Technical Accounting Update

Revenue Recognition and Leases

June 14-16, 2017

CFO & FINANCE MANAGERS Conference

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Revenue Recognition

Three Pillars of Impact

1

Financial statement impact, including P&L and balance sheet

Significant effort could be required to:

- Identify and quantify changes to revenue recognition (accelerate or defer);
- Identify and quantify changes to expense recognition (capitalize vs. amortize; gross vs. net);
- Implement process, controls and IT changes to account for changes to recognition pattern;
- Assess tax, FP&A, management reporting, regulatory impacts

2

Support items with no change under new model

Significant effort could be required to:

- Support no change in revenue and expense recognition, including obtaining data not previously collected (e.g. standalone selling price, estimating VC);
- Develop accounting policies or update existing policies to document judgments;

3

Support disclosure and presentation requirements

Significant effort could be required to:

- Identify new material quantitative and qualitative disclosures;
- Identify process to aggregate new quantitative and qualitative data that is not readily available
- Support presentation changes, including disaggregating revenue from contracts with customers, contract assets, costs to obtain, etc.

Transition methods

Full retrospective

Cumulative catch-up adjustment at 1/1/2016

	2016	2017	2018
Financial statements	New GAAP	New GAAP	New GAAP
Footnotes			ASC 250 disclosures

Modified retrospective

Cumulative catch-up adjustment at 1/1/2018

	2016	2017	2018
Financial statements	Legacy GAAP	Legacy GAAP	New GAAP
Footnotes			Legacy GAAP

Standard setting update

- FASB has issued four Accounting Standards Updates
  - Effective date deferral (issued August 2015)
  - Principal versus agent considerations (i.e., gross versus net) (issued March 2016)
  - Performance obligations and licenses (issued April 2016)
  - Transition practical expedients, collectibility, presentation of sales taxes and noncash consideration (issued May 2016)
- IASB has issued two amendments to IFRS 15
  - Effective date deferral (issued September 2015)
  - Other topics (e.g., performance obligations, licenses, transition practical expedients, gross versus net) (issued April 2016)

Implementation groups update

- FASB/IASB joint transition resource group (TRG)
  - Over 80 submissions received
  - Addressed issues through standard setting, discussions by TRG or through outreach to submitters
  - FASB has agreed to continue the TRG, while the IASB has not
    - Next TRG meeting is scheduled for November 7
- AICPA industry groups discuss industry-specific issues
  - All large firms, including EY, are represented in each industry group and central ‘clearing house’ group
  - Interpretative issues have been referred to FASB/IASB transition resource group
  - Non-authoritative audit guides to be issued or updated
  - Issue papers are being exposed as they are approved by FinREC

Scope and exceptions

What is in scope or affected

- Contracts with customers
- Sale of some nonfinancial assets that are not an output of the company's ordinary activities (e.g., property, plant and equipment, intangibles) and certain capitalized costs

What is not in scope

- Leasing contracts
- Insurance contracts
- Financial instruments contracts
- Certain nonmonetary exchanges
- Certain put options on sale and repurchase agreements
- Guarantees within the scope of ASC 460

Scope and scope exceptions

Considerations for financial institutions

- Many activities for a financial institution are not in the scope of the standard
  - Interest and dividend income, gains and losses on financial assets are out of scope
- Arrangements could be partially within the scope of the standard and partially in the scope of other standards
  - Apply separation and measurement guidance of other ASC Topics and then apply separation and measurement guidance from the revenue standard for any portions not addressed
  - Example – a customer contract that includes a line of credit and a fee for administrative services for custodial accounts (i.e., the portion related to administrative services is in the scope of the revenue standard)

Overview of the standard

What makes this complex?

Core principle – Recognize revenue to depict the transfer of goods or services to customers based on amounts the entity ***expects to be entitled*** to for such goods or services

Step 1

Identify the contract(s) with the customer

- Strict criteria to be a contract
- Assessing collectability
- Identifying the customer
- Contract modifications
- Identify explicit and implicit contract terms
- Established business practices
- Combining contracts

Step 2

Identify the separate performance obligations in the contract

- Identifying promised goods and services
- Determining performance obligations (i.e., distinct goods and services)
- Options granting a material right
- Rights of return
- Service-type and assurance-type warranties
- Principal versus agent

Step 3

Determine the transaction price

- May not equal "contractual" price
- Variable consid., incl. bonuses, returns, concessions, discounts
- Constraint on variable consid.
- Significant financing component
- Non-cash consideration
- Payments to customers
- Subsequent changes in transaction price

Step 4

Allocate the transaction price to the separate performance obligations

- Estimating standalone selling prices
- Exceptions for allocating variable consideration and discounts

Step 5

Recognize revenue when (or as) each performance obligation is satisfied

- Transfer of control: point in time or over time
- Measuring progress over time
- Consignment arrangements
- Customer acceptance
- Repurchase provisions
- Licenses

Step 1: Identify the contract(s) with a customer

- Contract defined as an agreement between two or more parties that creates enforceable rights and obligations
  - Can be written, oral or implied but must be legally enforceable
  - Does not exist if both parties have not performed and can cancel without penalty
- Arrangement must meet these criteria to be within scope of standard:
  - Parties have agreed to terms and are committed to perform
  - Each party's rights and payment terms can be identified
  - Contract has commercial substance
  - Collection is probable
- Contracts entered into at the same time with the same customer should be combined if certain criteria are met
- A contract modification is accounted for as a separate contract or as part of original contract depending on the change in scope/price

Step 1: Identify the contract with a customer

Contract modifications

- These criteria are assessed at the inception of the arrangement
  - If the criteria are met at inception, reassessment only occurs if there is a significant change in facts and circumstances
  - If the criteria are not met at inception, continue to assess

Contract modifications

Contract modifications may be evaluated as separate contracts, or combined with the existing contract. There could be an impact on the financial reporting depending on the nature of the modification

- Contracts which change the price and add new services are treated as new contracts

Step 1: Identify the contract
Combining contracts

- Two or more contracts entered into at or near the same time with the same customer, including related parties, should be combined if any of the following conditions is met:
  - Negotiated as a package with a single objective
  - Consideration to be paid in one contract depends on other contract
  - Goods and services are a single performance obligation

Combining contracts

Contracts may be combined in many cases where they were previously evaluated separately. Revenue pattern may be changed if additional services are bundled.

Step 2: Identify the performance obligations

- A performance obligation is a promise (explicit or implicit) to transfer a good or service to a customer
  - Performance obligations are accounted for separately if they are distinct
- Two-step process to identify if a good or service is distinct:
  - Step 1 – Determine if the good or service is capable of being distinct
  - Step 2 – Determine if the good or service is distinct within the context of the contract
- Performance obligations are identified at contract inception and determined based on contractual terms and the entity's customary business practice
- Incidental obligations or marketing incentives may be performance obligations (e.g., "free" maintenance provided by auto manufacturers)
- Options to purchase goods or services may be performance obligations if they provide a "material right" to the customer"

Step 2: Identify performance obligations

Two-step model to identify which goods or services are distinct

Step 1 - Focus on whether the good or service is ***capable of being distinct***

Customer can benefit from the individual good or service on its own

OR

Customer can use good or service with other readily available resources

Step 2 - Focus on whether the good or service is ***distinct in the context of the contract***

The good or service is not integrated with, highly dependent on, highly interrelated with, or significantly modifying or customizing other promised goods or services in the contract

Step 2: Identify the performance obligations

Principal versus agent considerations

- Determining whether an entity acts as a principal or an agent in a specific arrangement affects the amount of revenue recognized (gross versus net recognition)
  - Appropriately identifying the entity's performance obligation is fundamental to the principal or agent determination

Principal	Agent
► Provides goods or services itself	► Arranges for another party to provide goods or services

- An entity is a principal if the entity *controls* a promised good or service before its transfers to a customer
  - An entity may not be a principal if it obtains legal title only momentarily before the good or service is transferred to a customer

Step 2: Identify the performance obligations

Principal versus agent considerations (continued)

- An entity would likely be a principal if it controls:
  - A good or other asset (e.g., a right) that it obtains from another party that it then transfers to the customer
  - A right to a service to be performed by the other party, which gives the entity the ability to direct the other party to provide that service to the customer
  - A good or service that it then integrates with other goods or services into a bundle of goods or services that represents the specified good or service provided to the customer
- Indicators that an entity is an *principal* include:

Gross Indicators:	
	Entity is primarily responsible for fulfilling contract
	Entity has inventory risk
	Entity has discretion in establishing prices

Step 3: Determine the transaction price
Variable consideration

- The transaction price is estimated using the approach that better predicts the amount to which the company is entitled based on its facts and circumstances (i.e., not a “free choice”)
- The approach should be applied consistently throughout the contract and for similar types of contracts

Expected value	Most likely amount
► Sum of the probability-weighted amounts in a range of possible outcomes ► Most predictive when the transaction has a large number of possible outcomes ► Can be based on a limited number of discrete outcomes and probabilities	► The single most likely amount in a range of possible outcomes ► May be appropriate when the transaction will produce only two outcomes

<u>If transaction price is 100% constrained - no need to do this step</u>

(e.g. trade execution contracts)

Step 4: Allocate the transaction price

- Transaction price is allocated to each separate performance obligation in “an amount that depicts the amount of consideration to which the entity expects to be entitled in exchange for transferring the promised goods or services”

- Transaction price generally allocated based on relative standalone selling prices:

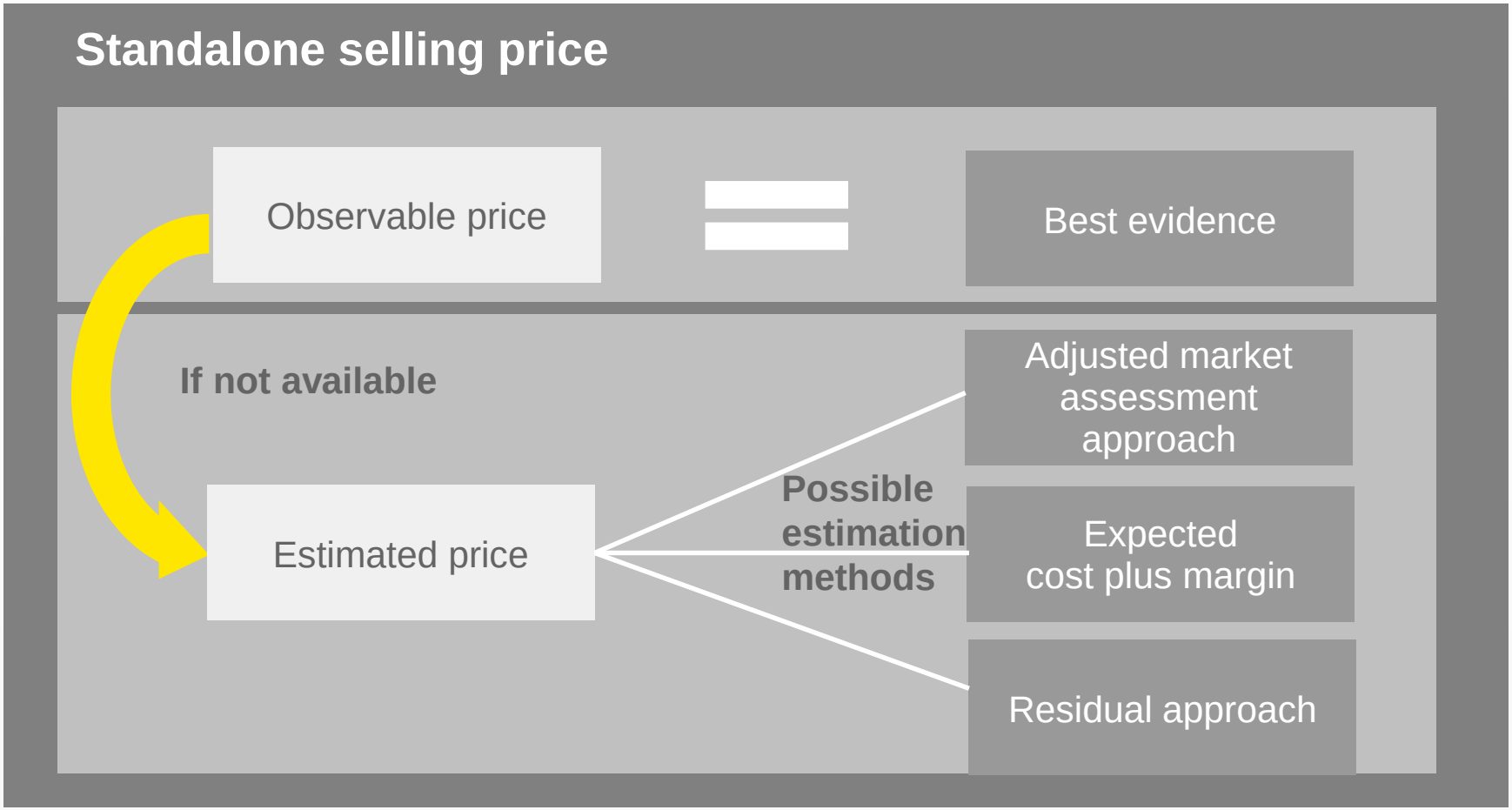
  - Price at which an entity would sell a promised good or service separately

  - Best evidence is the observable price in a entity’s standalone sales

  - Standalone selling prices used to perform the initial allocation should not be updated after contract inception

Step 4: Allocate the transaction price

Determine standalone selling price



Step 5: Recognize revenue

Core principle: Revenue recognized upon satisfaction of a performance obligation by transferring control of a good or service to a customer

When is control transferred?

Over time

Select a measure of progress

- Input method (e.g., cost incurred)
- Output method (e.g. units delivered)

At a point in time

Evaluate indicators of control

- Right to payment
- Transfer of legal title
- Physical possession
- Risks and rewards of ownership
- Customer acceptance

Contract costs

- Incremental costs of **obtaining** a contract are capitalized if they are expected to be recovered
  - Practical expedient to allow immediate expense recognition if the asset's amortization period would be one year or less
- Costs of **fulfilling** a contract that are not in the scope of other guidance are capitalized if the following are met:
  - The costs relate directly to a contract or an anticipated contract
  - The costs generate or enhance resources that will be used to satisfy performance obligations in the future
  - The costs are expected to be recovered
- Assets are amortized over the period the goods or services are transferred to the customer, and they are subject to impairment testing

Contract costs
Industry guidance

- Industry guidance retained for the following:
  - Capitalization of direct distribution costs for mutual funds with no front-end sales load (ASC 946-720-25-4, as amended)
  - Deferral of underwriting expenses (ASC 940-340-25-3)
  - Accruals related to soft-dollar arrangements (ASC 940-20-25-3)

Disclosure

- Key principle – to help financial statement users understand the nature, amount, timing and uncertainty of revenue and cash flows arising from contracts with customers
- Entity must present qualitative and quantitative information about:
  - Contracts with customers
  - Significant judgments and changes in judgments made when applying the guidance to those contracts
  - Assets recognized from costs to obtain or fulfill a contract
- For US GAAP entities, most disclosures are required for annual and interim periods
- IFRS requires fewer disclosures in interim periods

Key disclosure requirements

1 Disaggregation of revenue

- Disaggregate revenue into categories that depict how revenue and cash flows are affected by economic factors
- Sourcing and aggregating data
- Explain the relationship with segment disclosures

2 Performance obligations (POs)

- Information about POs, including:
  - Timing of satisfaction of performance obligations (e.g., upon delivery, as services are rendered)
  - Significant payment terms
  - Nature of the goods or services promised (and highlight POs where entity is agent)
  - Obligations for returns, refunds & similar obligations
  - Types of warranties and related obligations

3 Remaining performance obligations

- Methods used to determine the timing of satisfaction of performance obligations
- Transaction price allocated to remaining performance obligations
- Quantitative or qualitative explanation of when amounts are expected to be recognized as revenue

4 Other

- Disclose opening and closing balances of contract assets and contract liabilities. Explain significant changes
- Methods, inputs and assumptions used to determine the transaction price, apply the constraint, allocate to performance obligations
- Assets recognised from the costs to obtain or fulfil a contract

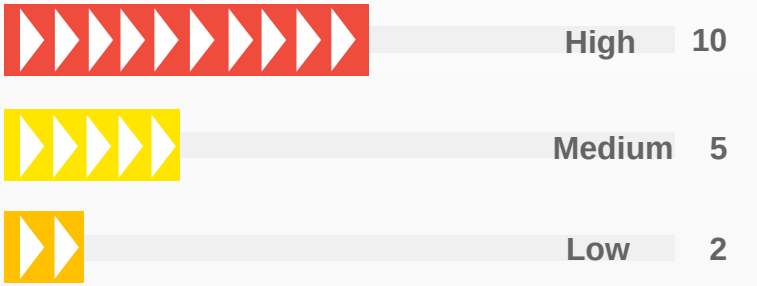
All quantitative disclosures in annual and interim (for public entities)

Sample disclosure heat map

Annual disclosures

- First reporting period – 12/31/18
- Includes comparative periods* (2017 and 2016)

Level of effort to implement**

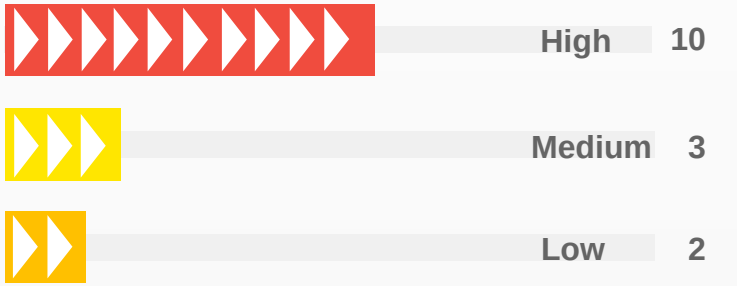


Total new annual disclosures 17

Interim disclosures

- First reporting period – 3/31/18
- Includes comparative periods* (2017 and 2016)

Level of effort to implement**



Total new interim disclosures 15

** Level of effort to implement	
High	Requires new quantitative data that may not be readily available
Medium	Requires new quantitative data that is currently fairly accessible
Low	New qualitative requirements, but no new quantitative data required

* If the modified retrospective transition approach is selected instead of full retrospective, additional transition disclosures are required.

Practical implementation

Step 1: Identify contracts and arrangements	Step 2: Identify performance obligations	Step 3: Determine transaction price	Step 4: Allocate transaction price	Step 5: Recognize revenue
Process considerations				
▪ Review and group related contracts/transactions to an accounting arrangement ▪ Contract modifications can be retroactive, prospective or accounted as a new contract	▪ Distinct contracted goods and services are grouped into performance obligations ▪ Performance obligations can be stated or implied and may not equate to transaction line items	▪ Transaction price is not necessarily the selling price ▪ Variable consideration is factored into the transaction price ▪ The transaction price needs to be reevaluated prior to issuing external financials	▪ Requires a process to establish and re-estimate stand-alone selling price ▪ Requires a process to allocate the transaction price ▪ Contract amendments may require a re-allocation of the transaction price	▪ Changes to coding of accounting transactions ▪ Capture and amortization of up-front contract costs
Technology considerations				
▪ Contracts scanned and work flow enabled for review and approval ▪ Systematically link individual contracts and transactions into accounting arrangements	▪ Systematically group line items to performance obligations ▪ Code transactions with expected revenue event type, trigger, time frames, etc.	▪ Compute variable consideration values (e.g., bonuses, rebates, bad debts, volume discounts, etc.) ▪ Track variable consideration types and estimates	▪ Compute and track historical stand-alone selling prices ▪ Automate allocations at the transaction level ▪ Automate the reallocation for contract amendments	▪ Compute proper revenue recognition and cost entries ▪ Automatically record revenue and cost to proper accounts ▪ Subledger reporting of revenue and contract assets and liabilities

Revenue recognition
Implementation challenges

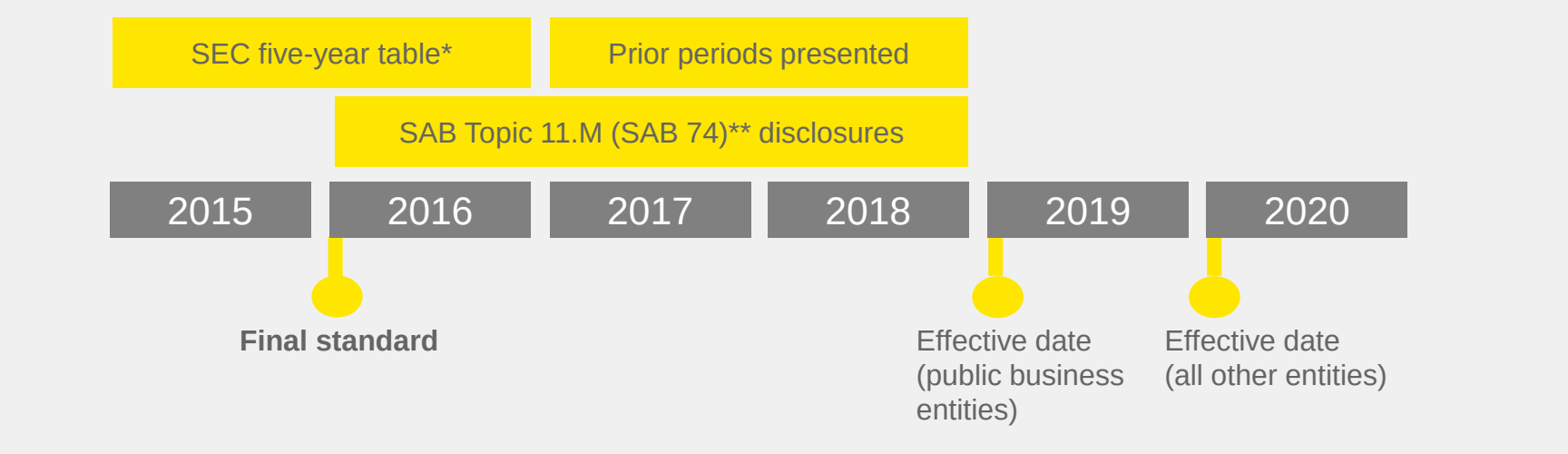
- Identify the performance obligation
  - Is the P.O. the selling of the insurance contract?
  - What are the trails for? Are they related to a different P.O. (e.g. marketing)?

- Recognizing revenue as performance obligation is satisfied
  - Does this mean all revenue is recognized upfront and a contract asset is created?
  - If a contract asset needs to be created, how do you estimate the useful life of a contract? (When can they be terminated? / Are they?)
  - Need to quantify the amount of trails to be received over time. Are they significant?

Leases

Overview of the standard

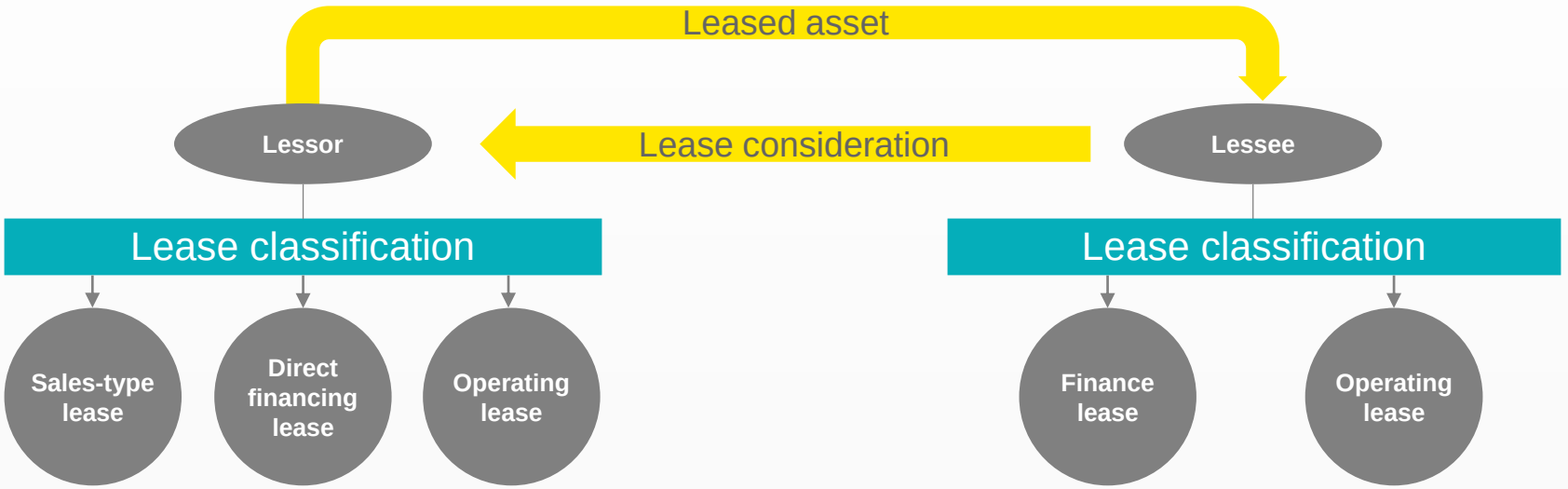
Timeline of events



- This involves applying transition provisions at the beginning of earliest comparative period presented in year of adoption.
- For example, a calendar-year entity that adopts the new standard on January 1, 2019, and presents three-year comparative financial statements applies the transition provisions on January 1, 2017 (i.e., the beginning of the earliest comparative period presented).

* The U.S. Securities and Exchange Commission (SEC) has not yet stated how items such as the five-year table would be impacted.
** Staff Accounting Bulletin

Leases
Overview of the right-of-use model



Lessor: similar to current GAAP with some changes

- Certain concepts are aligned with the revenue recognition standard
- Changes to what would be considered initial direct costs
- Leveraged lease accounting is eliminated for new leases after the effective date

Balance sheet

- Right-of-use asset
- Lease liability

Income statement

- Finance lease – generally “front-loaded” interest and amortization expense
- Operating lease – generally straight-line lease expense

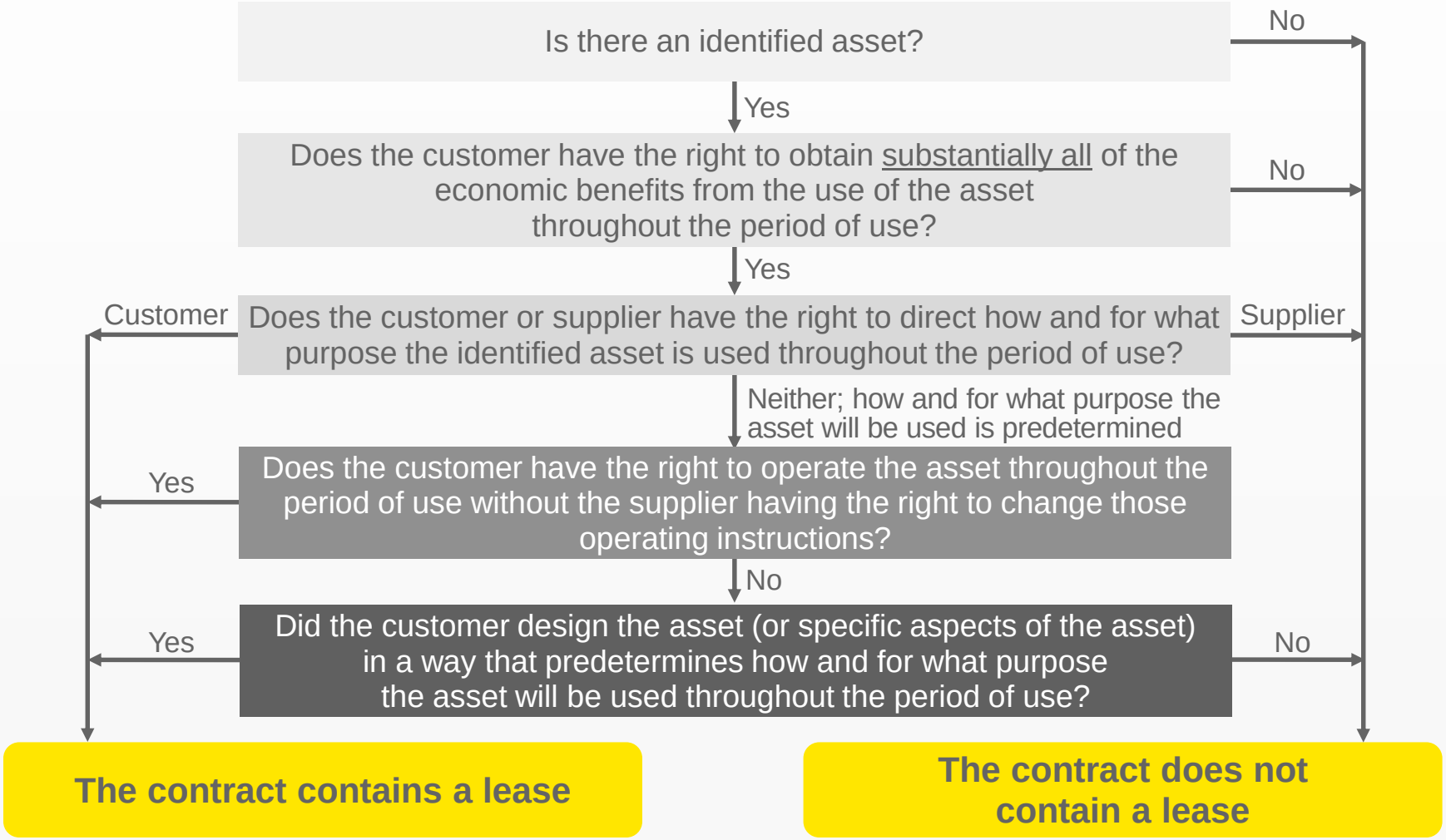
Leases
Scope and definition of a lease

- The new standard applies to leases, and sub-leases, of all assets (identified assets), except the following:
  - Leases of intangible assets
  - Leases to explore for or use natural resources, non-regenerative resources
  - Leases of biological assets, including plants and animals
  - Leases of inventory
  - Leases of assets under construction (construction in process)
- A contract would be a lease if it both:
  - Depends on the use of an identified asset (explicitly or implicitly)
    - No identified asset if the supplier has a substantive substitution right
  - Conveys the right to control the use of an identified asset – that is, the customer would have the right to:
    - Direct the use of the identified asset (i.e., direct how and for what purpose the asset is used throughout the period of use) **and**
    - Obtain substantially all of the potential economic benefits from directing the use

Determining when a customer has the right to direct the use of an identified asset may require judgment, particularly for arrangements that include significant services.

New leases standard

Determining whether an arrangement contains a lease



New leases standard

Lease term and purchase options

Lease term

- Any noncancelable periods
- Periods covered by an option to extend the lease if the lessee is reasonably certain to exercise that option
- Periods covered by an option to terminate the lease if the lessee is reasonably certain not to exercise that option
- Periods covered by an option to extend (or not terminate) the lease in which the exercise of the option is controlled by the lessor

- The Financial Accounting Standards Board said that “reasonably certain” has the same meaning as “reasonably assured” in ASC 840
  - Reasonably certain is generally interpreted as a high threshold
- Purchase options should be assessed in the same way as options to extend the lease term or terminate the lease

New leases standard
Lease payments

- Lease payments should be consistent with the lease term

Lease payments				
Fixed (including in-substance fixed) payments, less any lease incentives paid or payable to the lessee	Variable payments based on an index or rate	Exercise price of a purchase option*	Payments for penalties for terminating the lease**	Amounts it is probable that the lessee will owe under residual value guarantees (lessees only)

* Include only if reasonably certain of exercise

** Include only if the lease term reflects the lessee exercising an option to terminate the lease

- Lease payments also include fees paid by the lessee to the owners of a special-purpose entity for structuring a transaction
  - However, such fees are excluded from the fair value of the underlying asset for purposes of the leases classification test

Leases
Lease and non-lease components

- Many contracts contain a lease and an agreement to purchase or sell other goods or services (non-lease components)
  - Non-lease components would be identified and accounted for separately under other applicable GAAP
- Practical expedient
  - Lessees could make a policy election (by underlying asset class) to account for a lease and non-lease components as a single lease component
- Lessees would allocate contract consideration to the lease and non-lease components (unless practical expedient is elected) on a relative standalone price basis
- Lessors would allocate contract consideration using the new revenue recognition standard (ASC 606)

In a change to practice, some lease-related executory costs (e.g., maintenance) would be non-lease components.

Leases
Other concepts

- Variable lease payments that do **not** depend on an index or rate (e.g., performance- or usage-based payments)
  - Excluded from lease payments unless they are in-substance fixed
  - Recognize expense as incurred (lessees) or income as earned (lessors)

- Discount rate would be the rate the lessor charges the lessee – called the “rate implicit in the lease”
  - In a change to practice, calculation of the rate implicit in the lease would include a lessor’s initial direct costs (except for sales-type leases with selling profit or loss)
  - Lessees would use their incremental borrowing rate when the rate implicit in the lease cannot be readily determined
  - Lessees that are not public business entities (PBEs) could make an accounting policy election to use a risk-free rate for a period comparable to the lease term

Leases
Initial direct costs (IDCs)

- Only **incremental** costs would qualify as IDCs
- Costs would be incremental if they would not have been incurred if the lease had not been **executed** (e.g., commissions)
- Lessees would include their IDCs in the initial measurement of the right-of-use asset
- Lessors
  - Sales-type leases with selling profit or loss – expense IDCs at lease commencement
  - Direct financing leases – selling profit and IDCs are deferred and included in net investment at lease commencement
  - Operating leases – recognize lease payments as income and IDCs as expense over the lease term, generally straight line, variable lease payments recognized when earned

In a change to practice, lessors' IDCs would **exclude** allocated costs (e.g., salaries) and costs incurred before the lease is executed (e.g., legal advice).

New leases standard

Lease classification – lessees

A lease is a finance lease if it meets any one of the criteria below; otherwise the lease is an operating lease

- The lease transfers ownership of the underlying asset to the lessee by the end of the lease term
- The lease grants the lessee an option to purchase the underlying asset that the lessee is reasonably certain to exercise
- The lease term is for the major part of the remaining economic life of the underlying asset*
- The present value of the sum of the lease payments and any residual value guaranteed by the lessee that is not already reflected in the lease payments equals or exceeds substantially all of the fair value of the underlying asset
- The underlying asset is of such a specialized nature that it is expected to have no alternative use to the lessor at the end of lease term

* Not applicable for leases that commence at or near the end of the underlying asset's economic life

Leases
Classification - Lessors

Lessors

- A lease that *meets any* of the criteria is a sales-type lease
- A lease that *does not meet any* of the criteria is either:
  - Direct financing lease – (1) the present value of the sum of the lease payments and any residual value guaranteed by lessee and/or *any other unrelated third party* equals or exceeds to substantially all the fair value of the underlying asset and (2) collectibility is probable
  - Operating lease

Leases

Lessee accounting – recognition and measurement

	Finance lease	Operating lease
Initial recognition and measurement	Initially measure the right-of-use (ROU) asset[1] and lease liability at the present value of the lease payments	
Subsequent measurement – lease liability	Accrete the lease liability based on the interest method using discount rate determined at lease commencement[2] and reduce the lease liability by the payments made	Measure lease liability at the present value of remaining lease payments using discount rate determined at lease commencement[2]
Subsequent measurement – right-of-use (ROU) asset	Amortize the ROU asset, generally on a straight-line basis over the shorter of lease term or useful life of the ROU asset	Measure the ROU asset at the amount of lease liability and adjust for cumulative prepaid or accrued rents (i.e., non-straight-line rent payments), lease incentives received and lessee initial direct costs
Income statement effect	▸ Generally "front-loaded" expense ▸ Separate interest and amortization	▸ Generally straight-line expense ▸ Single line of lease/rent expense

1 Initial measurement of the ROU asset would also include the lessee's initial direct costs and prepayments made to the lessor less lease incentives received from the lessor.
2 As long as a reassessment and a change in the discount rate has not been triggered.

Lessee accounting
Presentation

ROU asset	Lease liability
▶ Lease ROU assets can be presented separately or together with other assets ▶ If not presented separately, disclose the line item where they are presented and the amount of lease ROU assets ▶ Finance lease ROU assets are prohibited from being presented in the same line item as operating lease ROU assets	▶ Lease liabilities can be presented separately or together with other liabilities ▶ If not presented separately, disclose the line item where they are presented and the amount of lease liabilities ▶ Finance lease liabilities are prohibited from being presented in the same line item as operating lease liabilities

New leases standard
Disclosure

- Disclosure objective – to enable financial statement users to assess the amount, timing and uncertainty of cash flows arising from leases
- New disclosures for lessees and lessors include:
  - Significant assumptions and judgments made
  - Maturity analyses of lease liabilities (for lessees) or lease receivables (for lessors), separately by lease type, as of the reporting date, including a reconciliation of undiscounted cash flows to the lease liabilities or receivables
- New disclosures for lessees include:
  - Separate quantitative disclosure of lease cost, by type (e.g., finance lease, operating lease, short-term lease, variable lease)
  - Weighted-average remaining lease term, separately by lease type
  - Weighted-average discount rate, separately by lease type
- New disclosures for lessors include:
  - Information about management of risks related to residual values of leased assets
  - For sales-type and direct financing leases, explanations of significant changes in balance of unguaranteed residual assets
  - Table of lease income recognized in each annual and interim reporting period

Leases
Transition

- The new standard would be applied as of the beginning of the earliest comparative period presented in the financial statements
- Lessees and lessors would be required to adopt the new standard using a modified retrospective transition approach
  - Certain transition relief would be available
    - May elect (together as a package) to not reassess:
      - Whether contracts are or contain leases
      - Lease classification for any expired or existing leases
      - Initial direct costs for any existing leases
    - May elect (separately or together with the above relief) to use hindsight with respect to lease renewals and purchase options when accounting for existing leases
- Full retrospective adoption would be prohibited
- Certain disclosures would be required in accordance with ASC 250, *Accounting Changes and Error Corrections*

Identifying risks and challenges

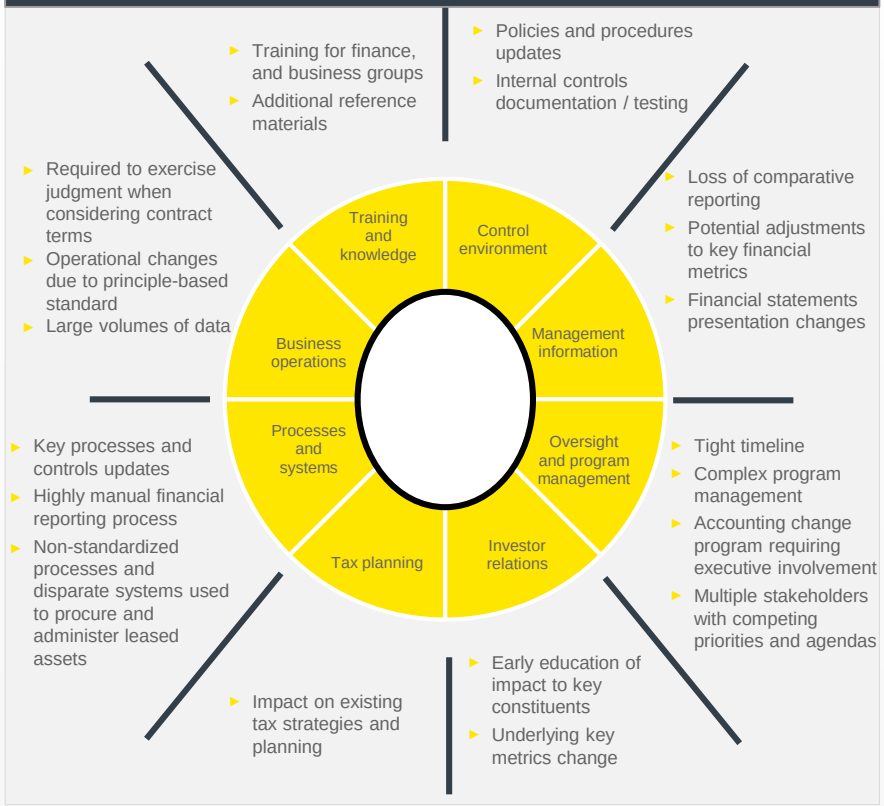
Top challenges:

- Manual lease reporting process
- Obtaining data points required for accounting, reporting, and disclosures
- Potential for unidentified leases, including embedded leases from service arrangements
- Identifying and separating lease and non-lease components
- Application of judgments and development of estimates
- Application of portfolio approach
- Intercompany transactions potentially impacting statutory reporting
- Negative impact to business groups' key financial metrics and operations

Top opportunities:

- Strategically communicate impact to investors and creditors
- Global reporting confidence
- Leasing cost savings
- Improve efficiency, including IT enablement

Transitioning to the new lease standard is complex



Technical accounting issues

Accounting decision challenges

Issue	Key questions / considerations

1 Intercompany (headquarter) leases	• Does the parent have a substantive substitution right for the identified asset (e.g., the space – such as a floor, a building, etc.)?
	  • Two conditions: (i) parent has the practical ability to substitute alternative space throughout period of use; and (ii) parent would benefit economically from the exercise of its right to substitute
	  • What is the legal form? Is it a legal agreement or SLA charge-off?

2 Third-party arrangements	• Does the third-party arrangement contain a lease? E.g., computer servers • Have you considered master service agreements and/or SLAs?
3 Equipment leases	• Typically, these are under an MSA and lease payment are made by schedule. Under ASC 842, the unit of account is at the individual asset level. Because of this, a greater level of analysis is required to identify all the individual leased assets under the MSA
4 Lease vs. non lease components	• Are there non-lease components in your contracts? Non-lease components (e.g., maintenance) are accounted for separately from the lease component in accordance with other GAAP (prospective basis) • Practical expedient: accounting policy election for lessees to account as a single component • Greater capital impact if practical expedient elected. Peers are evaluating .
5 Renewal options	• What is the lease term considering options? Periods covered by an option to extend the lease are included in the lease term, if *reasonably certain* to exercise • Renewals at fair value: how is FV determined for longer term leases (e.g., office space), if reasonably certain to exercise option on day 1?
6 Discount rate	• How will you determine your incremental borrowing rate, if cannot readily determine rate implicit in the lease? • ASC 842 definition: uses collateralized rate of underlying ROU asset. Will need a discussion with Treasury to determine this rate and ensure it is auditable

Financial and operational impacts

Capital and Financial Metrics

- Operating leases of lessees will now be recorded on balance sheet for the first time and will attract a 100% RWA charge, assuming treatment as PP&E
- Ratios are impacted:
  - Return on assets
  - Debt-to-equity ratios
  - Interest coverage ratios
  - Liquidity ratios
- Potential impacts to debt covenants
- Changes to EBITDA/EBIT levels

Taxes

- Recognition of lease-related assets and liabilities that are not on the balance sheet today would affect many aspects of accounting for income taxes such as:
  - Recognition and measurement of deferred tax assets and liabilities
  - Assessment of the recoverability of deferred tax assets
- Uncertainty around whether the right-of-use asset would be:
  - State and local tax: Included in the property factor for apportionment of income?
  - Sales and use tax: Subject to sales tax?
  - Property tax: Included in property tax base subject to property taxes?

Processes

Current processes are likely inadequate

- Summary of lease arrangements is currently maintained for footnote disclosure purposes
- Limited visibility to overall volume of lease contracts and terms
- Embedded lease arrangements are not widely documented or known
- Lease-versus-buy decisions are informal (significant and/or material assets only)

There may be opportunities for enhancement of

- Lease vs buy decision making
- Lease procurement
- Lease administration

Data

- Manual processes to compile data from various systems and/or spreadsheets
- Interim solution will be required for data collection and analysis prior to long-term technology solution
- Transition to long-term technology solution for automated reporting to G/L
- Lease contracts may not be maintained in a central repository
- Existing data structures may not have sufficient depth to support all critical data elements (e.g., discount rate, separation of lease and non-lease components and information required for disclosures) and allow documentation of management estimates

Systems

- Existing lease management systems may require review and modification because they lack computational ability to:
  - Calculate the balance sheet and income statement adjustments that vary based on whether the lease is classified as a finance lease or operating lease
  - Determine the impact of lease renewal, termination or purchase options as well as reassessment requirements
  - Manage differences between US GAAP and IFRS requirements
  - G/L and chart of accounts may require enhancement to accommodate new asset/liability classifications / reporting

Reports

- Parallel reporting may be necessary for comparative periods presented upon transition
- Financial reports may need to be enhanced to reflect presentation and disclosure requirements
- Management reports and key performance indicators may need to be modified to reflect new operating metrics
- Dual reporting for US GAAP and IFRS.

Practical considerations

What data do you need to collect?

This list provides a summary of the information that would need to be considered (if applicable) under the new lease standard. The entity needs to understand what information is readily available in its current-state lease environment (e.g., lease administration database, lease procurement or other process):

- Lease commencement date
- Lease expiration date
- Renewal option(s)
  - Lease payment terms
  - Lease incentives related to renewal
  - Option exercise evaluation
- Termination option(s)
  - Option date
  - Payment amount
  - Option exercise evaluation
- Purchase option(s)
  - Option date
  - Payment amount
  - Option exercise evaluation
- Lease payments
  - Fixed payment excluding consideration allocated to the non-lease components of the contract
  - Free rent/rent credit
  - Variable payment – index
  - Variable payment – performance/usage
  - Payment frequency
- Lease classification (fair value and economic life of the leased asset)
- Initial direct cost
- Lease incentives
- Residual value guarantee
- Discount rate
- Prepaid/accrued lease-related balance

Key Considerations:

- Understand the data that will be required to successfully transition to the new standard
- Review lease abstracts to assess completeness of data elements
- Processes and controls may need to be revised to ensure the organization has access to the data required for the accounting and reporting requirements, both at inception of a lease and over the lease term. The new standard requires leases to be re-measured for certain changes in estimates throughout lifetime of lease (e.g., changes to the lease term)

Implementation is a multiyear journey

Time-sequenced project plan

Below is an illustrative picture of the lease accounting change journey from today through implementation and beyond.