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Implementing the New Lease Guidance

October 22, 2018

Agenda

- Background
- Scope
- Effective dates & transition requirements
- Lessee accounting model
- Lessor accounting model
- Specialized topics
  - Sale leaseback
  - Lease modifications
  - Separating lease and non-lease components
  - Initial direct costs
  - Subleases
- Implementation framework
- Other practical considerations

Background and Scope

Background

Project added to agenda - July 2006

Discussion Paper - March 19, 2009

Exposure Draft – August 17, 2010
Comment period ended December 15, 2010

Outreach / Fieldwork / Re-deliberations

Revised Expose Proposal – May 16, 2013
Comment period ends Sept. 13, 2013

Outreach / Fieldwork / Re-deliberations

Issue final ASU – Feb. 25, 2016

Scope

Identifying a lease includes determining that the following are present:

Identified Asset

- Explicitly or implicitly specified
- No ability to substitute (or no benefit from substituting)

Right to Control Use During Term

- Ability to obtain substantially all of the economic benefits from the use
- Right to direct the use of the identified asset

Most leases today will be leases under the new standard!

Effective dates and transition requirements

Effective date

- Public business entities (PBEs) and certain not-for-profit entities and employee benefit plans - fiscal years (including interims within) beginning after Dec. 15, 2018, including interim periods within those fiscal years
- All other entities - fiscal years beginning after Dec. 15, 2019, interim periods beginning after Dec. 15, 2020.
- Early application permitted for all entities.

Transition

- Lessee – **Modified retrospective** for capital and operating leases existing at or entered into after the beginning of the earliest comparative period presented (no required transition for leases that expired before application).
- Lessee – **Cumulative transition** method allows entities to initially apply the transition provisions at the adoption date and recognize a cumulative-effect adjustment to the opening balance of retained earnings in the period of adoption.
- Lessor – require modified retrospective transition approach for sales-type, direct financing, and operating leases existing at, or entered into after, the date of initial application (no required transition for leases that expired before application).

Lessee Accounting Model – How to determine classification

Criteria

- Five classification criteria (ASC 842-10-25-2) similar to existing GAAP
- No bright line thresholds
- Largely based on whether lessee obtains control of the underlying asset rather than control over merely **the use of** the underlying lease asset
- "Reasonably certain to exercise"
  - Lease term includes periods subject to extension options if the lessee is ***Reasonably Certain*** to exercise that option
  - Application of reasonably certain in the lease term assessment and consideration of options to purchase is intended to be applied similar to the existing "reasonably assured" threshold

Related party leases

- Accounted for on the basis of legally enforceable terms and conditions stated in the lease, rather than on the basis of the lease's economic substance.

Lessee Accounting Model – Measurement and presentation

Impact	Finance Lease	Operating Lease
Has control of the lease asset passed to the lessee?	Yes	No
Balance sheet	Right-of-use asset Lease liability	Right-of-use asset Lease liability
Income statement (characterization)	Interest expense Amortization expense	Lease expense (including initial direct costs)
Pattern of expense	Front-loaded	Straight-line
Cash flow statement	Operating - cash paid for interest Financing - cash paid for principal	Operating - cash paid for lease payments

Lessee Accounting Model – Measurement and presentation (cont.)

Other considerations related to measurement and presentation

- Most short term leases will not require recognition on balance sheet

- Discount rate
  - Practical expedient – non-PBEs may use a risk free rate in measuring the lease liability
  - Portfolio approach – entities with large number of similar leases
  - Implementation planning is critical in selecting a discount rate

- Variable lease payments
  - Only included in lease liability if they depend on an index or rate
  - Use the applicable index or rate at the commencement date; no need to adjust the rate at each period unless another event causes the lease to be adjusted
  - Recognize variable lease payments that were not included in the lease liability when the amounts become probable
  - Variable payments could be considered fixed if the variable payments are virtually assured of being incurred (eg. below-market rent).

Lessee Accounting Model – Disclosures

Qualitative	Quantitative

Qualitative

- Nature of leases and significant terms
- Significant assumptions and judgments made in application
- Leases that have not yet commenced but create significant rights and obligations for the lessee
- Main terms and conditions of sale and leaseback transactions
- Whether the entity made an accounting policy election for the short-term lease exemption

Quantitative

- Finance lease cost, segregated between amortization and interest
- Operating lease cost
- Short-term lease cost
- Variable lease cost
- Sublease income
- Net gain or loss on sale and leaseback transactions
- Maturity analysis of lease payments
- Separately for finance and operating leases:
  - Cash paid for amounts included in lease liabilities, segregated between operating and financing
  - Lease liabilities arising from obtaining ROU assets
  - Weighted-average remaining term
  - Weighted-average discount rate

Let’s walk through a hypothetical lease…

Entity ABC, a lessee, entered into a four year lease of a commercial office building. At lease commencement, management of Entity ABC determined that the lease should be classified as an operating lease because the lease did not meet any of the five criteria to be classified as a finance lease.

- The lease includes the following annual escalating lease payments due at the end of each year:
  - Year 1 - $12,000
  - Year 2 - $14,000
  - Year 3 - $16,000
  - Year 4 - $18,000
- The lessor agreed to provide Entity ABC with six months of free rent in the first year of the lease. There are no extension periods, no options to purchase, and no other lease incentives from the lessor. Additionally, there were no initial direct costs.
- As the rate implicit in the lease could not be determined, Entity ABC used a discount rate of 6.682% which is its incremental borrowing rate.

Let's walk through a hypothetical lease…

At the commencement of the lease, Entity ABC would initially measure and record the right-of-use asset, lease liability, and the free-rent incentive as follows:

	Payments
Year 1	$ 6,000
Year 2	14,000
Year 3	16,000
Year 4	18,000
Total	$ 54,000

	Debit	Credit
Right-of-use asset	$ 45,000	
Lease liability		$ 45,000

PV of lease payments at the discount rate of 6.682% = $45,000

- The initial measurement of the lease liability and right-of-use asset was determined based on the present value of the lease payments using the 6.682% discount rate. Note that the free-rent incentive is factored into the Year 1 cash flows.

Let's walk through a hypothetical lease…

Entity ABC would then record the following entries in Year 1 of the lease:

		Debit		Credit
Lease expense	$	13,500		
Right-of-use asset			$	7,500
Cash			$	6,000

- To record lease expense and adjust the right-of-use asset for the difference between cash paid of $6,000 and the straight-line lease expense of $13,500 (i.e., accrued rent).

	Payments
Year 2	14,000
Year 3	16,000
Year 4	18,000
Total	$ 48,000

		Debit		Credit
Lease liability	$	2,993		
Right-to-use asset			$	2,993

- To adjust the lease liability to the present value of the remaining lease payments at the end of Year 1, with an offset to the right-of-use asset. The adjustment of $2,993 is calculated as the initially recognized lease liability ($45,000) less the present value of remaining lease payments ($42,007) at the end of Year 1, or in-effect, the "principal" portion.

Let's walk through a hypothetical lease…

A summary of the lease contract's accounting (assuming no changes due to reassessment, lease modification, or impairment) is as follows:

	Initial	Year 1	Year 2	Year 3	Year 4
Cash lease payments:		$ 6,000	$ 14,000	$ 16,000	$ 18,000
Income statement					
Lease expense (straight-line)		13,500	13,500	13,500	13,500
(Accrued) prepaid rent for period		$ (7,500)	$ 500	$ 2,500	$ 4,500
Balance sheet					
Lease liability	$ (45,000)	$ (42,007)	$ (30,814)	$ (16,873)	$ -
Right-of-use asset					
Lease liability	$ 45,000	$ 42,007	$ 30,814	$ 16,873	$ -
Add: cumulative (accrued) prepaid rent	-	(7,500)	(7,000)	(4,500)	-
	$ 45,000	$ 34,507	$ 23,814	$ 12,373	$ -

Lessor Accounting Model – How to determine classification

Criteria

- Underlying theme of control
- If the lease does not meet any of the initial five criteria (ASC 842-10-25-2) for a sales-type lease, a lessor will determine if the lease meets the two criteria that trigger classification as a direct-financing lease (ASC 842-10-25-3(b)).
  - Present value of the sum of the lease payments and any additional guaranteed residual value equals or exceeds substantially all of the FV of the lease asset, and
  - It is ***PROBABLE*** that the lessor will collect the lease payments and any guaranteed residual value
- Leases that do not meet any of the initial five criteria to be classified as sales-type leases and that do not meet criteria to be classified as direct-financing leases will be classified as operating leases.
- Elimination of leveraged leases
  - Existing leveraged leases at transition date will be grandfathered

Lessor Accounting Model – Measurement and presentation

	Direct-Financing or Sales-Type	Operating Lease
Balance sheet	Recognize net investment in the lease and derecognize leased asset (unless, for sales-type lease, collectability is not probable, and the lease asset is not derecognized)	Continue to recognize underlying asset
Income statement (characterization)	Direct-financing – interest and profit over lease term, loss at commencement Sales-type – interest over lease term, profit / loss at commencement if collectability is probable	Lease income, typically straight-line
Cash flow statement	Operating – cash received	Operating - cash received

Lessor Accounting Model – Disclosures

Qualitative	Quantitative

Qualitative

- Nature of leases and significant terms
- Significant assumptions and judgments made in application
- Residual value risk management
- Significant changes in unguaranteed residual assets and deferred selling profit

Quantitative

- Table of lease income
- Lease income related to variable lease payments not included in measurement of lease receivable
- Maturity analysis of undiscounted cash flows; reconciliation to the lease receivable is required for sales-type and direct-financing leases
- Profit or loss recognized at commencement date
- Required PP&E disclosures for assets subject to operating leases

Specialized Topics – Sale and leaseback transactions

- Has a sale occurred? Definition of a sale conforms to the new revenue recognition standard, which requires giving up control of the underlying asset.
- A sale leaseback resulting in a finance lease from a lessee standpoint, or a sales-type lease from a lessor standpoint, will not qualify for sale leaseback accounting because control has not transferred to the buyer-lessor.
- Repurchase options preclude sale treatment, EXCEPT if the repurchase option is exercisable only at the then-prevailing fair value and the underlying asset is not specialized.
- The accounting for both parties generally will be consistent with the accounting for the purchase and sale of any similar nonfinancial asset.
  - The standard provides guidance for sale and leaseback transactions entered into at off-market terms.

Specialized Topics – Lease modifications

- Lease modification – Defined in Topic 842 as: “A change to the terms and conditions of a contract that results in a change in the scope of or the consideration for a lease.”

- Lease modification guidance in Topic 842 was designed to more closely align lease modification accounting with contract modification accounting for sellers of goods or services under the new revenue recognition standard, Topic 606.

- Guidance covering lease modifications in Topic 842 is radically different from prior GAAP. Entities should carefully assess any changes in lease contracts to determine whether a modification has occurred. Past practice may not be applicable under the new standard.

- Start by asking whether a modification should be accounted for as a separate contract
  - If YES – Then account for the new contract in the same manner as any other new lease
  - If NO – Then remeasure and reallocate the remaining consideration in the modified lease, and reassess the classification at the effective date of the modification.

Specialized Topics – Separating lease and non-lease components

Common examples of non-lease components: bundled services, executory costs (taxes, insurance, common area maintenance)

	Lessee	Lessor
Separation	Separate unless applying accounting policy election	Separate non-lease components. Apply the ASC 606 revenue recognition guidance to separated non-lease components to determine further separation.
Allocation	Relative standalone price of components (observable prices or if not available, maximize observable information)	Apply the ASC 606 revenue recognition guidance
Accounting Policy Election	May elect, by class of underlying leased asset, to not separate non-lease components from the lease component.	N/A

Other Topics – Initial direct costs

Initial direct costs (IDC's) are incremental costs of a lease that would not have been incurred if the lease had not been obtained.

- Key difference in new standard – Lessees and lessors can no longer include allocated costs (eg. salaries) and other costs incurred before the lease is obtained (eg. legal review) in IDC's.

Lessees	• Include IDC's in the initial and subsequent measurement of the ROU asset.
Lessors	• Include IDC's in the initial and subsequent measurement of the net investment in the lease for direct financing leases and sales-type leases with no selling profit or loss. • Expense IDC's at lease commencement for sales-type leases with selling profit or loss. • Expense IDC's over the lease term for operating leases, consistent with recognition of lease income.

Specialized Topics - Subleases

- Entities entering into subleases should give careful consideration to whether the original lessee/sublessor remains the primary obligor under the lease.
- If the original lessee/sublessor is relieved of the primary obligation, the sublease transaction shall be considered a termination of the original lease and profit or loss is recognized upon derecognizing the ROU asset and lease liability.
- If the original lessee/sublessor remains the primary obligor, the sublessor must assess sublease classification independent of the classification assessment that it makes as the lessee of the same asset. The sublease classification should be determined based on the lessor accounting model.
  - If sublease is an operating lease – Continue to account for the original lease, and assess the ROU asset for impairment if lease cost exceeds anticipated sublease income.
  - If sublease is a sales-type or direct financing lease – Derecognize the head lease ROU asset, adjust the head lease liability under finance lease provisions, recognize a net investment in the sublease, and evaluate the net investment for impairment.

Impacts to Internal Controls

- How will the new process affect the way I engage in leases?
  - Do approval chains need to be reviewed and adjusted?
  - Is your process centralized or decentralized?
- How do you ensure consistent application of the standard?
- Do I have a standard process to inform accounting and record the activity?
- How are amendments / renewals / modifications communicated?
- New controls around the lease application and access

Other Topics – Implementation considerations (continued)

Other practical considerations

- Non-PBEs – Consider whether it makes sense to elect a policy to use the risk-free rate. Ease of application versus smaller lease liability and lease asset.
- Establish a methodology to determine the organization's incremental borrowing rate
- Separating lease and non-lease components – Ease of application versus smaller lease liability and lease asset.
- Consider the availability and practicality of other practical expedients offered as a package at transition. An entity may elect, as a package, to not reassess
  - Whether any expired or existing contracts are, or contain, leases (as defined in Topic 842)
  - The lease classification for any expired or existing leases
  - Previous capitalization of initial direct costs for any existing leases
- Entities can also make an election to use hindsight in determining the lease term (generally regarding options to extend or terminate the lease, or purchase the leased asset) and in assessing impairment of ROU assets. This may be elected separately or in conjunction with the above practical expedients, and must be applied consistently to all leases.

Pain Points

Scoping

The standard will require organizations to know what all their leases are and have the necessary information to track them.

Manual Process

A software solution to perform the accounting will be needed. The leases tracked in Excel is no longer feasible.

Ongoing Controls

Processes and controls for lease acquisition and modification will need to be addressed in addition to the accounting

Resource Burden

Companies will face a resource shortage to read through all their contracts, manage the implementation of the new standard in addition to regular accounting processes.

ASC 842 Impact Assessment And Implementation Consulting Services

1 → 2 → 3 → 4 → 5 → 6

1. Understand the New Standard

The new standard's requirement to recognize operating leases on the balance sheet will significantly affect many companies. The changes will have an impact not only accounting policies but the systems used to manage leases.

2. Gather Information

Obtain an understanding of current and in-process lease agreements as well as relevant policies, procedures, data, and systems involved.

3. Evaluate Impact

Establish a cross-functional team, inclusive of accounting, tax, purchasing, IT, and legal, to evaluate the impact across the entire organization.

4. Select Transition Approach

Significant planning should go into the selection of a transition approach and required system enhancements (e.g. Crowe Leased Asset Calculator). This includes selection of practical expedients and organization of the lease accounting function.

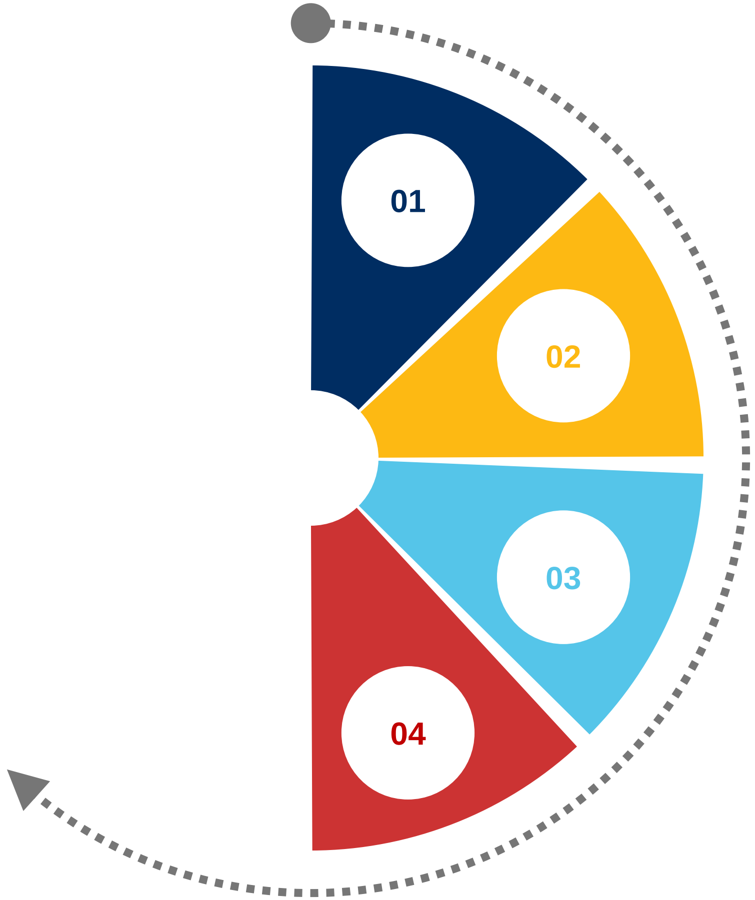
5. Design Solution

Based upon magnitude of impact (number of leases / companies), develop a project plan and timeline, and secure necessary resources to meet the effective date.

6. Implement and Monitor

Execute the project plan, monitor status, and communicate with relevant stakeholders.

Crowe’s Lease Solutions



Scoping & Impact Assessment

- Scoping of leasing environment – determine population of all leases, look for unrecorded leases
- ASC 842 impact assessment report, including gaps noted, assessing ASC 842
- Technical memos and executive summaries, project plan and timeline for implementing ASC 842

Technology Enablement

- Technology Solution Implementation and Testing
- Integration into ERP backbone system, or GL package, as needed
- Crowe Lease Accounting Optimizer
- Lease Query

People, Process & Controls

- We cover people, processes and controls in this solution. We’ll help with controls around the implementation of the standard, RCM modifications, sox and operational, etc.
- Process flow recommendations, and assistance on implementation
- Writing of policy and procedures around lease initiation, modification, and recording.

Analysis & Impact Completion

- Creation of the required disclosures
- Evaluation and implementation of required entries for full vs. modified retrospective
- Any additional entries to bring your entity into compliance with the standard

Scoping and Impact Assessment

In the Scoping and Impact Assessment phase Crowe will work with management to identify the location of both lease contracts but the required metadata that will be required for entry into your selected ASC 842 software.   This review is a combination of both qualitative and quantitative reviews to identify the location of lease asset classes and the applicable owners.

- **People, Process, Controls:** Crowe begins the scoping and assessment phase of the project with an assessment of the current lease initiation and modification controls. This allows Crowe to identify key process owners for further inquiry as well as identify bottleneck points for particular asset classes.
- **Quantitative:** Crowe utilizes both financial statement and transaction level detail to identify potential asset classes and services with embedded leases. Aggregated lease information is compared to financial results to ensure completeness.
- **Qualitative:** Utilizing information gathered in the inquiry stage and quantitative analysis, Crowe will train relevant process owners on the expectations of the standard and inquire to identify both leases that are apparent as well as services that may contain embedded leases.

Utilizing this approach, Crowe is able to clearly identify the entire population of leases and the process owners responsible for providing the required estimates and information needed to accurate calculate and record the required lease liabilities and right of use assets. Additionally, Crowe can assist Management with determining the impact of these populations under the standard and any resulting changes in accounting policies that will be required.

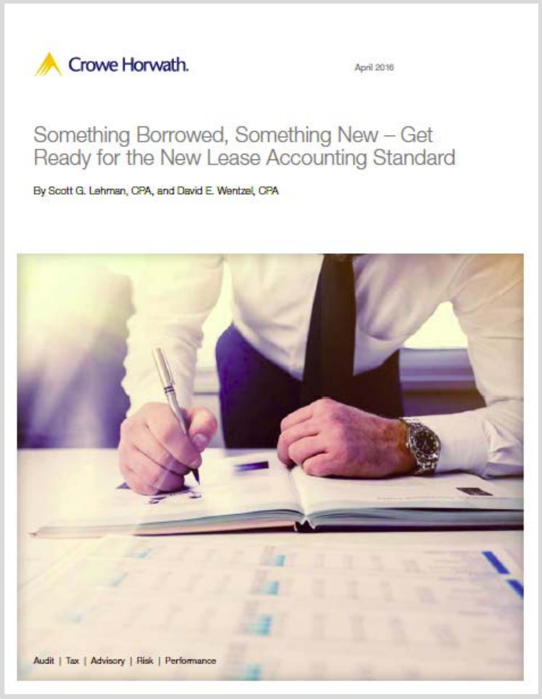
Crowe’s approach provides Management, with a clear approach for implementation of ASC 842.

Resources

Resources

Crowe Newsletter, “Something Borrowed, Something New: Get Ready for the New Lease Accounting Standard”

- Issued April 8, 2016
- 16 pages
  - Background
  - Who Will Be Affected
  - Sale and Leaseback Transactions
  - Effective Dates
  - Transition
  - Disclosures



https://www.crowe.com/insights/asset/borrowed-new-lease-accounting-standard/

Questions

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Thank you

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