

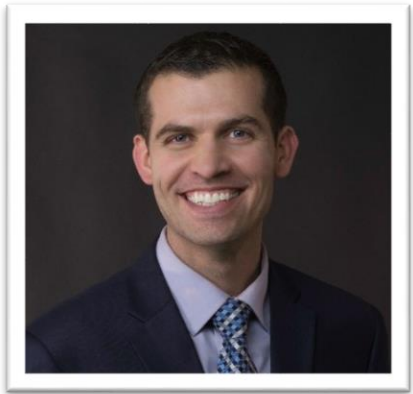


Smart decisions. Lasting value.™

Welcome

Year-End Accounting, Tax, and
Business Planning Seminar

Today's Speaker



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Objectives

This session will provide an overview of the new lease accounting standard, Accounting Standards Update (ASU) 2016-02.

As a result of participating in this session, you should be able to:

- Describe the provisions of the new lease accounting standard, and summarize the potential impacts of that guidance on financial statements and disclosures
- Summarize some of the challenges of implementing ASU 2016-02



Agenda

- The Why Behind ASU 2016-02
- Financial Statement Implications
- Observations from First Wave of Adopters
- Implementation Challenges
- Day 2 Considerations



The Why Behind ASU 2016-02

Lessee Illustration



**Retail
Corporation**

- Real Estate

Lessee Illustration



Retail Corp

\$\$ \$50 million
\$\$

Liabilities

Lessee Illustration



Retail Corp

\$\$\$\$\$
\$\$\$\$\$
\$\$\$\$\$
\$\$\$\$\$
\$\$\$\$\$
\$\$\$\$\$
\$\$\$\$\$

**\$3.3 billion (~65 times the amount
of on balance sheet debt!)**

Liabilities

Background on the New Leasing Standard



Why?

To increase transparency and comparability



How?

Recognizing lease assets and lease liabilities on the balance sheet and requiring new disclosures



Who is affected?

Any entity that enters into a lease*



Survey Says...





Roughly speaking, how many operating leases does your organization have?

- A. 0 – 25
- B. 26 – 100
- C. 101 – 1,000
- D. More than 1,000



Financial Statement Implications

Balance Sheet Implications

| | Topic 840 | | Topic 842 | |
|--|--|---|---|---|
| | Capital leases | Operating leases | Finance leases | Operating leases |
| Assets |  | --- |  |  |
| Liabilities | \$\$ | --- | \$\$ | \$\$\$\$\$ |
| Off balance sheet rights & obligations | --- |  \$\$\$\$\$ | --- | --- |

Initial Recognition and Measurement

| Account | DR | CR |
|--------------------|---|---|
| Right of Use Asset | Lease Liability + Initial Direct Costs + Prepaid Lease Payments – Lease Incentives Received | |
| Lease Liability | | Present Value of Future Minimum Lease Payments |

ASC 842 Lessee Overview – Balance Sheet

Short-Term Leases

- Exempt from being recognized on the balance sheet.
- **Short-term** means lease term of 12 months or less
- Recognize **short-term leases** in profit or loss on a straight-line basis over the lease term

Variable Lease Payments

- Not included in the lease liability
- Think percentage rent or performance-based lease payments
- However, variable payments contingent on an index are included at initial recognition

Nonlease components

- Unless a **practical expedient** is elected, companies should **exclude** non-lease components from the initial measurement of the lease liability

ASC 842 Lessee Overview – Income Statement

| | ASC 842 | |
|--|----------------|----------------------|
| | Finance leases | Operating leases |
| Revenue | | |
| Operating costs (excluding depreciation and amortization) | -- | Single lease expense |
| EBITDA | | |
| Depreciation and amortization | Depreciation | -- |
| Operating profit | | |
| Finance costs | Interest | -- |
| Profit before tax | | |

Income Statement

- Operating lease expense still recognized as a single-lease expense on a straight line basis
- Finance leases retain their interest and depreciation charge.

Under IFRS 16, all leases are treated as **finance leases**

Did you know???

Lessee Accounting Model – Disclosures

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

Lessee Accounting Model – Disclosure Example

Quantitative disclosures

- Finance lease cost
- Operating lease costs
- Short-term costs
- Variable lease costs
- Sublease income
- Total lease costs
- Gain or loss from sale-and-leaseback
- Cash paid in measurement of lease liabilities
- Weighted-average remaining lease term
- Weighted-average discount rate
- Maturity analysis for lease obligations

Note: for illustrative purposes only

| | Year Ending December 31, | |
|--|--------------------------|--------------|
| | 20X2 | 20X1 |
| Lease cost | | |
| Finance lease cost: | \$XXX | \$XXX |
| Amortization of right-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 | <u>\$XXX</u> | <u>\$XXX</u> |
| Other information | | |
| (Gains) and losses on sale and leaseback transactions, net | \$(XXX) | \$XXX |
| Cash paid for amounts included in the measurement of lease liabilities | XXX | XXX |
| 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 | X.X years | X.X years |
| Weighted-average remaining lease term—operating leases | X.X years | X.X years |
| Weighted-average discount rate—finance leases | X.X% | X.X% |
| Weighted-average discount rate—operating | X.X% | X.X% |

Observations from First Wave of Adopters

ASU 2016-02, *Leases*

Observations from first wave of adopters

- Very little, if any, impact to equity; largely a balance sheet “gross up”
 - Other than for deferred gains on sale-and-leaseback transactions, companies generally silent on reason for retained earnings adjustments
- Most companies adopted using a modified retrospective approach (applied as of the date of adoption, prior periods unchanged)
- Practical expedients, including the “package of 3”, were used extensively
 - As an exception, very few entities elected to use the “hindsight” practical expedient

Example Balance Sheet Presentation

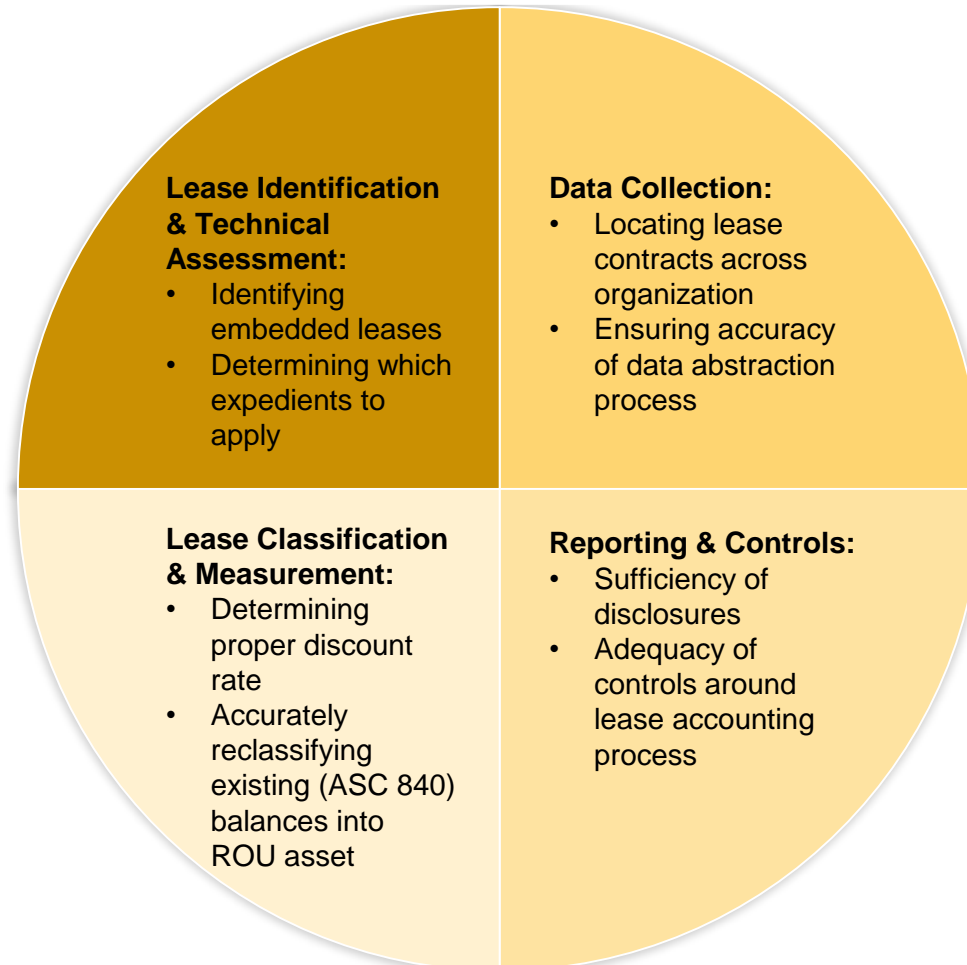
AMAZON.COM, INC.
CONSOLIDATED BALANCE SHEETS
(in millions, except per share data)

| | December 31, 2018 | March 31, 2019 |
|--|-------------------|----------------|
| | | (unaudited) |
| <u>ASSETS</u> | | |
| Current assets: | | |
| Cash and cash equivalents | \$ 31,750 | \$ 23,115 |
| Marketable securities | 9,500 | 13,905 |
| Inventories | 17,174 | 16,432 |
| Accounts receivable, net and other | 16,677 | 15,979 |
| Total current assets | 75,101 | 69,431 |
| Property and equipment, net | 61,797 | 61,048 |
| Operating leases | — | 20,132 |
| Goodwill | 14,548 | 14,708 |
| Other assets | 11,202 | 12,783 |
| Total assets | \$ 162,648 | \$ 178,102 |
| <u>LIABILITIES AND STOCKHOLDERS' EQUITY</u> | | |
| Current liabilities: | | |
| Accounts payable | \$ 38,192 | \$ 31,809 |
| Accrued expenses and other | 23,663 | 24,588 |
| Unearned revenue | 6,536 | 7,298 |
| Total current liabilities | 68,391 | 63,695 |
| Long-term lease liabilities | 9,650 | 33,275 |
| Long-term debt | 23,495 | 23,322 |
| Other long-term liabilities | 17,563 | 9,400 |
| Commitments and contingencies (Note 4) | | |

Implementation Challenges

ASU 2016-02, Leases

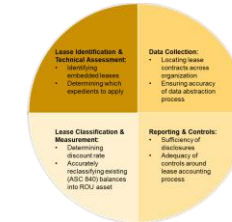
Implementation challenges



ASU 2016-02, Leases

Implementation challenges

Identifying all leases – the new “on/off switch”



Sources of complexity

- Decentralized procurement
- Lease accounting function decentralized
- Finding all the amendments
- Lack of a robust process to capture embedded leases
- Translation issues

Implementation strategies

- Look to detail behind lease commitments disclosure
- Review GL account activity and A/P and vendor details
- Inquire across organization
- Use lease questionnaires

Keep an eye out

- Leases could be hiding in...
 - Exclusive supply agreements
 - Contract manufacturing arrangements
 - Clinical supply agreements
 - IT service contracts
 - Inventory management contracts
 - Office management contracts
 - Outsourcing arrangements

ASU 2016-02, Leases

Implementation challenges

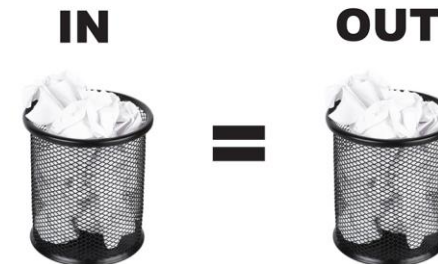
Data collection and accuracy

Sources of complexity

- Resource limitations (e.g., sheer volume of contracts)
- Inadequate training for data extractors (e.g., inconsistent interpretations, don't know what to look for)
- Improper or no controls over data entry quality

Implementation strategies

- Start early
- Create standardized data extraction templates
- Provide proper training
- Ensure proper controls over data entry quality



ASU 2016-02, Leases

Implementation challenges

Classification & measurement – discount rates



Sources of complexity

- No recent debt issuances, or no debt at all
- Using a single discount rate for all leases may not be reasonable
- Qualitative adjustments may be needed (e.g., collateral differences, term)
- Auditor approval

Implementation strategies – discount rate

- Look to recently issued debt
- Estimate a rate based on the Company's published or implied credit rating and relevant market data (e.g., market rates, cap rates)
- Obtain a rate quote from a trusted lending partner
- Engage a third-party specialist
- Talk with auditors early!

Other sources of measurement complexity

- Lease term
- Variable lease payments
- Portfolio approach

ASU 2016-02, Leases

Implementation challenges

Classification & measurement – discount rates



Sources of complexity

- No recent debt issuances, or no debt at all
- Using a single rate for all leases may not be reasonable
- Qualitative adjustments may be needed (e.g., collateral differences, term)
- Auditor approval

Implementation strategies – discount rate

Reminder:

Private companies can elect to use the risk-free rate as their incremental borrowing rate. However, keep in mind that the use of a lower rate means a larger liability...

- Engage a third-party specialist
- Talk with auditors early!

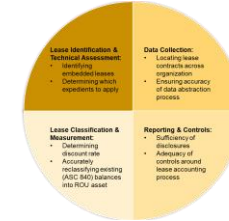
Other sources of measurement complexity

- Lease term
- Variable lease payments
- Portfolio approach

ASU 2016-02, Leases

Implementation challenges

Reporting & controls



Sources of complexity

- How will we capture all the necessary data to satisfy reporting & disclosure requirements?
- If we use a system solution, how can we assure accuracy of reported results? How can we get auditor comfortable with system output?

Implementation strategies

- Start early!
- Test system solutions using company-specific fact patterns
- Complete system controls documentation
- Involve auditors early on

Other Reminders

- Don't forget to...
 - Use cross-functional teams
 - Consider interaction with current ERP or GL systems

Adoption and Go-Forward Controls

Adoption

- Implementation plan review
- Executive-level sign-offs
- Key personnel training
- Audit team involvement, early and often
- Evaluate controls affected
- Review workflows, access and approvals
- UAT procedures for software
- Reconcile reports to ensure completeness
- Management review controls

Go-Forward

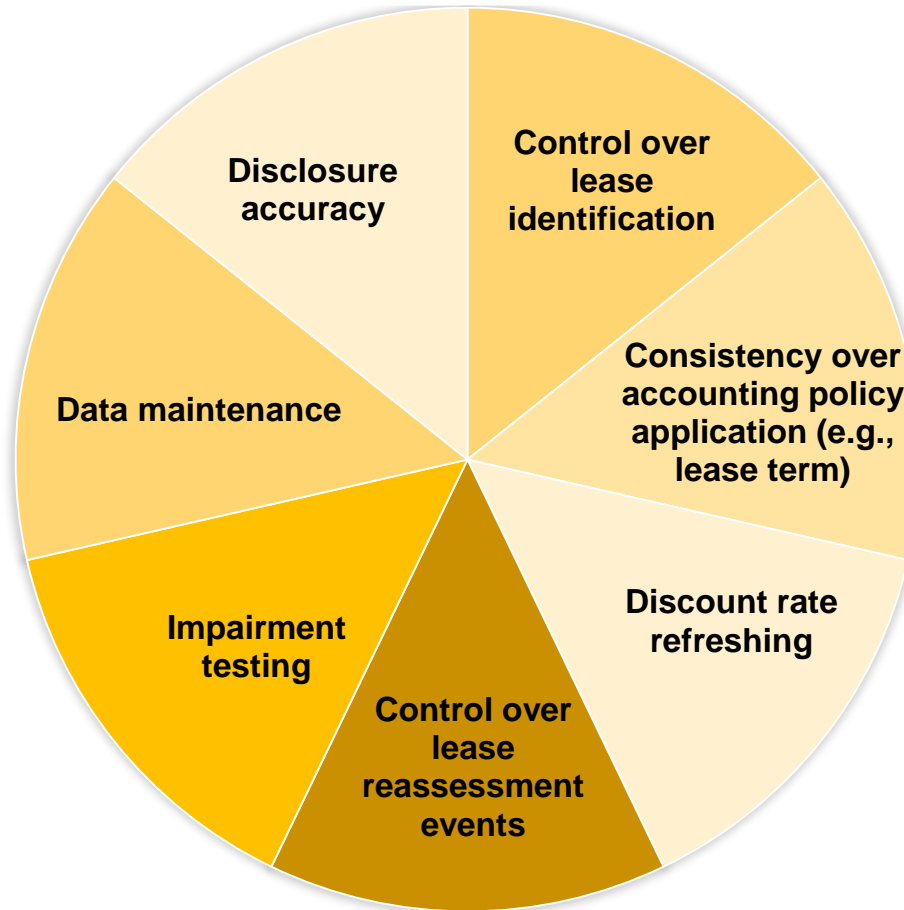
- Defined roles and responsibilities
- Notifications and communication lines
- Timely service contract / embedded lease reviews
- Timely communication and review of new leases and/ or modifications
- Quarterly sign-off on triggering events for reassessment events
- Discount rate calculations, if material
- Disclosures



Day 2 Considerations

ASU 2016-02, *Leases*

“Day 2” Considerations



ASU 2016-02, Leases

“Day 2” Considerations – Reassessment Events

Reminder:

After lease commencement, lessees must monitor for certain events that could trigger a change in the measurement of lease assets and liabilities

| Event | Description |
|---|---|
| Significant event or change in circumstance | A significant event or change in circumstances occurs that is within the lessee’s control that directly affects whether the lessee is reasonably certain to (1) extend the lease, (2) not terminate the lease or (3) purchase the underlying asset. |
| Contractual event | There is an event that is written into the contract that obliges the lessee to exercise or not exercise an option to extend or terminate the lease. |
| Option exercised | The lessee elects to (not) exercise an option even though it had previously determined that it was not reasonably certain to do so. |
| Resolution of contingency | There is a resolution of a contingency that results in lease payments that were previously variable becoming fixed |
| Amount payable under RVG | The lessee’s estimate of amounts due under a lessee-provided residual value guarantee changes |

ASU 2016-02, *Leases*

“Day 2” Considerations – Data Maintenance, etc.

Reminder:

The new lease standard requires virtually all leases to be accounted for on balance sheet. This requires greater control over processes and data.

Don't forget:

- Data maintenance (i.e. ledgers, mapping considerations etc.)
- New reconciliations (i.e. underlying detail to general ledger)
- New technology considerations (i.e. ongoing access review, SSAE 18 review etc.).
- On-going accounting policy review/appropriateness:
 - Capitalization threshold (i.e. too high or too low)
 - Incremental borrowing rate (refresh considerations, practical expedients)
 - Renewal options assumptions
 - Contingent lease incentives (e.g. remeasurement vs. up-front estimation)
 - Impairments (e.g. include or exclude operating leases from asset groups and undiscounted cash flows)



Thank you

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