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Welcome

Lessons Learned from Implementing the
New Lease Accounting Standards.



Agenda

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02 Effective Dates & Transition Methods

03 Lessee Accounting Overview

04 Lessor Accounting Overview

05 Implementation Framework

06 What We Have Learned

A1 Sale Leaseback

A2 Lease Liabilities





A3 Separating Lease Components

A4 Initial Direct Costs

A5 Subleases

What will you gain from this session?

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

-  Recognize the impact of the new lease accounting standards
-  Identify areas in your organization that may be affected
-  Identify key personnel and technology needed to efficiently implement the new standards
-  Evaluate the impact of the changes on required financial reporting



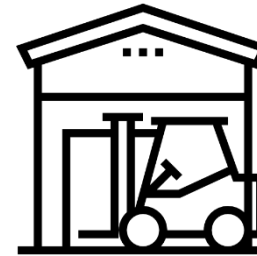
01 Background & Scope

Lessee Illustration



**Retail
Corporation**

- Real Estate



**Manufacturing
Corporation**

- Forklifts
- Production Machines
- Compressors

Lessee Illustration



Retail Corp

\$\$
\$\$

Liabilities



Manufacturing Corp

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

Liabilities

Lessee Illustration



Retail Corp

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Liabilities



Manufacturing Corp

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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



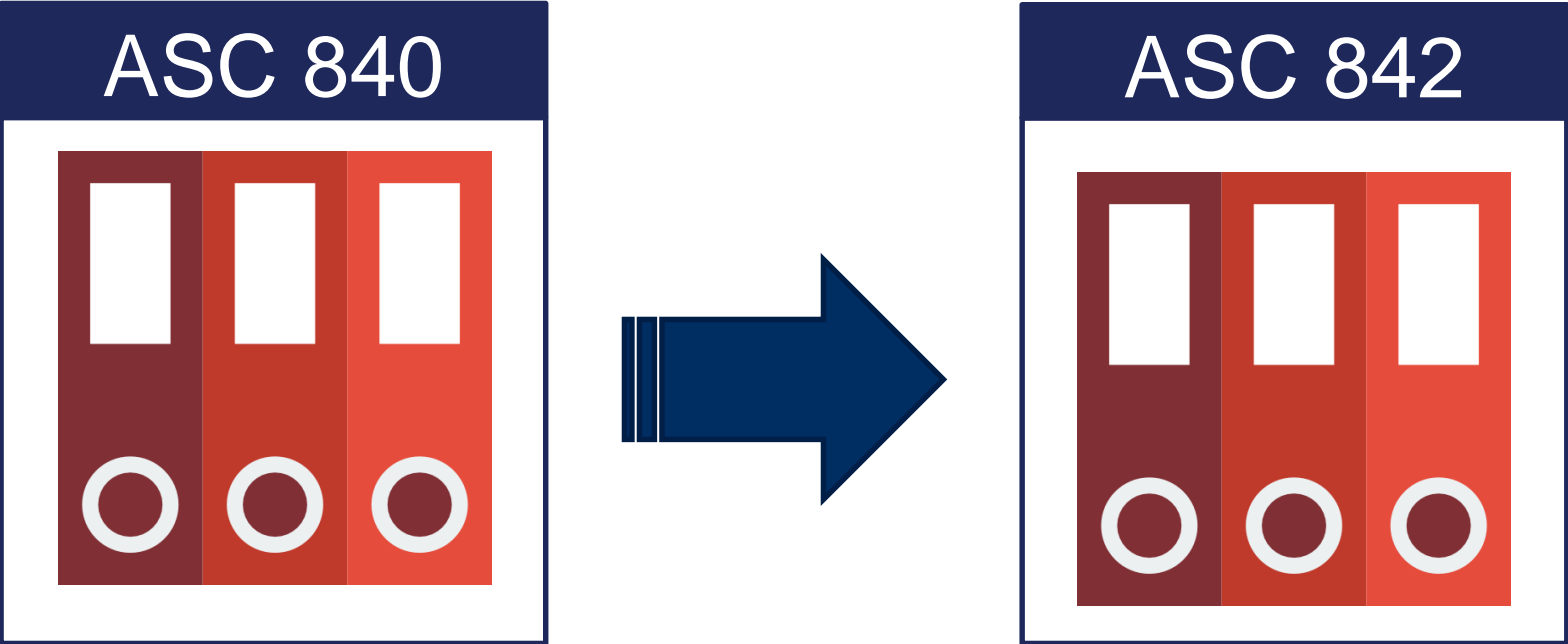
Who is affected?

Any entity that enters into a lease*



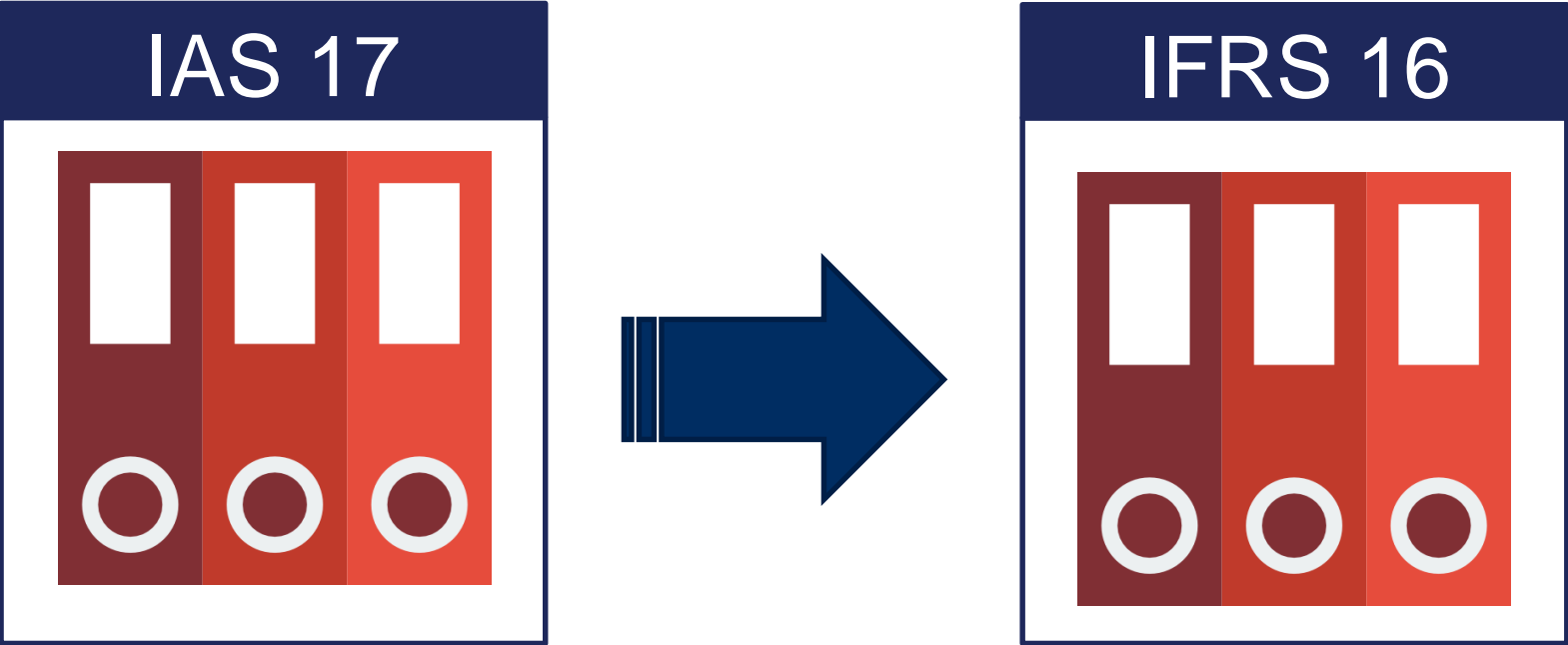
New FASB Standard

Financial Accounting Standards Board
(FASB)



New IFRS Standard

International Financial Reporting Standards (IFRS)



Scope Exceptions – U.S. GAAP

- Leases of intangible assets (see ASC Topic 350, “Intangibles – Goodwill and Other”)
- Leases to explore for or use minerals, oil, natural gas, and similar nonregenerative resources (see Topic 930, “Extractive Activities – Mining,” and Topic 932, “Extractive Activities – Oil and Gas”)
- Leases of biological assets, including timber (see Topic 905, “Agriculture”)
- Leases of inventory (see Topic 330, “Inventory”)
- Leases of assets under construction (see Topic 360, “Property, Plant, and Equipment”)

02 Effective Dates

Effective Dates – ASC 842

- All fiscal years beginning after:



**December 15,
2019**

- A public business entity
- A not-for-profit entity that has issued publicly traded bonds
- An employee benefit plan that files financial statements with the SEC.



**December 15,
~~2020~~ 2021**

- All other entities

Effective Date – IFRS 16

- All fiscal periods starting on or after:







**January 1,
2019**

For all entities

03 Lessee Accounting Model Overview

ASC 842 Lessee Overview – Balance Sheet

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

ASC 842 Lessee Overview – Balance Sheet

Short-Term Leases

- **Short-term leases** are exempt from being recognized on the balance sheet.
- **Short-term** means less than 12 months and no purchase option reasonably likely to be exercised
- 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 in the period in which the obligation for those payments is incurred
- Think percentage rent or performance-based lease payments
- However, variable payments contingent on an index are included at initial recognition

Nonlease components

- Unless the **practical expedient** to account for all lease components as one is adopted, companies should **exclude** non-lease components from the initial measurement of the lease liability
- For example: common area maintenance, taxes, and insurance

ASC 842 Lessee Overview – Income Statement

	ASC 842	
	Finance leases	Operating leases
Revenue	x	x
Operating costs (excluding depreciation and amortization)	--	Single 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.

ASC 842 Lessee Overview – Classification

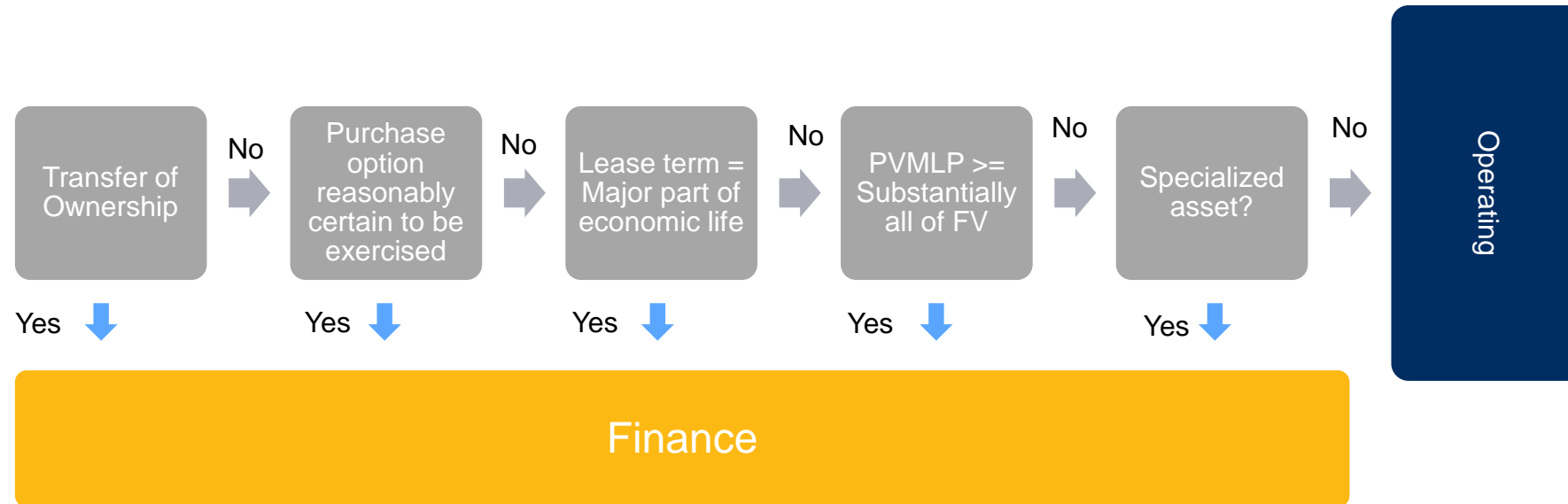
Criteria

- 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




ASC 842 Lessee Overview – Classification



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

IFRS 16 Lessee Model – Balance Sheet

	IAS 17 / Topic 840		IFRS 16
	Finance leases	Operating leases	All leases
Assets			
Liabilities	\$\$		\$\$\$\$\$\$
Off balance sheet rights / obligations		 <hr style="border-top: 1px dashed orange;"/> \$\$\$\$	

Balance Sheet

Under the current model (IAS 17) operating leases are treated as off-balance sheet arrangements.

Under the new model (IFRS 16) nearly all leases are recognized in the balance sheet as a finance lease.

IFRS 16 Lessee Model – Income Statement

	IAS 17 / Topic 840		IFRS 16
	Finance leases	Operating leases	All leases
Revenue	x	x	x
Operating costs <i>(excluding depreciation and amortization)</i>	---	<i>Single expense</i>	---
EBITDA			↑↑
<i>Depreciation and amortization</i>	<i>Depreciation</i>	---	<i>Depreciation</i>
Operating profit			↑
<i>Finance Costs</i>	<i>Interest</i>	---	<i>Interest</i>
Profit before tax			↔

Income Statement

Under the current model, operating lease costs are recorded as a single straight-line cost in the income statement.

Under the new model, nearly leases will be considered finance leases, and will have a depreciation and interest charge to the income statement.

Lease Example 1

ABC Corp. enters into a lease of a machine from XYZ Corp.	
Term	36 months
Economic Life	10 years
Purchase Option	None
Due at signing	5,000
Payments	2,000 per month at end of month
Rate	7%
Fair value of asset	141,200
Residual value guarantee	None

Calculate Present Value of Minimum Future Lease Payments

$$P \left[\frac{1 - (1 + r)^{-n}}{r} \right]$$

P = Periodic Payment

r = rate per period

n = number of periods

- Use present value tables
 - (2,000 * 32.3865)
- Excel Formula =PV(0.07/12,36,-2000,0,0)

\$64,772.93

Lease Classification Test

ABC Corp. enters into a lease of a machine from XYZ Corp.

Does ownership transfer?	No, the machine reverts back to XYZ Corp. at lease termination
Is purchase option reasonably certain of exercise?	No, lease contains no purchase option
Is lease term major part of economic life?	No, ABC Corp. leases the machine for only 30% (3/10 years) of asset's economic life
Is present value of lease payments substantially all of assets fair value?	No, present value of lease payments is only 46% (\$64,773/141,200) of asset's fair value
Is asset specialized in nature?	No, the machine can be used for any general corporate purpose

OPERATING LEASE

Operating Lease Initial Recognition

Journal Entry at Lease Commencement		
Right of use asset	\$69,772.93	
Lease liability		\$64,772.93
Cash		\$5,000.00

Operating Lease Schedules

	Expense	Liability			Asset
		Cash Payment*	Interest	Principal Reduction	Reduction
Year	A	B	C	D	A-C
1	25,667	29,000	3,897.27	20,102.73	21,769.73
2	25,667	24,000	2,444.04	21,555.96	23,222.96
3	25,667	24,000	885.76	23,114.24	24,780.24
Total	77,000	77,000	7,227.07	64,772.93	69,772.93

*Some totals have been affected by rounding

Summary of Year 1 Journal Entries

Year 1 Journal Entry for Operating Lease		
Lease expense	25,667.00	
Lease liability	20,102.73	
Cash		24,000.00
Right-of-use asset		21,769.73

Lease Example 2

Change in Assumptions

Assume the same facts as in the previous example except that the leased machine now includes a transfer of ownership clause at the end of the lease term.

Lease Classification Test

ABC Corp. enters into a lease of a machine from XYZ Corp.	
Does ownership transfer?	Yes, the ownership of the machine transfer to the ABC corp. at the end of the lease term.
Is purchase option reasonably certain of exercise?	No, lease contains no purchase option
Is lease term major part of economic life?	No, ABC Corp leases the machine for only 30% (3/10 years) of asset's economic life
Is present value of lease payments substantially all of assets fair value?	No, present value of lease payments is only 46% (\$64,773/141,200) of asset's fair value
Is asset specialized in nature?	No
FINANCE LEASE	

Finance Lease Accounting Treatment

	Asset	Liability			Expense
	Amortization	Cash Payment	Interest	Principal Reduction	
Year	A	B	C	D	A+C
1	23,257.64	29,000.00	3,897.27	20,102.73	27,154.91
2	23,257.64	24,000.00	2,444.04	21,555.96	25,701.68
3	23,257.65	24,000.00	885.76	23,114.24	24,143.41
Total	69,772.93	77,000.00	7,227.07	64,772.93	77,000.00

Year 1 Journal Entry for Finance Lease		
Interest expense	3,897.27	
Amortization expense	23,257.64	
Lease liability	20,102.73	
Cash		24,000.00
Accumulated amortization		23,257.64

F/S Impact Comparison

	Operating Lease	Finance Lease
Balance Sheet, lease commencement		
Right of use asset	669,773	669,773
Lease liability	664,773	664,773
Income Statement, Year 1		
Lease expense	25,667	
Amortization expense		23,258
Interest expense		3,897
Pretax income	(25,667)	(27,165)
Statement of Cash Flows, Year 1		
Included in operating activities	(24,000)	(3,897)
Included in Investing activities		
Included in Financing activities		(20,103)
Balance Sheet, end of Year 1		
Right of use asset (net)	48,003	46,515
Lease liability	44,670	44,670

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

04 Lessor Accounting Model Overview

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

Lessors 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 a sales-type lease, collectability is not probable and the lease asset is not derecognized)	Continue to recognize underlying asset
Income statement (characterization)	<p>Direct-financing – interest and profit over lease term; loss at commencement</p> <p>Sales-type – interest over lease term; profit/loss at commencement if collectability is probable</p>	Lease income, typically straight-line
Cash flow statement	Operating – cash received	Operating – cash received

Lessors Accounting Model – Disclosures

Qualitative

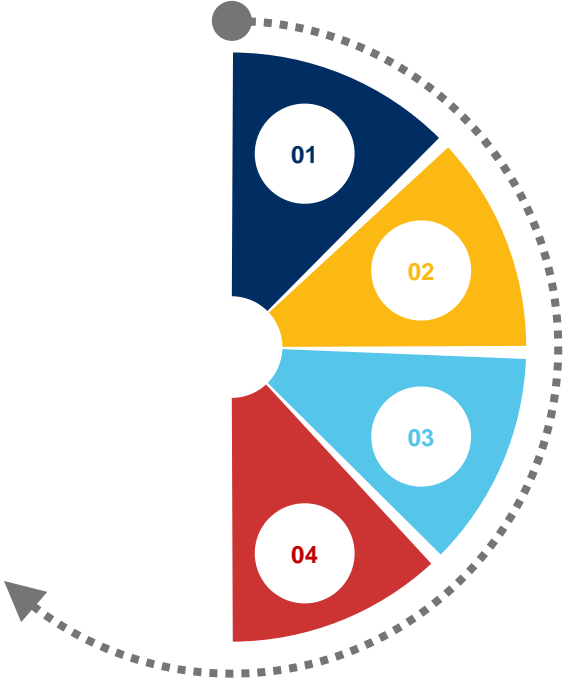
- Nature of leases and significant terms
- Significant assumptions and judgments made in application
- Residual value risk management
- Significant changes in unguaranteed residual assets and deferred selling profit

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

05 Implementation Framework

Lease Implementation 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



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.

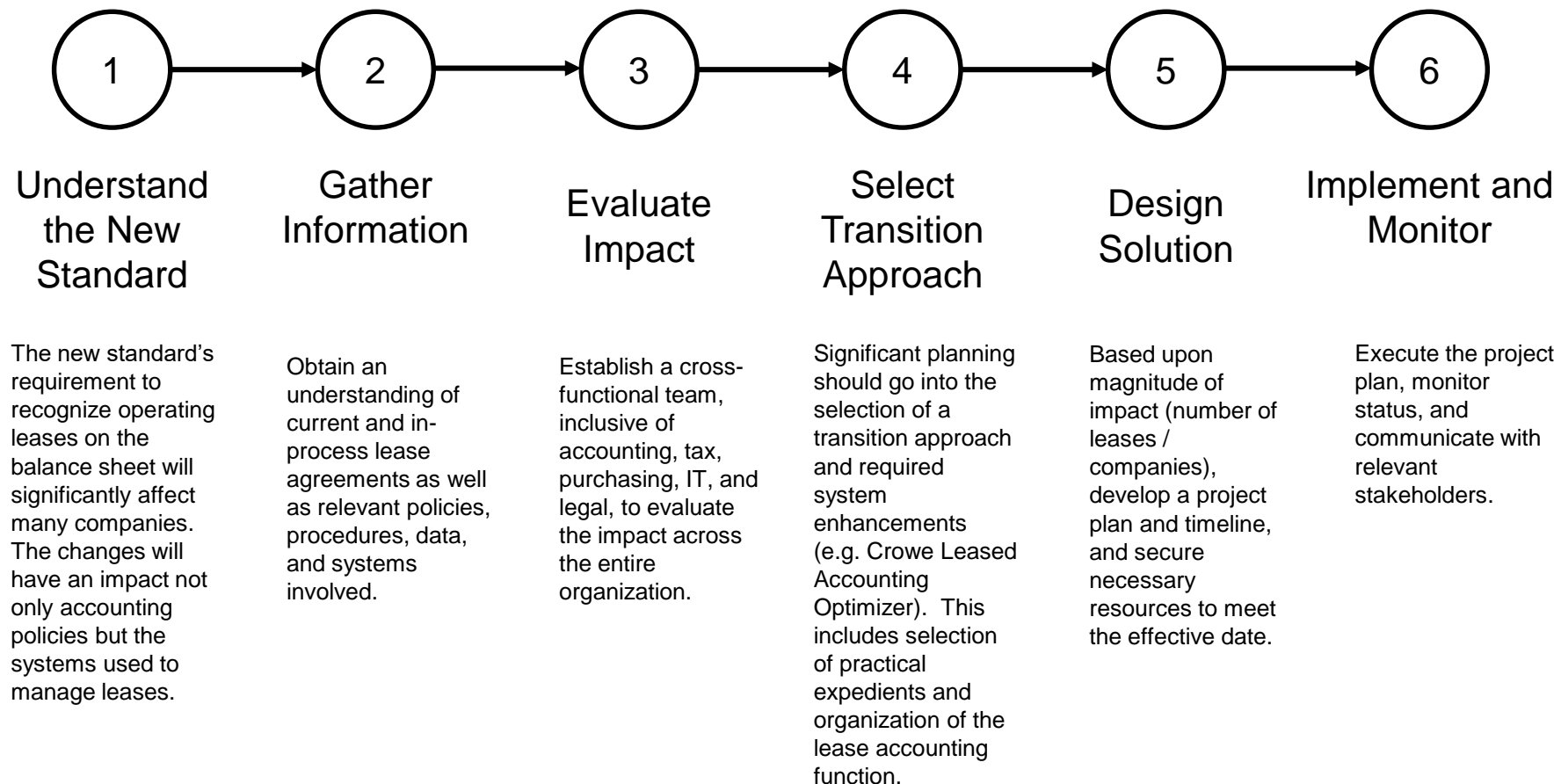


Analysis & Impact Completion

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

ASC 842 Impact Assessment And Implementation Consulting Services

Crowe's Lease Accounting Framework provides companies with the structure, technology, and knowledgeable resources required to quickly navigate through the complex assessment and implementation process.



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 accurately 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 and the auditors with a clear approach for implementation of ASC 842.

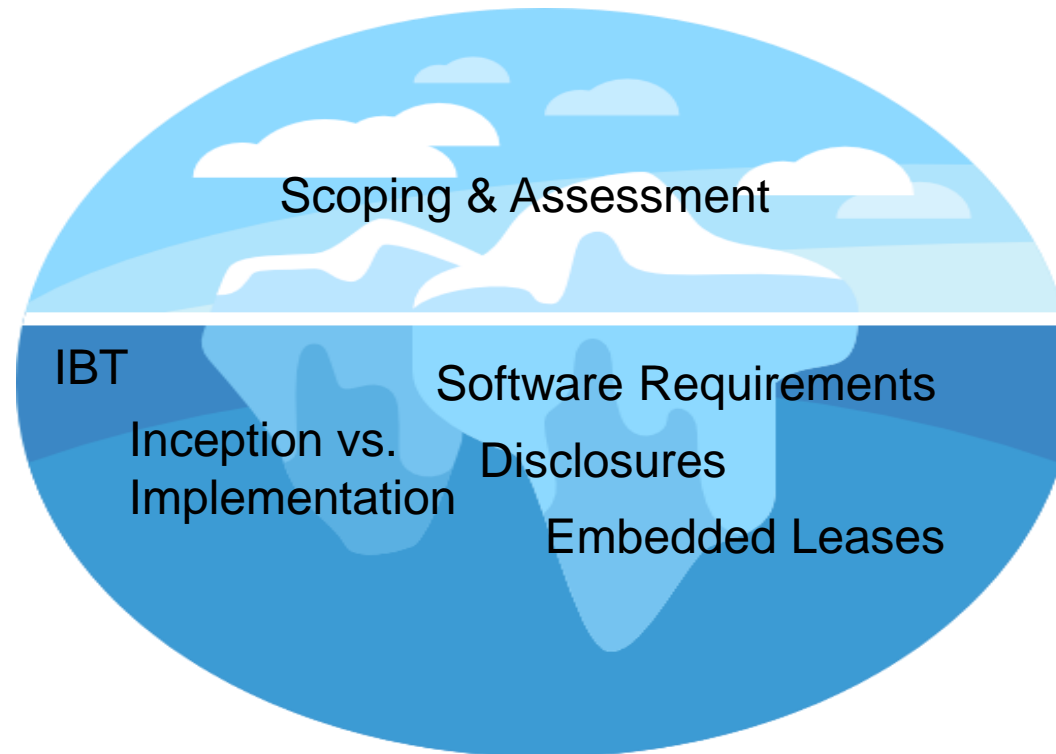
Impacts on Internal Controls

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

06 What We Have Learned

Key Lessons Learned

- Finding your leases is only the start...



Key Lessons Learned

- START EARLY!!!
- If you have not begun the process of evaluating your leases please start soon. You will need to consider the following areas:
 - **Scoping:** Did I identify all my leases? Can I get my auditors comfortable with my approach?
 - **Software:** Am I going to use a software?
 - **People:** Who will be performing my lease accounting?
 - **Policies:** Do I know how to arrive at my IBR? Did I document my practical expedients?
 - **Process:** What controls am I going to put in place?

Scoping

- What steps did you take to ensure your population of leases was complete?
- Did you document the steps you have taken?
- Did this process include embedded leases?
- Was the review limited to the data or did we inquire with operations?
- Do you know what data you need from each lease?
- Where is that data stored and in what manner?

Software

- Is your software hosted or SAAS?
- What steps need to be taken to install new software in your organization (e.g. security requirements)?
- Have you tested the upload process?
- How many licenses will you need?
- Is the software integrated or is there a manual JE process?

People

- Who will enter the leases? Do you have a centralized process or de-centralized process?
- Who can approve leases that need to get entered?
- Who will own the process overall?

Policies

- How will you calculate the incremental borrowing rate (IBR)? Will you use the risk-free rate?
- What practical expedients will you utilize?

Process

- Have you identified and documented your implementation process?
- What controls did you have for implementation?
- Have you identified your controls for the on-going lease entry process?
- Do you have processes in place to ensure your leases are complete?

Other Topics – Implementation Considerations

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
- 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 for 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.



Thank you

Please contact Simon Little with questions or for more information.

Simon Little
TMT Senior Manager
Consulting
Crowe LLP

A1 Sale Leaseback

Sale and Leaseback Transactions

- Has a sale occurred? The definition of a sale – which requires giving up control of the underlying asset – conforms to the new revenue recognition standard.
- 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.

A2 Lease Modifications

Lease Modifications

- Lease modification is 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, account for the new contract in the same manner as any other new lease.
 - If NO, remeasure and reallocate the remaining consideration in the modified lease, and reassess the classification at the effective date of the modification.

A3 Separating Lease Components

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*

A4 Initial Direct Costs

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 (e.g., legal review) in IDC's.

Lessees	<ul style="list-style-type: none">• Include IDC's in the initial and subsequent measurement of the ROU asset.
Lessors	<ul style="list-style-type: none">• 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.

A5 Subleases

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 the 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 the 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.



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