Lease of Property
<p>A lessor will classify a lease of assets other than property as a Type A lease (receivable-and-residual approach) unless:*</p> <ol style="list-style-type: none"><li>1. "The lease term is for an insignificant part of the <b>total</b> economic life of the underlying asset" (emphasis added); or</li><li>2. "The present value of the lease payments is insignificant relative to the fair value of the underlying asset."</li></ol> <p>* If a lessee has a significant economic incentive to exercise an option to purchase the underlying asset, the lease would be classified as a Type A lease regardless of whether it meets the exceptions.</p>	<p>A lessor will classify a lease of property as a Type B lease (operating-lease approach) unless:</p> <ol style="list-style-type: none"><li>1. "The lease term is for the major part of the <b>remaining</b> economic life of the underlying asset" (emphasis added); or</li><li>2. "The present value of the lease payments accounts for substantially all of the fair value of the underlying asset"; or</li><li>3. "[The] lessee has a significant economic incentive to exercise an option to purchase the underlying asset."</li></ol>

In determining whether to use the receivable-and-residual or operating-lease approach for a particular lease, the lessor would consider the nature of the leased asset as well as the terms and conditions of the lease.

An entity would determine the appropriate lease classification as of the lease commencement date and would not be required to reassess its classification unless the lease is subsequently modified and accounted for as a new lease. For example, a lessor may initially determine that a six-month equipment lease, with an option to renew for an additional two years, qualifies for the operating-lease approach because the lease term, which the lessor concludes should exclude the renewal option period, is considered an insignificant part of the total economic life of the underlying asset. If circumstances change and the lessee decides to renew the lease for the additional two years (i.e., the lessee now has a significant economic incentive to renew the lease), the lessor would not need to reconsider the lease classification.

#### Example 1: Lease Classification

Manufacturer Co. produces equipment with a fair value of \$100,000. It leases the equipment to a customer for 2 years. The **total** economic life of the equipment is 10 years. The present value of the lease payments is \$20,000.

Because the lease involves an asset other than property and the terms of the lease do not meet either of the exemptions (i.e., the lease term is for more than an insignificant part of the total economic life of the underlying asset, and the present value of the lease payments is not insignificant in relation to the fair value of the underlying asset), Manufacturing Co. would classify the lease as a Type A lease and account for it by using the receivable-and-residual approach.

### Recognition and Measurement

When required to use the receivable-and-residual approach, the lessor would derecognize the leased asset at lease commencement and, in its place, recognize the following:

- A lease receivable, representing the lessor's right to receive lease payments over the term of the lease. The lease receivable would be initially measured as the present value of the lease payments, discounted at the rate the lessor charges the lessee, plus any initial direct costs.
- A residual asset, representing the lessor's claim to the economic benefits of the leased asset at the end of the lease term. The residual asset would be initially measured as the net amount of (1) the gross residual asset, which represents the present value of the expected residual value; (2) the **present value of certain variable payments** (if any); less (3) the deferred profit (if any).

### Example 2: Initial Recognition Under the Receivable-and-Residual Approach

Manufacturing Co. leases equipment with a carrying value of \$80,000 and a selling price (fair value) of \$100,000 to a customer for seven years. The present value of the lease payments is \$75,000, and the present value of the residual asset is \$25,000. In light of the nature of the underlying asset and the terms of the lease, Manufacturing Co. determines that it should use the receivable-and-residual approach to account for the lease.

To initially recognize the lease at lease commencement, Manufacturing Co. would record the following journal entry:

	Debit	Credit
Lease receivable	\$ 75,000	
Gross residual asset	25,000	
Deferred profit (residual asset)		\$ 5,000 <sup>(a)</sup>
Equipment		80,000
Income		15,000 <sup>(b)</sup>

(a) Calculated as the (1) difference between the fair value and the carrying amount of the leased asset at inception ( $\$100,000 - \$80,000 = \$20,000$ ) less (2) the amount of income recognized at lease inception ( $\$15,000$ ).

(b) Calculated as (1) the difference between the fair value and the carrying amount of the leased asset at inception ( $\$100,000 - \$80,000 = \$20,000$ ) multiplied by (2) the lease receivable divided by the fair value of the leased asset at inception ( $\$75,000 \div \$100,000 = 75\%$ ).

The guidance proposed in the ED could significantly affect when a lessor recognizes lease income.

In subsequent periods, the lessor would recognize interest income from the unwinding of the discount on the lease receivable. In addition, the lessor would subsequently accrete the gross residual asset to an amount equal to the expected residual value of the leased asset at the end of the lease term. The deferred profit would not be recognized until the residual asset is sold or re-leased.

For leases that qualify for the operating-lease approach, the lessor would continue to recognize the leased asset on the balance sheet and would accrue lease income over the term of the lease, generally on a straight-line basis.

### Effect on Income Statement

The guidance proposed in the ED could significantly affect when a lessor recognizes lease income. For current operating leases that would be accounted for under the receivable-and-residual approach, recognition of income on a straight-line basis over the lease term would be replaced with recognition of up-front profit (if any), followed by recognition of a decreasing amount of interest income in each subsequent period.

In addition, under the receivable-and-residual approach, lessors would only recognize the part of the day 1 profit attributable to the portion of the asset that the lessee acquired. This differs from current U.S. GAAP, under which sales-type lessors recognize up-front profit equal to the entire difference between the fair value and the carrying amount of the leased asset. Under the ED, lessors would be prohibited from recognizing the profit related to the residual asset at lease commencement.

**Example 3(a): Comparison of Current Operating-Lease Accounting With Proposed Receivable-and-Residual Approach**

Tractor Inc. (the lessor) leases equipment with a carrying value of \$70,000 and a seven-year life to XYZ Corp. (the lessee) for three years. The annual lease payment is \$20,000 (paid at year-end), which is based on an implicit interest rate of 6 percent. At lease commencement, the fair value of the leased equipment is \$100,000, and the present value of the expected residual value of the asset at the end of the three years is \$46,540. Under current U.S. GAAP, the lease is accounted for as an operating lease. Tractor Inc. determines that under the proposed guidance, it would use the receivable-and-residual approach to account for the lease.

The following table illustrates the differing effects of current operating-lease accounting and the ED's receivable-and-residual approach on Tractor Inc.'s statement of comprehensive income.

	Current U.S. GAAP (Operating-Lease Approach)					Proposed Guidance (Receivable-and-Residual Approach)				
	Y0	Y1	Y2	Y3	Total	Y0	Y1	Y2	Y3	Total
Revenue	—	\$ 20,000	\$ 20,000	\$ 20,000	\$ 60,000	\$ 53,460 <sup>(a)</sup>	—	—	—	\$ 53,460
Cost of sales (depreciation)	—	<u>(10,000)</u>	<u>(10,000)</u>	<u>(10,000)</u>	<u>(30,000)</u>	<u>(37,422)</u>	—	—	—	<u>(37,422)</u>
Gross margin	—	10,000	10,000	10,000	30,000	16,038 <sup>(b)</sup>	—	—	—	16,038
Operating expense	—	—	—	—	—	—	—	—	—	—
Interest income <sup>(c)</sup>	—	—	—	—	—	—	6,000	5,160	4,270	15,430
Net income	—	<u>\$ 10,000</u>	<u>\$ 10,000</u>	<u>\$ 10,000</u>	<u>\$ 30,000</u>	<u>\$ 16,038</u>	<u>\$ 6,000</u>	<u>\$ 5,160</u>	<u>\$ 4,270</u>	<u>\$ 31,468</u>

- (a) Amount represents the present value of future lease payments (three payments of \$20,000 each), discounted by the rate the lessor charges the lessee (6 percent).
- (b) The year 0 profit of \$16,038 represents profit recognized at lease commencement when the leased asset is transferred to the lessee. It is calculated as (1) the difference between the fair value and the carrying amount of the leased asset at inception (\$100,000 – \$70,000 = \$30,000) multiplied by (2) the lease receivable divided by the fair value of the leased asset at lease commencement (\$53,460 ÷ \$100,000 = 53.46%). That is, \$16,038 = \$30,000 × 53.46%.
- (c) Interest income equals the periodic interest income on the lease receivable plus the periodic accretion of the gross residual asset. In the first year, the interest income on the receivable is \$3,208 (\$53,460 × 6%), and the accretion of the gross residual asset is \$2,792 (\$46,540 × 6%).

**Example 3(b): Comparison of Current Sales-Type Lease Accounting With Proposed Receivable-and-Residual Approach**

Tractor Inc. (the lessor) leases equipment with a carrying value of \$100,000 and a 10-year life to XYZ Corp. (the lessee) for eight years. The annual lease payment is \$20,000 (paid at year-end), which is based on an implicit interest rate of 6 percent. At lease commencement, the fair value of the leased equipment is \$150,000 and the present value of the expected residual value of the asset at the end of the lease is \$25,804. Under current U.S. GAAP, the lease is accounted for as a sales-type lease. Tractor Inc. determines that under the proposed guidance, it would use the receivable-and-residual approach to account for the lease.

The following table illustrates the differing effects of current sales-type lease accounting and the ED's receivable-and-residual approach on Tractor Inc.'s statement of comprehensive income.

	Current U.S. GAAP (Sales-Type Lease Accounting)					Proposed Guidance (Receivable-and-Residual Approach)				
	Y0	Y1	Y2	Y3–Y8	Total	Y0	Y1	Y2	Y3–Y8	Total
Revenue	\$124,196 <sup>(a)</sup>	—	—	—	\$124,196	\$124,196 <sup>(a)</sup>	—	—	—	\$124,196
Cost of sales	<u>(74,196)</u>	—	—	—	<u>(74,196)</u>	<u>(82,797)</u>	—	—	—	<u>(82,797)</u>
Gross margin <sup>(b)</sup>	50,000	—	—	—	50,000	41,399 <sup>(c)</sup>	—	—	—	41,399
Operating expenses	—	—	—	—	—	—	—	—	—	—
Interest income <sup>(d)</sup>	—	9,000	8,340	33,788	51,128	—	9,000	8,340	33,788	51,128
Net income	<u>\$ 50,000</u>	<u>\$ 9,000</u>	<u>\$ 8,340</u>	<u>\$ 33,788</u>	<u>\$ 101,128</u>	<u>\$ 41,399</u>	<u>\$ 9,000</u>	<u>\$ 8,340</u>	<u>\$ 33,788</u>	<u>\$ 92,527</u>

- (a) Amount represents the present value of future lease payments (eight payments of \$20,000 each) discounted by the rate the lessor charges the lessee (6 percent).
- (b) Under current U.S. GAAP, a lessor would recognize the full manufacturer's profit on a sales-type lease (\$50,000) whereas under the receivable-and-residual approach, the lessor would defer recognition of the profit on the residual asset (\$8,601) until the residual asset is either sold or re-leased.
- (c) The year 0 profit of \$41,399 represents profit recognized at lease commencement when the leased asset is transferred to the lessee. It is calculated as (1) the difference between the fair value and the carrying amount of the leased asset at inception (\$150,000 – \$100,000 = \$50,000) multiplied by (2) the lease receivable divided by the fair value of the leased asset at lease commencement (\$124,196 ÷ \$150,000 = 82.80%). That is, \$41,399 = \$50,000 × 82.80%.
- (d) Under the receivable-and-residual approach, the interest income equals the periodic interest income on the lease receivable plus the periodic accretion of the gross residual asset. In the first year, the interest income on the receivable is \$7,452 (\$124,196 × 6%), and the accretion of the gross residual asset is \$1,548 (\$25,804 × 6%).

The lessor's business model could also widen the disparity between the impact of current U.S. GAAP and that of the ED on how lease income is recognized in the statement of comprehensive income. If the lessor's business model is to use leasing "as an alternative means of realizing the value from the goods that it would otherwise sell," the income statement presentation under the receivable-and-residual approach would be on a gross basis, as indicated in Example 3. However, if the lessor's business model is to use leasing to provide financing to the lessee, the up-front profit would be presented on a net basis (i.e., in a single line item).

## Other Items

### Components of a Lease Contract

Lease contracts generally include a number of "components," including the lessee's right to use the leased asset, executory costs (e.g., property taxes), and possible service arrangements between the lessee and lessor.

Under the ED, the lessor would identify the various lease and nonlease components and allocate the consideration receivable among them on the basis of their relative stand-alone selling prices. If the stand-alone selling price of a component is unavailable, the lessor would use an appropriate method to estimate it, such as "cost plus margin."

Under the ED, the lessor would identify the various lease and nonlease components and allocate the consideration receivable among them on the basis of their relative stand-alone selling prices.

#### Example 4: Identifying Lease Components and Allocating the Consideration Receivable

Car Finance Co. leases a car with a selling price of \$25,000 to Customer A for five years. The annual payment is \$4,000. In addition to the use of the car, Customer A receives annual maintenance services from Car Finance Co. for the first three years.

Car Finance Co. determines that the contract consists of two components: (1) Customer A's right to use the car over the five-year lease term (the lease component) and (2) the maintenance for three years (the nonlease component). The maintenance services are not offered separately from lease arrangements. However, on the basis of the amounts it pays its dealers to perform the maintenance, it estimates that under the cost-plus-margin approach, the selling price of such services would be \$2,500. The company also estimates that it would sell the car without the maintenance agreement for \$23,000.

Under the ED, Car Finance Co. would allocate the consideration receivable from the lease contract as follows:

	Stand-Alone Selling Price	Allocation Percentage	Annual Payment	Amount Allocated
Lease component	\$ 23,000	90.2%	\$ 4,000	\$ 3,608
Nonlease component	2,500	9.8%	\$ 4,000	392
	<u>\$ 25,500</u>	<u>100%</u>		<u>\$ 4,000</u>

### Expected Variable Lease Payments Included in the Lease Rate

For leases that contain usage- or performance-based variable lease payments, the lessor would need to consider whether the base lease rate includes an expectation of receiving those variable lease payments. If the base lease rate does not include that expectation, the variable lease payments would be recognized in income when earned unless they are in-substance fixed lease payments.

However, the base lease rate may reflect an expectation of receiving variable lease payments — for example, when a lessor leases a car for a base payment of \$0 and expected usage-based lease payments of \$4,800 each year. In such situations, the lessor would not record a receivable for the \$4,800 but would include the present value of the expected variable lease payments as part of the residual asset. Upon receiving an expected lease payment, the lessor would decrease that portion of the residual asset and recognize a portion of the deferred profit in accordance with the formula proposed in ASC 842-30-55-4.<sup>1</sup>

<sup>1</sup> For titles of *FASB Accounting Standards Codification* (ASC) references, see Deloitte's "Titles of Topics and Subtopics in the *FASB Accounting Standards Codification*."

### Example 5: Expectation of Collecting Variable Lease Payments

Manufacturer Inc. (the lessor) leases equipment with a carrying value of \$8,000 to VLP Corp. (the lessee) for three years. The annual base lease payment is \$500 (paid at year-end). At lease commencement, the fair value of the leased equipment is \$10,000 and the present value of the expected residual asset is \$5,026. Under the lease, Manufacturer Inc. charges the lessee a rate of 10 percent, which includes the lessor's expectation of receiving a usage-based variable lease payment of \$1,500 at the end of each year. The \$1,500 is not considered an in-substance fixed lease payment.

On the basis of the terms and conditions of the lease, Manufacturer Inc. determines that it should use the receivable-and-residual approach to account for the lease. The following table shows how Manufacturer Inc. would initially record the lease and subsequently adjust the residual asset for the variable lease payments received.

Year	Base Payment	Expected Variable Lease Payment	Lease Receivable <sup>(a)</sup>	Interest Income [X]	Gross Residual Asset <sup>(b)</sup> [A]	Accretion of Gross Residual Asset [Y]	Residual Asset Related to Expected Variable Lease Payments <sup>(c)</sup> [B]	Deferred Profit [C]	Net Residual Asset [A]+[B]-[C]	Profit Realized <sup>(d)</sup> [Z]	Total Income for the Period [X]+[Y]+[Z]
0			\$ 1,244		\$ 5,026		\$ 3,730	\$ 1,751	\$ 7,005	\$ 249	\$ 249
1	\$ 500	\$ 1,500	868	\$ 124	5,529	\$ 503	2,487	1,503	6,513	505	1,132
2	500	1,500	455	87	6,082	553	1,243	1,254	6,071	505	1,145
3	500	1,500	0	46	6,690	608	0	1,005	5,685	505	1,159
				<u>\$ 257</u>		<u>\$ 1,664</u>				<u>\$ 1,764</u>	<u>\$ 3,685</u>

(a) The receivable is measured at the present value of the fixed lease payments (three payments of \$500 each), discounted at the rate the lessor charges the lessee (6%).

(b) The gross residual asset is the present value of the estimated residual asset at the end of the lease term. The gross residual amount is subsequently accreted at the rate the lessor charges the lessee.

(c) Initially equal to the present value of the expected lease payments contemplated in the lease rate (three payments of \$1,500). In subsequent periods, the amount is adjusted in accordance with the formula proposed in ASC 842-30-55-4, as the variable lease payments are received.

(d) The year 0 profit of \$249 represents profit recognized at lease commencement when the leased asset is transferred to the lessee. It is calculated as (1) the difference between the fair value and the carrying amount of the leased asset at inception (\$10,000 – \$8,000 = \$8,000) multiplied by (2) the lease receivable divided by the fair value of the leased asset at lease commencement (\$1,244 ÷ \$10,000 = 12.4%). In subsequent periods, the amount is determined in accordance with the formula in ASC 842-30-55-4. That is, \$505 = \$1,500 – ([(\$1,500 ÷ \$4,500) × \$3,730 × (\$8,000 ÷ \$10,000)]).

## Variable Lease Payments Based on a Reference Interest Rate

Under the ED, a lessor would include variable lease payments that are based on an index or a rate in the measurement of the lease receivable. The lessor would use the spot rate, rather than the forward rate, to measure such payments. The payments (and, accordingly, the receivable) would be remeasured in each reporting period for any changes in the index or rate. If the variable payments are based on a reference interest rate (e.g., the LIBOR rate), the discount rate used to calculate the receivable would also need to be updated in each reporting period for any changes in the rate. Any changes in the lease receivable would be recognized in earnings.

### Example 6: Reference-Rate-Indexed Lease

A manufacturer leases equipment to a customer with the following terms:

Terms	
Lease term	4 years (no renewal options)
Interest rate	Reference interest rate
Annual lease payments (in arrears)	\$108,900 (base amount) — adjusted for changes in the reference rate (rate adjustment)
Carrying value of the equipment (cost)	\$425,000
Fair value of the equipment (sales price)	\$500,000
Expected residual value	\$114,572

Year	Reference Rate	Payment	Receivable <sup>(a)</sup>	Interest	Gross Residual Asset <sup>(b)</sup>	Deferred Profit	Net Residual Asset <sup>(c)</sup>	Income <sup>(d)</sup>
0	3.5%	\$ 108,900	\$ 400,000		\$ 100,000	\$ (15,000)	\$ 85,000	\$ 60,000
1	4.2%	110,360	305,100	\$ 14,000	103,500	(15,000)	88,500	17,500
2	3.7%	109,571	207,554	12,814	107,123	(15,000)	92,123	16,437
3	4.0%	109,888	105,662	7,679	110,872	(15,000)	95,872	11,428
4		—		4,226	114,752	(15,000)	99,752	8,106
Total		\$ 438,719		\$ 38,719				\$ 113,471

- (a) The receivable is measured at the present value of the remaining expected future lease payments by using the reference interest spot rate (originally, 3.5%). At the end of year 1, the receivable equals the present value of the revised remaining lease payments (three payments of \$110,360 each), discounted at the revised discount rate (4.2%).
- (b) The gross residual asset is the present value of the estimated residual asset at the end of the lease term (the present value of \$114,572 at a 3.5% discount rate). The gross residual amount is subsequently accreted at the initial rate the lessor charges the lessee (3.5 percent).
- (c) The residual asset initially equals \$85,000 [carrying amount of underlying asset – (carrying amount of underlying asset × [lease receivable ÷ fair value of underlying asset])]; that is, [\$425,000 – (\$425,000 × [\$400,000 ÷ \$500,000])].
- (d) The year 0 profit of \$60,000 represents profit recognized at lease commencement when the leased asset is transferred to the lessee. It is calculated as (1) the difference between the fair value and the carrying amount of the leased asset at inception (\$500,000 – \$425,000 = \$75,000) multiplied by (2) the lease receivable divided by the fair value of the leased asset at lease commencement (\$400,000 ÷ \$500,000 = 80%). In all other periods, profit equals periodic interest income on the lease receivable plus periodic accretion of the gross residual asset.

## Residual Value Guarantees

Under the ED, lessors would only recognize amounts receivable under residual value guarantees as lease payments if the counterparty to the residual value guarantee (which may be the lessee) also receives the benefits of the residual asset at the end of the lease term (i.e., the lessor is guaranteed to receive a fixed amount at the end of the lease). However, the lessor would need to consider residual value guarantees when assessing the residual asset for impairment.

## Impairment

The ED would require the lessor to test the lease receivable and residual asset for impairment by applying ASC 310 and ASC 360, respectively. ASC 360 prescribes a two-step process for determining whether an asset is impaired. In the first step, the sum of undiscounted cash flows expected from the asset is compared with the asset's carrying amount. If the carrying amount exceeds the sum of undiscounted cash flows, the carrying amount is compared with the fair value of the asset. Because the residual asset under the receivable-and-residual approach would initially be measured on a discounted basis, the ASC 360 two-step impairment

model may result in delayed recognition of impairment as compared with lease arrangements currently accounted for as sales-types leases. For current operating leases that would be accounted for under the proposed receivable-and-residual approach, the impairment analysis under ASC 360 would shift from a focus on the recoverability of the entire leased asset to the recoverability of the residual asset.

## Modifications

The ED provides guidance on accounting for modifications to leases. Modifications include substantive changes to the lease contract, such as changes to the contractual lease term or contractual lease payments. When a modification occurs, entities would account for the contract as a new contract when the modification becomes effective. C&IP lessors would need to use judgment in determining whether a contract modification is substantive because the ED does not include any interpretive guidance on this topic.

## Challenges

Entities will encounter numerous challenges in implementing the ED, including those related to:

- *Increased judgment* — Given the replacement of bright-line rules with a principles-based approach, an entity will often have to use judgment in applying the ED (e.g., when determining lease classification and measuring lease payments and lease term). These judgments should be consistent from period to period and throughout the organization if the accounting function is decentralized.
- *Data requirements* — Entities need to summarize, validate, and analyze detailed data from individual leases to implement the proposed requirements. Organizations that operate in multiple jurisdictions often lack a central repository housing key data on all lease contracts. To ensure consistent application, entities may need to gather these details for the entire organization. This task is likely to be complex and time-consuming.
- *Changes to systems, processes, and controls* — Entities will most likely need to make several changes to systems, processes, and controls to store key data, perform calculations, and process accounting entries in a controlled and secure environment on an ongoing basis. These changes should be investigated well before the standard is implemented to allow for lengthy lead times. Automation of this process will be imperative for effective and efficient financial reporting.
- *Contractual terms tied to financial metrics* — The proposed accounting changes could affect many key financial statement measures tied to the statement of comprehensive income (e.g., EBITDA). Companies should proactively assess the impact of the accounting changes on contracts with terms linked to financial metrics, such as debt arrangements, earn-outs, and compensation arrangements.
- *Taxes* — Tax departments will need to evaluate how the accounting changes will affect the overall tax analysis, including possible changes in cash taxes paid (i.e., financial statement changes may affect transfer pricing, state apportionment, or non-U.S. taxes) and changes in deferred tax positions related to book/tax differences in accounting for leases.

## Thinking Ahead

The boards have requested feedback on many of the core elements of the ED. C&IP entities are encouraged to play an active role in the standard-setting process. Comments on the ED are due by September 13, 2013.

Given the replacement of bright-line rules with a principles-based approach, an entity will often have to use judgment in applying the ED.

## Contacts

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