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THE NEW LEASE ACCOUNTING STANDARD ASC 842

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Protiviti Perspective provided by Nikhil K., New Delhi

Internal Audit, Risk, Business & Technology Consulting

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THE NEW LEASE STANDARD

Learning Objectives

- Refresher on the New Lease Standard timing and key impacts
- Gain in depth insights into lessee accounting under the New Lease Standard
- Understand potential unexpected complexities for transition to the New Lease Standard
- Understand external auditor feedback and expectations
- Plan and implement post adoption process changes and controls

THE NEW LEASE STANDARD – BIG PICTURE

Effective Date

Public Business Entities: The amendments in ASU 2016-02 are effective for public business entities **for fiscal years beginning after December 15, 2018,** including interim periods within those fiscal years (i.e., January 1, 2019, for a calendar year entity). **Early adoption** is allowed.

Non-Public Business Entities: Should apply the amendments **for fiscal years beginning after December 15, 2019** (i.e., January 1, 2020, for a calendar year entity), and interim periods within fiscal years beginning after December 15, 2020. **Early adoption** is allowed.

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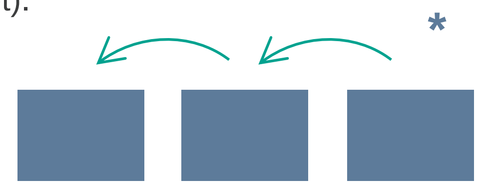
THE NEW LEASE STANDARD – BIG PICTURE

Overview

Transition Method:

“Modified retrospective” application may be applied, which would require all leases existing at, or entered into after, the beginning of the earliest comparative period presented in the financial statements.

“Cumulative effect” application records the effects of adopting as of the beginning of the fiscal year (lease liability and right of use asset).



Transition Guidance:

Under **modified retrospective** a company must apply the guidance at the beginning of the earliest period presented in a set of financial statements for substantially all leases outstanding at initial application (i.e. restating 2017 and 2018 lease data for public calendar year companies).

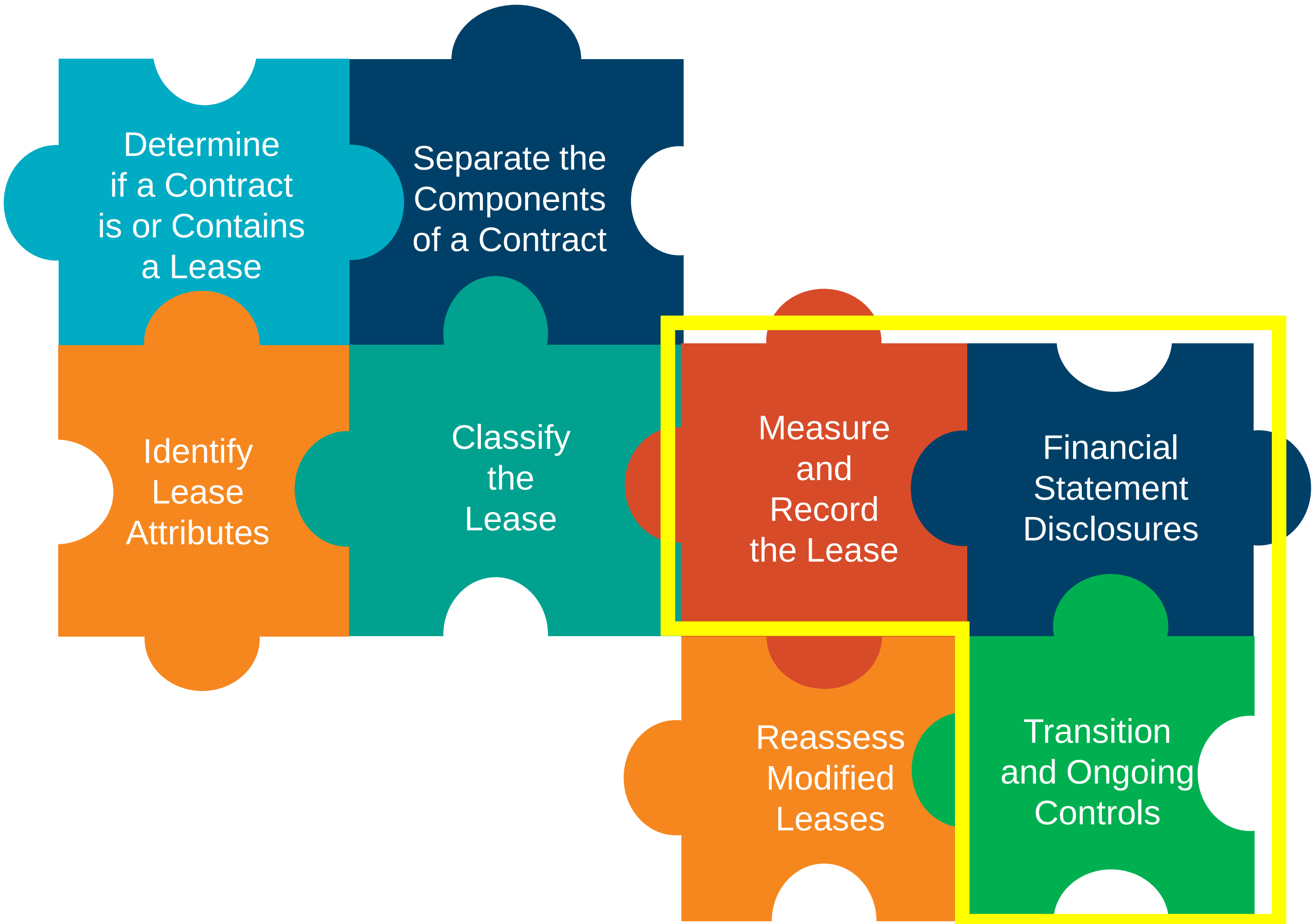
Under **cumulative effect**, previous year data does not have to be restated and disclosures are made under ASC840 with ASC842 only applying to 2019 financial statements and disclosures.

<u>Note: Practical expedients are provided.</u>

NEW: An entity may continue to apply the legacy guidance in ASC 840, including its disclosure requirements, in the comparative periods presented in the year they adopt the new lease standard.

THE NEW LEASE STANDARD

A Closer Look – Accounting and Financial Reporting Impacts



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A Closer Look – Accounting Impacts

Initial Lease Liability & Right of Use Asset

Measure and Record the Lease

Measure the Initial Lease Liability

Initial Lease Liability = Present Value of Unpaid Future Lease Payments + Present Value of amount probable of being owed under RVG (residual value guaranteed)

Measure the Initial Right of Use Asset

Initial Right of Use Asset = Initial Lease Liability + Initial Direct Costs + Prepaid Lease Payments - Lease Incentives Received

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THE NEW LEASE STANDARD

Measure and Record the Lease

A Closer Look – Accounting Impacts: P&L

Operating Lease (Lease Cost (i.e., expense) is determined on a straight-line basis)

Lease Cost = [Sum of Undiscounted Lease Payments for Lease Term + Initial Direct Costs - Incentives Received] / # of Periods in Lease Term

Finance Lease (Assuming straight-line amortization method)

Amortization Expense = Initial Right of Use Asset / # of Periods in Lease Term

+

Interest Expense = Lease Liability * Interest Rate

Tip :

The amortization method may be straight-line or another systematic basis that is representative of the pattern in which the lessee expects to consume the remaining economic benefits from its right to use the underlying asset.

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Measure and Record the Lease

A Closer Look – Accounting Impacts

A "Simple" Example

The Scenario

ABC Company enters into a three year contract for office space on the 5th floor of a 20 story high-rise building. The office space can be used at ABC's discretion. There are no renewal options and ABC Company does not anticipate early termination.

Under the terms of the contract, ABC will make annual payments (occurring at the end of each period) as follows:

Year 1	$10,000
Year 2	$12,000
Year 3	$14,000
Total	**$36,000**

The Company has determined that its incremental borrowing rate is 4.235%.

How should ABC account for this contract?

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A Closer Look – Accounting Impacts

A "Simple" Example

Measure and Record the Lease

Question: What is the initial lease liability and ROU asset?

Initial Lease Liability

Present Value of Unpaid Future Lease Payments

Payments of $10K, $12K, & $14K
Discounted at the incremental borrowing rate of 4.235%

=NPV(0.04235,10000,12000,14000)

=$33,000

Right of Use Asset

Since there are no initial direct costs, prepaid lease payments, or lease incentives, the ROU Asset = Initial Lease Liability

=$33,000

Answer: Both the initial lease liability and ROU asset equal $33,000

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Measure and Record the Lease

A Closer Look – Accounting Impacts

A “Simple” Example

Question: What is the accounting at the end of Year 3

Year	Cash Payments	"Interest" Portion	"Principal" Portion	Lease Liability	Lease Cost (Expense)	Adjustment to ROU Asset	ROU Asset
0				$ (33,000)			$ 33,000
1	$ (10,000)	$ 1,398	$ 8,602	$ (24,398)	$ 12,000	$ (10,602)	$ 22,398
2	$ (12,000)	$ 1,033	$ 10,967	$ (13,431)	$ 12,000	$ (10,967)	$ 11,431
3	$ (14,000)	$ 569	$ 13,431	$ -	$ 12,000	$ (11,431)	$ -
Totals	$ (36,000)	$ 3,000	$ 33,000		$ 36,000		

Discount Rate (Incremental Borrowing Rate)	4.235%

At the end of Year 3

	Debit	Credit
Operating Lease Cost	$12,000	
Lease Liability	$13,431	
Cash		$ 14,000
ROU Asset		$ 11,431

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A Closer Look – Accounting Impacts - A "Simple" Example (Continued)

Measure and Record the Lease

Finance Lease Accounting Entries:		
At lease commencement		
ROU Asset	$33,000	
Lease Liability		$33,000
Year 1		
Interest Expense	$1,398	
Lease Liability	$8,602	
Cash		$10,000
Amortization Expense	$11,000	
ROU Asset		$11,000
Year 2		
Interest Expense	$1,033	
Lease Liability	$10,967	
Cash		$12,000
Amortization Expense	$11,000	
ROU Asset		$11,000
Year 3		
Interest Expense	$569	
Lease Liability	$13,431	
Cash		$14,000
Amortization Expense	$11,000	
ROU Asset		$11,000

Operating Lease Accounting Entries:		
At lease commencement		
ROU Asset	$33,000	
Lease Liability		$33,000
Year 1		
Operating Lease Expense	$12,000	
Lease Liability	$8,602	
Cash		$10,000
ROU Asset		$10,602
Year 2		
Operating Lease Expense	$12,000	
Lease Liability	$10,967	
Cash		$12,000
ROU Asset		$10,967
Year 3		
Operating Lease Expense	$12,000	
Lease Liability	$13,431	
Cash		$14,000
ROU Asset		$11,431

Note: This "simple" example does not consider impact at transition date, nor more realistic lease attributes.

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A Closer Look – Impact on Accounting & Financial Reporting

Measure and Record the Lease

Other Key Inputs to Consider during Transition

- Consider materiality as you review the Company's complete lease environment (document and prove out any materiality decisions)
- Variable rent, such as CPI or other index driven increases
- Unamortized initial direct costs
- Unamortized lease incentives
- Unamortized favorable / unfavorable leases
- Potential to take additional renewal or option periods during lease review process (i.e. reasonable certain)
- Pay particulate attention to any sale leaseback or build to suit leases

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Measure and Record the Lease

A Closer Look – Incremental Borrowing Rate

The incremental borrowing rate is the rate of interest that a lessee would have to pay to borrow on a collateralized basis over a similar term an amount equal to the lease payments in a similar economic environment.

A Company's unsecured line of credit rates will likely *not* be used for determining the incremental borrowing rates for collateralized leases under ASC 842.

Assuming the company is a public company and cannot determine the implicit interest rate in the lease, some potential considerations in determining a Company's incremental borrowing rate include:

- Comparison of the Company's similar collateralized term loans
- Sale-leaseback transactions of similar assets, borrowing value and lease terms
- Determination from quoted rates from bankers or lenders for similar assets, borrowing value and lease terms
- Use of the parent company's incremental rate for subsidiary if treasury functions are carried out and supported by the parent to the sub
- Interest rate of other companies with a similar credit profile and rating for similar assets, borrowing value and lease terms
- Interest rate should be adjusted for any third party guarantee provided
- Reasonable loan origination fees should be incorporated in determining the effective incremental borrowing rate.

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Measure and Record the Lease

A Closer Look – Accounting Impacts at Transition

Lease Liability & Right of Use Asset Calculation

Measure the Initial Lease Liability

Lease Liability = **Present Value of Unpaid Future Lease Payments** + **Present Value of amount probable of being owed under RVG (residual value guaranteed)**

Measure the Initial Right of Use Asset

Initial Right of Use Asset = Lease Liability + Unamortized Initial Direct Costs +/- Prepaid Rent / Deferred Rent - Unamortized Lease Incentives Received +/- Clear other BS Lease-Related Accounts

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THE NEW LEASE STANDARD

Getting Started with Transition – Transitional Practical Expedients

The following Transitional Practical Expedients are available:

An entity may elect the following practical expedients, which **must be elected as a package** and applied consistently by an entity to all of its leases (including those for which the entity is a lessee or a lessor), when applying the pending content that links to this paragraph to leases that commenced before the effective date:

- An entity need not reassess whether any expired or existing contracts are or contain leases.
- An entity need not reassess the lease classification for any expired or existing leases (that is, all existing leases that were classified as operating leases in accordance with Topic 840 will be classified as operating leases, and all existing leases that were classified as capital leases in accordance with Topic 840 will be classified as financial leases).
- An entity need not reassess initial direct costs for any existing leases.

An entity also may elect a practical expedient, which must be applied consistently by an entity to all of its leases (including those for which the entity is a lessee or a lessor) to **use hindsight in determining the lease term** (that is, when considering lessee options to extend or terminate the lease and to purchase the underlying asset) and in assessing impairment of the entity's right-of-use assets. This practical expedient may be elected separately or in conjunction with the transitional practical expedient package above.

Additional Transition Method: An entity may continue to apply the legacy guidance in ASC 840, including its disclosure requirements, in the comparative periods presented in the year that they adopt the new leases guidance in ASC 842.

Financial Statement Disclosures

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A Closer Look – Quantitative Disclosure Requirements

The new disclosure requirements include a number of new key measurements. Below are some of the more interesting requirements

- While short team leases (<12 months) don’t have to be accounted for under ASC842 there is a disclosure requirement.
- Lease classification disclosures
- Variable lease costs
- Various weighted average disclosures for remaining lease terms and also the discount rate
- Maturity analysis - Undiscounted cash flows annually for each of the next 5 years and thereafter
- Reconciliation of undiscounted cash flows to the discounted lease liabilities in the balance sheet
- Comparative periods, prior to transition, may be presented using legacy guidance under ASC840.

	Year Ending December 31,	
	20X8	**20X7**
Lease cost		
Finance lease cost	$XXX	$XXX
Amortization of night-of-use assets	XXX	XXX
Interest on lease liabilities	XXX	XXX
Operating lease cost	XXX	XXX
Short-term lease cost	***XXX***	***XXX***
Variable lease cost	XXX	XXX
Sublease income	(XXX)	(XXX)
Total lease cost	**$XXX**	**$XXX**
Other information		
(Gains) and losses on sale and leaseback transactions, net	$(XXX)	$(XXX)
Cash paid for amounts included in the measurement of lease liabilities		
Operating cash flows from finance leases	XXX	XXX
Operating cash flows from operating leases	XXX	XXX
Financing cash flows from finance leases	XXX	XXX
Right-of-use assets obtained in exchange for new finance lease liabilities	XXX	XXX
Right-of-use assets obtained in exchange for new operating lease liabilities	XXX	XXX
Weighted-average remaining lease term – finance leases	XX years	XX years
Weighted-average remaining lease term – operating leases	XX years	XX years
Weighted-average discount rate – finance leases	X.X%	X.X%
Weighted-average discount rate – operating leases	X.X%	X.X%

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Financial Statement Disclosures

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A Closer Look – Quantitative Disclosure Requirements

Balance Sheet	
Non-current Assets:	Companies can either present these items in the balance sheet or within the notes to the financial statements along with the balance sheet line items in which the assets/liabilities are included.
Operating lease right-of-use assets	
Finance lease right-of-use assets	
Current Liabilities:	Right-of-use assets and lease liabilities are subject to the same considerations as other nonfinancial assets and liabilities in classifying them as current and non-current in classified statements of financial position.
Operating lease liabilities – current	
Finance lease liabilities – current	
Non-current Liabilities:	Right-of-use assets and lease liabilities for operating leases and finance leases should be presented separately rather than combined on the balance sheet.
Operating lease liabilities – non-current	
Finance lease liabilities – non-current	

Income Statement	
Operating lease expense	Interest expense on the lease liability and amortization of the right-of-use asset shall be presented in a manner consistent with presentation of other interest expense and depreciation or amortization of similar assets.
Interest expense	
Amortization expense	

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Financial Statement Disclosures

A Closer Look – Quantitative Disclosure Requirements

Cash Flow

Operating Leases	
Operating Cash Activity - Lease Payments	
Investing Cash Activity - Payments to bring asset to intended location and use	
Finance Leases	
Financing Cash Activity - Principal payments	
Operating Cash Activity – Interest payments	
Both Operating and Finance Leases	
Operating Activity – Non Capitalized short term leases and variable lease payments	

Operating Leases
Cash payments for lease payments are presented within operating activities, except for payments that represent costs to bring another asset to the condition and location necessary for its intended use, which are presented within investing activities.

Finance leases
Cash payments for the principal portion of the finance lease liability are presented within financing activities, and cash payments for the interest portion are presented in accordance with ASC 230, Statement of Cash Flows.

Both types of leases:
Lease payments for short-term leases not recognized on the balance sheet and variable lease payments (not included in the lease liability) are presented within operating activities.

Noncash activity (e.g., the initial recognition of the lease at commencement) is disclosed as a supplemental noncash item.

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Financial Statement Disclosures

A Closer Look – Qualitative Disclosure Requirements

- Information about the nature of leases, including:
  - General description of leases
  - Basis for variable lease payments
  - Existence and terms of options to extend or terminate leases including narrative disclosure of options that are included and excluded from right-of-use assets and lease liabilities
  - Existence and terms of residual value guarantees
  - Restrictions or covenants imposed by leases
- Information about leases that have not yet commenced but that create significant rights and obligations for the lessee, including the nature of any involvement with the construction or design of the underlying asset
- Information about significant assumptions and judgements made in applying ASC 842 including:
  - The determination of whether a contract contains a lease
  - The allocation of consideration in a contract between lease and non-lease components
  - The determination of the discount rates used to measure leases

LEASES ARE PREVALENT

Just look at what companies are disclosing now

Target	FedEx
ROU Asset = $0.9 - $1.4Bn Lease Liability = $1.2 - $1.7Bn	ROU Asset = $13Bn+ Lease Liability = $13Bn+

Citigroup	Microsoft
ROU Asset = $5Bn Lease Liability = $5Bn	ROU Asset = $5.2Bn - $6.6Bn Lease Liability = $5.2Bn - $6.6Bn

LEASES ARE PREVALENT

Just look at what companies are disclosing now

Lease Accounting Disclosure - Target Corp.

We plan to adopt the standard in the first quarter of 2018. **We expect to take advantage of the package of practical expedients permitted within the new standard, which among other things, allows us to carryforward the historical lease classification. In addition, we plan to elect the hindsight practical expedient to determine the reasonably certain lease term.**

While lease classification will remain unchanged, hindsight may result in different accounting lease terms for certain leases and affect the timing of depreciation, interest, and rent expense, and the amount of lease assets and liabilities recognized.

We expect to make an **accounting policy election that would keep leases with an initial term of 12 months or less off of the balance sheet** and would result in recognizing those lease payments in the Consolidated Statements of Operations on a straight-line basis over the lease term.

While we are continuing to assess all potential impacts of the standard, we expect to record additional net lease liabilities of $1.2-$1.7 billion, with an offsetting increase to leased assets of $0.9-$1.4 billion. The difference between these amounts will be recorded as an adjustment to retained earnings. We do not believe the standard will materially affect our consolidated net earnings. **These estimates — based on our current lease portfolio — may change as we continue to evaluate the new standard and as we implement a new lease accounting information system. The estimates could also change due to changes in the lease portfolio, which could include (a) lease volume, (b) lease commencement dates, and (c) renewal option and lease termination expectations. We will update our estimates each quarter as changes occur.**

We do not believe the new standard will have a notable impact on our liquidity. The standard will have no impact on our debt-covenant compliance under our current agreements.

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Transition and Ongoing Controls

Adoption Control Considerations

1. Perform a scoping analysis or financial analysis to identify all leases (completeness of lease population)
2. Document the process and judgements made around the contracts reviewed (sample of contracts or full lease population review)
3. Review/update Company accounting policy around leases
4. Review the contract/lease analysis that documents the application of ASC 842
5. Review of specific leases or topics that require knowledge and judgment in adopting the new standard
6. Review of the discount rate used/calculated
7. Review completeness and accuracy of the data used to compute the transition entry
8. Prepare and review of 10Q/10K disclosures around the transition to ASC 842 (SAB 74)
9. Document and review the financial impact at transition (right of use asset, lease liability, elimination of deferred rent, etc.)
10. Prepare and review the new quantitative and qualitative disclosures for the first 10Q

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A Closer Look - Considerations

Ensure the Enterprise-Wide Lease Inventory is Reliable

Lessees should determine that all leases deployed across the organization are identified on a timely basis and aggregated to create a complete and accurate lease inventory and related lease data elements.

Evaluate the Supporting Systems and Data

Companies should consider selecting and implementing a suitable technology solution to simplify the lease data gathering process, to perform calculations & JE's, to determine disclosures, to interface with disbursements, etc.

Engage External Audit

Company's should engage external auditors early and often during the lease transition to validate decisions and treatment, which should help avoid potential restatements that occurred with 840 adoption.

The most significant challenges will likely be data collection, having proper systems in place, and documenting your decisions at transition.

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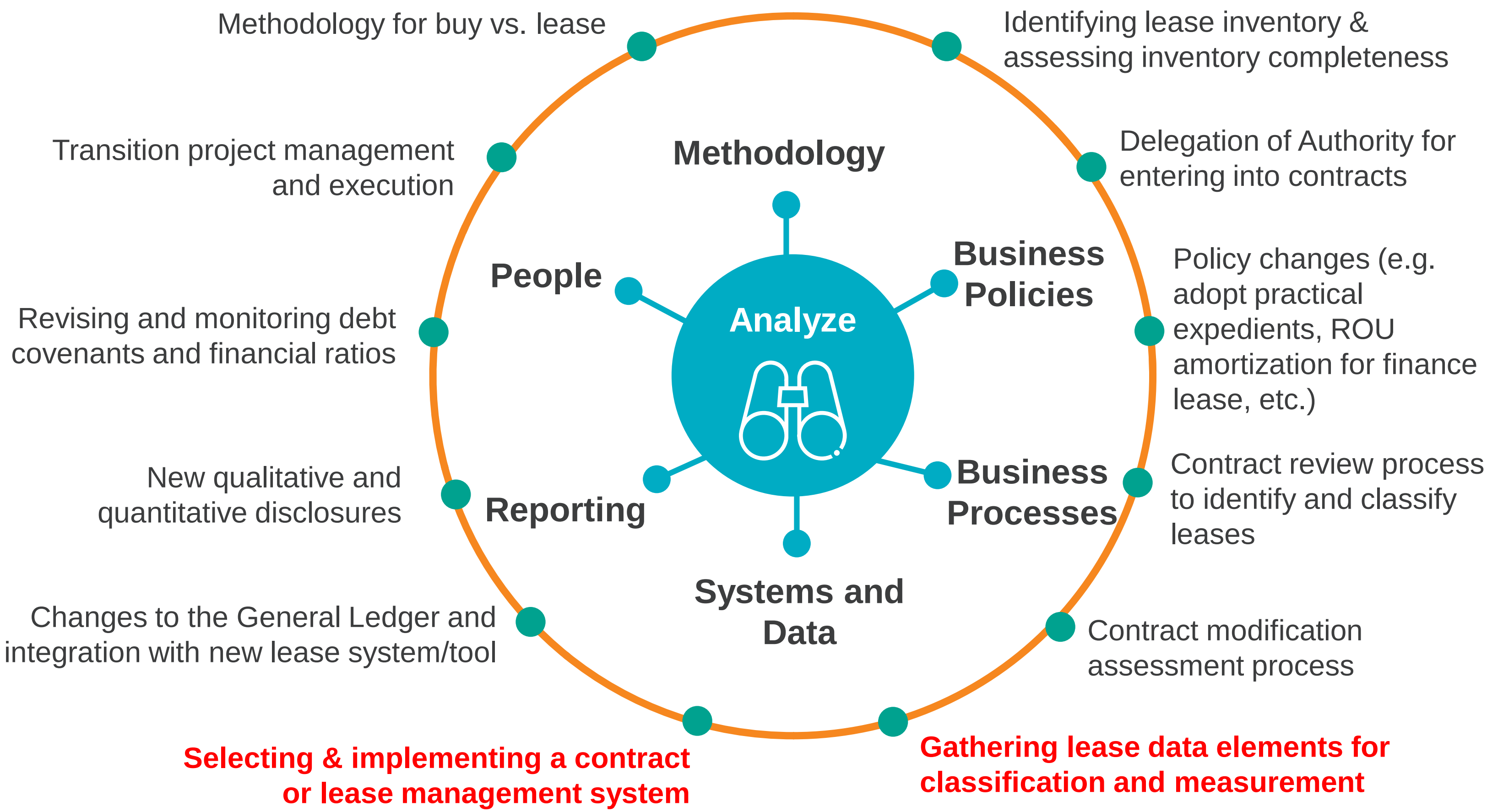
A Closer Look - Organizational Impacts

It is important to consider the implications not only on the financial records, but also to your organization's infrastructure both during transition and in the future state upon adoption of ASC 842. You can do this by using the Protiviti Six Elements of Infrastructure Model.



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Potential Ongoing Control Considerations after Transition

1. Annual review/update of the accounting policy around leases
2. Periodic review of the discount rate used/calculated
3. Potential new triggers for Accounting to acquire all contract changes and approval of changes
4. Perform and review the lease classification test for all new and modified leases
5. Review the computation of lease costs for each new lease to ensure appropriate judgment was used (initial direct costs, non-lease components, allocation of costs, etc.)
6. Review of contract modifications to ensure appropriate accounting treatment/impact
7. Preparation and review of the right to use asset and lease liability account reconciliations
8. Prepare and review the quantitative and qualitative disclosures for the 10Q/10K
9. Updated impairment analysis to include lease assets

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How We Can Help

Perform a **Gap Assessment** to identify potential impacts of new standard

Develop a transition **Project Plan**

Review Contracts to determine accounting treatment under the new standard

Educate stakeholders in all potentially impacted departments

Research and **Select a System** solution

Provide **Project Management and/or backfill** services during transition

Inventory and **Gather Lease Data** elements

Assist in **Implementing and Testing a System** solution

Draft accounting **Position Paper**

Update **Accounting Policy** documentation

Update **Process and Control** documentation

Calculate Financial Statement Impact of transition

Draft **Financial Statement Disclosures**

Take us up on a consultative meeting to discuss how we can help you build/validate a transition project plan for the new lease standard (requires some data gathering on your part and a working session).

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