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CONTRACT STRUCTURING UNDER THE NEW LEASE ACCOUNTING RULES: THE CASE OF CUSTOM DESIGN RETAIL, INC.

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ABSTRACT

In 2013, the International Accounting Standards Board and the U.S. based Financial Accounting Standards Board published a revised exposure draft that proposes significant changes to lease accounting under U.S. Generally Accepted Accounting Principles (GAAP). One change involves the lessee recognizing a right-of-use asset and related lease liability for all leases, including those currently classified as operating leases. This case requires students to consider the impact that the proposed leasing standard will have on a lessee's balance sheet. In addition, the case addresses how such an accounting change creates challenges for management who operate under a plethora of contracts based on accounting numbers determined by the accounting standards. Lastly, the case introduces an ethical dilemma faced by accountants of a hypothetical public company. Students are asked to reflect on this ethical dilemma with the help of the Institute of Management Accountant's (IMA's) Statement of Ethical Professional Practice.

INTRODUCTION

Custom Design Retail, Inc. (CDR) is a national fashion merchandiser that caters to the style-conscious woman market. Founded in 1966, CDR grew from a single store through marketing savvy to 243 stores in 47 states by 2007. CDR's founder built its marketing strategy around two ideas he developed as a department store executive. First, a fashion clothes retailer should find and focus on a market niche, such as the style-conscious segment of women who would pay a premium for a higher level of service in selecting fit and fashion. Second, a smart retailer that provides a high level of service has an opportunity to learn from its customers. CDR systematized the learning process by training its staff to gather customer information and feed it to management. The detailed customer intelligence helped inform purchasing and inventory management. The strategy helped CDR to identify and act on changing customer tastes and buying patterns more quickly than larger, better funded rivals. It also helped the firm put the right mix of products on the shelves at the right time, fostering strong customer loyalty. Compared to competitors, CDR tended to overstock less and avoid deep discounting to clear shelves for newer fashions.

CDR's business model proved to be scalable. The company succeeded in executing an expansion strategy into upscale malls in selected U.S. cities, opening one to three stores per month for seven years beginning in 1986. By 1995, the company had over 150 stores operating in 37 states. The firm's strong operating performance generated much of the cash flow to fund the store expansion. But by the mid-1990s, the company's founder was ready to turn over day-to-day operating responsibility for the business and diversify his holdings in the company. This led to a search for a new CEO and preparation for public sale of stock, which were completed in 1995 and 1996 respectively. The company operated relatively smoothly over the first eight or nine years of the successor CEO's tenure. However, around 2005, the company began lagging behind competitors in terms of sales and profitability.

In 2006, the CEO initiated a comprehensive strategic review of the company's operations and opportunities. The review indicated that fashion merchandising was underperforming relative to forecasts, and it highlighted a significant challenge. CDR was having difficulty translating its business model to the internet. Customers were unhappy with the firm's website. Its limited on-line customer base indicated that the website was slow and cumbersome to navigate. Merchandise images were unavailable for many items. Surveys indicated that customers were dissatisfied with assistance from the drill-down capabilities on its website and from its call center provider. The surveyed customers found competitors' websites far superior to CDR's.

The CEO proposed a new strategic plan that included a significant investment project in information technology (IT) and website development. The CEO firmly believed that such an investment would be necessary to increase CDR's internet presence and improve the company's ability to compete effectively in the online market. The technology initiative met resistance from the board. Several board members, including the founder, were reluctant to invest heavily in an area where the firm seemed to be at a competitive disadvantage. They also quibbled with the results from the online customer surveys and argued that the firm's strength was in its stores. Other board members supported the plan, but all were concerned that the overall spending on IT development would exceed funds generated from operations. They feared that a significant investment in IT development would drag down operating profits and expand the company's use of long-term debt.

The divided board debated about the IT development plan during several meetings in 2007. Ultimately, a compromise was struck with the agreement that the funding of the IT project should come from operating profit. Furthermore, the board was clear to state that the company must first invest any operating profit toward necessary store improvements before funding the IT project. The board expressed its belief that the market places significant value on the company's low leverage position, and that the company should not take on any additional debt for IT development or store improvements.

CDR's investment plans were interrupted by the financial crisis and the recession that began in 2008. Consumer spending was hard hit by the recession; unemployment rose quickly and family income growth stagnated during this time. Retail sales and operating margins plunged nationally. Retailers expended huge amounts of cash during the recession, bringing them under financial pressure from suppliers, landlords, and bank creditors. When bank credit lines came up for renewal, marginal retailers no longer met credit standards and were unable to secure new funding sources. As suppliers curtailed extension of trade credit, retailers small and large filed for reorganization. Some, like Circuit City, went into liquidation.

CDR was not immune to the recession. Projections for modest growth in women's apparel turned into declining revenues. Operating margins, which had been forecast to improve, weakened, and the firm experienced its first operating loss since becoming a public company. CDR weathered the storm partly by moving quickly to cut prices and pare inventories early in the downturn. CDR also cut back its investments in store refurbishments and information technology, conserving cash to pay landlords and creditors. By the beginning of the third quarter of 2010, the economy had stabilized. Though reported unemployment remained stubbornly high at more than 9.5 percent, GDP was growing and consumers had begun spending again. CDR's sales had yet to recover from the recession, but with visibility returning to the market, the CEO felt it was time to ramp up the IT investment again.

THE AUGUST 16, 2010 MORNING MEETING

Gladys Stewart, CDR's Chief Financial Officer (CFO), does not especially like surprises. Stewart institutes a weekly meeting with her Controller, Ken Clark, and Treasurer, Andrew Lloyd, to update them on strategic initiatives and to get updates on initiatives under their leadership. The top agenda item at the weekly meeting is always current events. Lately, this means reviewing the firm's financial performance in the context of the moribund recovery from the "Great Recession." Stewart passes around Exhibits 1 and 2 showing CDR's income statements and balance sheets leading up to the recession and for the first two quarters of 2010. The second quarter of 2010 has been the best for CDR since 2007, but sales and margins continue to miss targets.

Stewart also passes around an analyst report that caught the attention of CDR's CEO. The report describes the growth rates of retail sales and e-commerce and e-commerce's share of retail sales in the U.S. for the past five years. Stewart notes, "The report argues pretty strongly that consumer shopping and buying habits are changing. Overall people still aren't buying a lot online, particularly in our segment, and we are below the averages. But people are shopping more intensively online before purchasing." Stewart then turns to Ken Clark and asks, "We've started to pick that up in our web traffic, haven't we, Ken?"

Clark nods and says, "It's one way to look at what we're seeing. Web traffic is up, but online sales are flat and store sales are not coming up as quickly as we budgeted."

Stewart describes the current situation: "People pull in the purse strings in recessions. This recession has really driven them to use technology more in the shopping process – even among our customers who don't buy online. They're looking for more information online before making purchases. Internet marketing is evolving. We're great at capturing store traffic information, but we

EXHIBIT 1

CDR Income Statements for the First Two Quarters of 2010 and for the Years Ending 2006-2009 (in $Millions)

	Jun-2010	Mar-2010	Dec-2009	Dec-2008	Dec-2007	Dec-2006
Sales	56.575	52.550	219.775	240.661	271.197	278.992
Cost of Goods Sold	30.550	28.903	128.311	135.889	145.091	145.886
Gross Profit	26.025	23.647	91.464	104.772	126.106	133.106
SG&A Expense	22.065	22.896	92.131	105.892	106.609	106.776
Operating Profit	3.960	0.751	-0.667	-1.120	19.497	26.330
Non-Operating Inc/Exp	0.041	-0.044	1.112	2.250	1.815	2.154
Pretax Income	3.919	0.795	-1.779	-3.370	17.682	24.176
Total Income Taxes	0.811	0.156	-0.442	-0.522	3.740	5.078
Net Income	3.108	0.639	-1.337	-2.848	13.942	19.098

don't have the technical capabilities we need to track our online customers. We're missing opportunities to provide them with product suggestions or targeted coupons by e-mail – let alone to mobile phones. Customers are starting to expect this. We can't provide images of all of our SKUs, and we're going to wake up someday soon to our competition's online animated fitting rooms. We don't have the kind of technical capability we need to adapt to this evolving market. As you surely know, the CEO is anxious to move forward in significantly upgrading our web presence, and I'm on board with her. If we don't get this right, I think in the long-term we're going to be working for Macy's or Kohl's."

Stewart concludes, "During our last meeting I asked for an update on our hardware and software investment options. What can you tell us, Ken?"

"Our office has been working with IT for some time now, specifying our needs and also on identifying and vetting vendors," Ken Clark begins. "We put out a request for proposals to three vendors. We think our best match is with Lisson Grove Systems. They have the ability to put together a comprehensive solution and they have a strong reputation in our industry. They can start as soon as we approve the contracts. We can have all of the hardware and software in place and tested and the back-office people hired by the end of the first quarter of next year. Store managers and corporate staff should be fully trained when we go live."

Clark refers Stewart and Lloyd to a report from the IT Department (Exhibit 3). "I asked IT to send me a summary of the outlays for the main components of Lisson Grove's proposal. The complete package requires expenditures of around $12 million in the first year and $4 million each year after if we purchase everything – including hardware, software licenses, web-site development, and training. Their pricing is on the high side, but we're convinced we're paying for a superior product bundle."

Stewart quickly takes in the figures from Exhibit 3 and turned to Andrew Lloyd. "Andy, you've been working with our capital financing team. In round figures, our board mandates we commit $4 million above depreciation of operating profit for store improvements. If we need another

EXHIBIT 2

CDR Balance Sheets for the First Two Quarters of 2010 and for the Years Ending 2006-2009 (in $Millions)

	Jun-2010	Mar-2010	2009	2008	2007	2006
ASSETS						
Cash & Equivalents	25.197	23.474	21.015	22.988	33.598	35.917
Net Receivables	7.577	6.910	6.849	5.568	6.445	8.940
Inventories	20.446	19.306	19.544	20.282	21.681	22.413
Other Current Assets	3.118	2.443	1.943	1.795	2.465	2.217
Total Current Assets	56.338	52.133	49.351	50.633	64.189	69.487
Net Plant and Property	56.461	58.837	59.813	64.781	68.025	70.377
Other Assets	13.944	14.443	13.369	12.320	13.488	14.057
TOTAL ASSETS	126.743	125.413	122.533	127.734	145.702	153.921
LIABILITIES						
Current Maturities of LT Debt	1.250	1.250	1.250	1.525	0.000	1.250
Accounts Payable	10.547	10.459	9.413	10.054	20.077	24.826
Other Current Liabilities	3.133	3.251	2.244	2.790	8.413	12.447
Total Current Liabilities	14.930	14.960	12.907	14.369	28.490	38.523
Long-tem Debt, net current	0.000	1.250	2.500	3.750	0.000	0.000
Other Liabilities	10.651	12.000	10.806	11.772	16.448	21.115
TOTAL LIABILITIES	25.581	28.210	26.213	29.891	44.938	59.638
EQUITY						
Common Stock	0.165	0.164	0.164	0.164	0.163	0.163
Capital Surplus	27.859	26.989	26.745	26.931	27.005	34.466
Retained Earnings	73.138	70.050	69.411	70.748	73.596	59.654
Stockholders' Equity - Total	101.162	97.203	96.320	97.843	100.764	94.283
TOTAL LIABILITIES & EQUITY	126.743	125.413	122.533	127.734	145.702	153.921

$11 to $12 million for IT infrastructure and web development, how soon will we have enough operating profit to begin this project?"

"Well," Lloyd bemoans, "I don't foresee that type of investment coming out of operating profits in the near future." He passes copies of a forecast (Exhibit 4) to Stewart and Clark and

EXHIBIT 3

Report from IT Department Pertaining to Vendor Proposal for IT Upgrades

Below is a summary of the outlays for the main components of the Lisson Grove System's proposal for CDR's upgrade in information technology and web presence. The one-time expenditures involve various hardware, terminal, and server components; training; and website and system configuration and integration. These one-time expenditures total $8,020,000. The ongoing annual expenditures total $3,900,000 and include costs for license fees, support personnel, and maintenance. CDR would own all the hardware and we estimate a useful life of 5 years for these components.

Components	**Cost**
One-time Expenditures	
Hardware, including POS terminals and e-commerce servers	$6,225,000
Training, including corporate staff and store employees	675,000
Web site development and system integration	1,120,000
Total	$8,020,000
Annual Expenditures	
Software licenses including comprehensive e-commerce suite	$3,245,000
Ongoing personnel costs due to increased staffing needs	410,000
Web-site maintenance	245,000
Total	$3,900,000

EXHIBIT 4

CDR 3-Year Operating Income Forecast (in $Millions)

	2010	2011	2012
Sales	$230.25	$256.00	$280.00
Cost of Goods Sold	126.50	137.70	151.20
Gross Profit	103.75	118.30	128.80
Selling, General &Administrative Expenses	85.50	89.00	92.00
Depreciation Expense	11.80	12.00	12.25
Operating Income	$6.45	$17.30	$24.55

explains, "As you know, the board mandates that the store improvement and IT investment decisions be based upon the next year's operating income forecast, and here is that forecast. It looks like we may have finally turned the corner last quarter, and we expect operating profits to slowly climb back to their pre-financial crisis amounts in the next few years. Despite this positive trend, there is not going to be enough operating profit to cover both store improvements and IT investments in the near future. Just looking at 2011, we would have to dedicate around $16 million of operating profit toward store improvements, which leaves just over $1 million for IT. In 2012, if all goes as projected, we would have around $8 million for IT."

"That's simply not acceptable!" Stewart exclaims while pounding the table. "If we keep going down this brick and mortar path led by our dinosaur board, we're doomed." Lloyd and Clark nod in agreement while staring at the forecast.

"What about leasing some of the IT components?" Stewart inquires in frustration. "We lease most of our stores on an operating basis so they don't show up in the leverage ratios. And it's common to lease IT equipment. Could we tie some of the IT investment components into a service contract? Even if it's a relatively expensive option, the financing cost will be built into the leases and the service contracts. This might avoid the IT funding issue and allow us to move ahead with our plan."

Lloyd is pleased to have the CFO already on board with what he felt might be their only alternative for financing the IT investment in the near term. "It's a good idea," he replies. "In fact, we included leasing as part of our request for proposals. Lisson Grove offered to provide all of the hardware for our project on a 3-year noncancellable lease with an option to purchase at termination for market value. The terms of the lease calls for quarterly payments of $500,000 to commence at the initiation of the lease and for Lisson Grove to maintain the hardware during the life of the lease. Our IT department determined that we would most likely not exercise the lease purchase option in three years."

Stewart, encouraged by the leasing idea, states. "We seem to have found a potential option to fund the IT development plan, but we also need to think deeper about the financial reporting consequences. I've been getting updates from our audit partner on the FASB and IASB's work on harmonizing accounting standards. The standard setting boards are in the midst of writing a new standard for lease accounting. As you know, most of our stores are operating leases and currently not on the balance sheet. We need to assess how this new standard will impact our balance sheet, and whether this will raise the ire of our board. This could also affect how we will structure the terms of any new leases. I know our leasing department has been working with the auditors on this issue, so I'm sure they'll have some useful information for us (see Exhibit 5)."

She continues while gathering her papers, "Let's push up our next meeting a few days to make sure we're on top of this. At that meeting, I would like a full analysis on leasing the IT development project. I need to know how this lease will impact the financials, under both the proposed and current leasing standards. I also need to know how applying the new leasing standard to our existing operating leases will impact the balance sheet."

Stewart stands up and states, "If this project doesn't move forward gentlemen, we will all probably be looking for work next year. We might have to get creative in how we present this information at the next board meeting." She then leaves the conference room.

Lloyd looks at Clark and mutters, "Might as well forget the golf league this evening, we're in for a long night." Clark sighs and nods in agreement.

EXHIBIT 5

Summary Information on Store Leases

CDR currently has 240 outstanding leases for their retail stores with over 200 individual landlords. The vast majority of CDR's store leases have a 5 or 10-year term, an annual rental amount of around $58,000, and an option to renew for the same time period under similar terms. The rental payments are due at the beginning of each period. The renewal decision is based on several factors including the company's strategic plan and the demographic profile of the population surrounding the store's location. The amounts below were gathered from the individual lease contracts and the market demographics profile reports maintained by the marketing department for each location. Based on the demographics profiles, the leasing department subjectively classified each store's demographics as follows:

- Poor = aging population that is decreasing in size and discretionary income.
- Adequate = population that is maintaining its age, size, and discretionary income.
- Good = population that is getting younger and increasing in size and discretionary income.

The following table summarizes the leased stores by term and demographic classification.

		Demographics			
Lease Term	Years Remaining of Lease*	Poor	Adequate	Good	Total
5 years	3 years	8 stores	57 stores	32 stores	97 stores
10 years	3 years	20 stores	39 stores	14 stores	73 stores
10 years	8 years	7 stores	41 stores	22 stores	70 stores

*This is an average of remaining years left of the original lease term. The 10 year leases consist of two categories: leases commenced in last 5 years (70 stores), and leases commenced over 5 years ago (73 stores).

Since a future renewal option is usually negotiated at the time of the lease renewal, it is safe to assume that all of the outstanding leases have a renewal option. Also, CDR's incremental borrowing rate is currently 6 percent.

Lastly, the revised *Leases* Exposure Draft defines the lease term as follows:

> An entity shall determine the lease term as the noncancellable period of the lease, together with both of the following:
> a. Periods covered by an option to extend the lease if the lessee has a significant economic incentive to exercise that option.
> b. Periods covered by an option to terminate the lease if the lessee has a significant economic incentive not to exercise that option (ED 842-10-25-1).

REQUIREMENTS

Please refer to the revised *Leases* Exposure Draft when answering the questions that pertain to the new lease accounting proposal.

1. Describe the significant balance sheet changes for lessees resulting from the proposed lease accounting requirements.
2. Refer to Exhibit 5 and estimate the impact that applying the proposed lease accounting requirements for CDR's store operating leases would have had on their 2009 Balance Sheet.
3. Assume CDR accepts the Lisson Grove lease agreement.
    a. Determine the balance sheet impact for leasing the IT project under the current lease accounting requirements.
    b. Determine the balance sheet impact for leasing the IT project under the proposed lease accounting requirements.
    c. Would the Lisson Grove lease agreement allow management to invest in the IT project in 2011 and still satisfy the board's mandate? Please comment on whether the lease option satisfies both the spirit and form of the board's mandate.
    d. Assume CDR management executes the Lisson Grove lease and makes the IT investment in 2011 (based on the 2011 Operating Income Forecast presented in Exhibit 4). How may Andrew Lloyd and Ken Clark 'creatively' present this IT investment decision to the board? Assume Ken Clark determines that the lease commitment will have a minimal net effect on the presented 2011 Forecasted Operating Income due to the expected increase of gross profit from the improved web presence offsetting the related IT expenses for the year.
4. Provide some suggestions as to ways CDR can structure future leases that would minimize their impact on the balance sheet under the proposed lease accounting requirements. Consider both the store leases and the Lisson Grove Systems' proposal. Identify and discuss any potential costs associated with your suggestions.
5. As preparers of public financial statements, management accountants of a public company, and members of the accounting profession, both Ken Clark and Andrew Lloyd have certain responsibilities to various stakeholders. Members of the accounting profession, like all professions, are expected to behave ethically. Several accounting organizations [e.g., the American Institute of Certified Public Accountants (AICPA), the Institute of Internal Auditors (IIA), and the Institute of Management Accountants (IMA)] have codes of professional conduct that prescribe the ethical conduct that accounting profession members should strive to achieve. Please refer to the IMA's Statement of Ethical Professional Practice at www.imanet.org/pdfs/statement%20of%20Ethics_web.Pdf to answer the following questions:
    a. Identify the components of the IMA's Statement of Ethical Professional Practice that are most applicable to the CDR case.
    b. As financial statement preparers and management accountants for a publicly listed company, Ken Clark and Andrew Lloyd have a fiduciary responsibility to a variety of CDR stakeholder groups. Identify these various stakeholder groups and describe Clark and Lloyd's responsibility to each of them.
    c. Discuss the ethical implications surrounding management's possible adoption of the leasing plan described in the case.

d. Provide a suggested ethical course of action that Ken Clark and Andrew Lloyd should take for the situation described in the case.

REFERENCE

Financial Accounting Standards Board (FASB). 2013. *Leases (Topic 842) a revision of the 2010 proposed FASB Standards Update, Leases (Topic 840)*. Exposure Draft No. 2013-270. Norwalk, CT: FASB.

TEACHING NOTES

Teaching notes are available from the editor. Send a request from the "For Contributors" page of the journal website, http://gpae.bryant.edu.