South Carolina CPE Day 2019

Revenue from contracts with customers (ASC 606)

EY

Building a better working world

Agenda

- Overview
- The five-step model
- Accounting implementation key challenges
- SEC staff comments

Overview

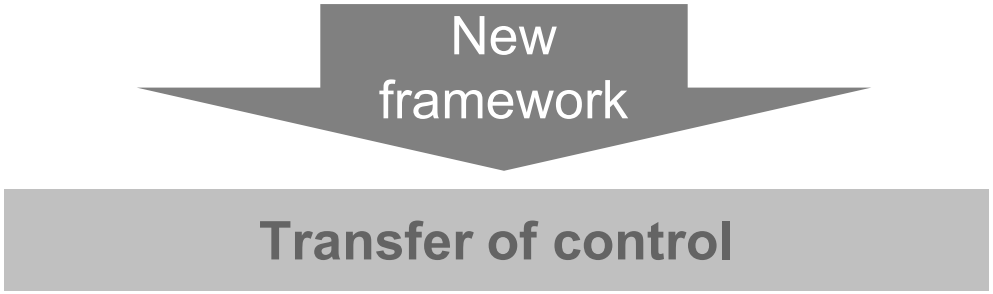
Revenue recognition standard

- The model addresses revenue arising from contracts with customers
  - The FASB and IASB created one comprehensive revenue recognition model for all contracts across virtually all entities and sectors
  - The new standard replaces virtually all existing US GAAP and IFRS guidance on revenue recognition
  - Consistent with this, the SEC and SEC staff have updated their interpretive guidance so that companies can apply the new revenue recognition standard without reconciling with existing SEC revenue recognition guidance
- The FASB and IASB standards, as originally published, were substantially the same
- Both Boards amended their standards, resulting in some additional differences

Overview

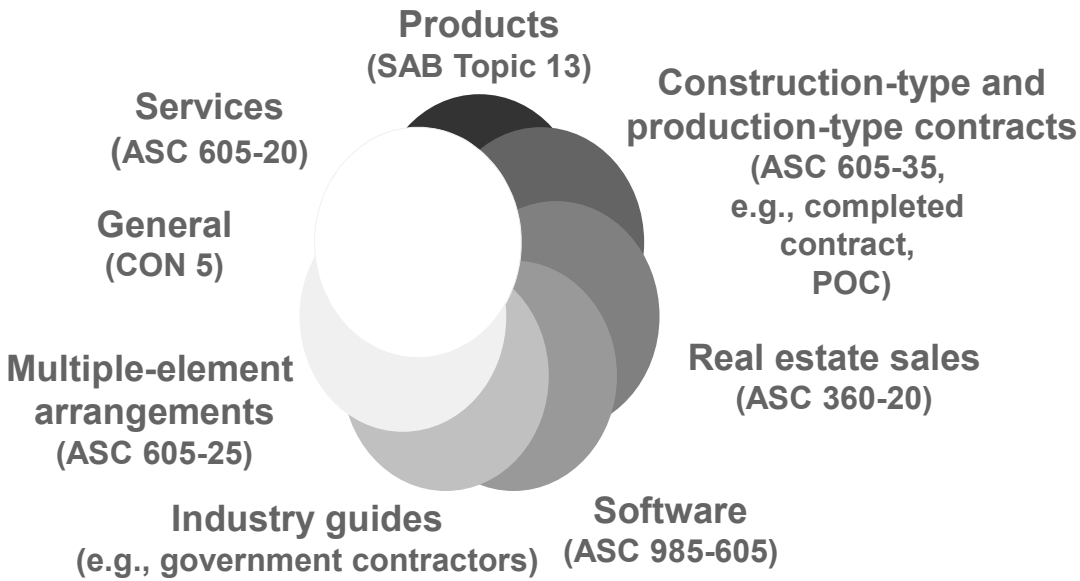
Objective of the standard

- To clarify the principles for recognizing revenue and to develop a common revenue standard for US GAAP and IFRS that would:
  - Remove inconsistencies and weaknesses in existing revenue requirements
  - Provide a more robust framework for addressing revenue issues
  - Improve comparability of revenue recognition practices across entities, industries, jurisdictions and capital markets
  - Provide more useful information to users of financial statements through improved disclosure requirements
  - Simplify the preparation of financial statements by reducing the number of requirements to which an entity must refer



Overview

What's changing?



Transfer of control

- Single revenue standard for all contracts with customers
- The standard is more principles-based than current guidance
- Potential changes:
  - Differences in the number of performance obligations
  - Disconnect between billing and revenue recognition
  - More estimates included in revenue
  - Change in revenue patterns

The five-step model

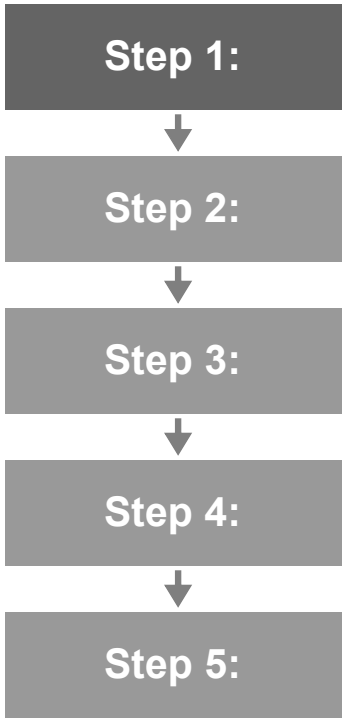
Overview

- Core principle: recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity ***expects to be entitled*** in exchange for those goods or services

Step 1:	Identify the contract(s) with a customer
Step 2:	Identify the performance obligations in the contract
Step 3:	Determine the transaction price
Step 4:	Allocate the transaction price to the performance obligations
Step 5:	Recognize revenue when (or as) each performance obligation is satisfied

The five-step model

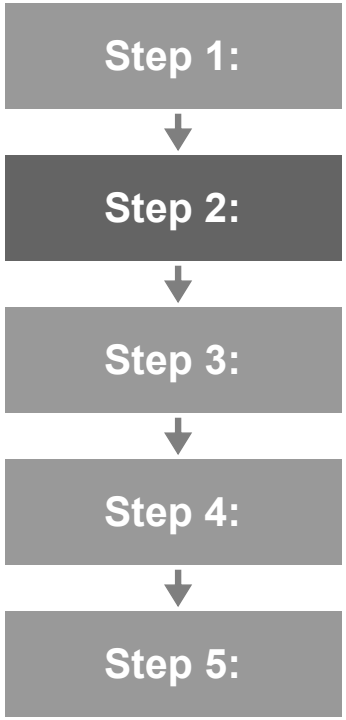
Step 1: Identify the Contract



- Concept of the contract is similar to current GAAP
  - Contract = Deal
- Arrangement must meet the following criteria to be within scope of standard:
  - Parties have agreed to terms and are committed to perform
  - Each parties' rights and payment terms can be identified
  - Contract has commercial substance
  - Collection is probable (Note: This is a key change from current standard)
- Contracts entered into at the same time with the same customer should be linked if certain criteria are met
- **Contract modifications** could constitute a new revenue **contract** or retroactively impact the existing contract

The five-step model

Step 2: Identify the Performance Obligation (POB)



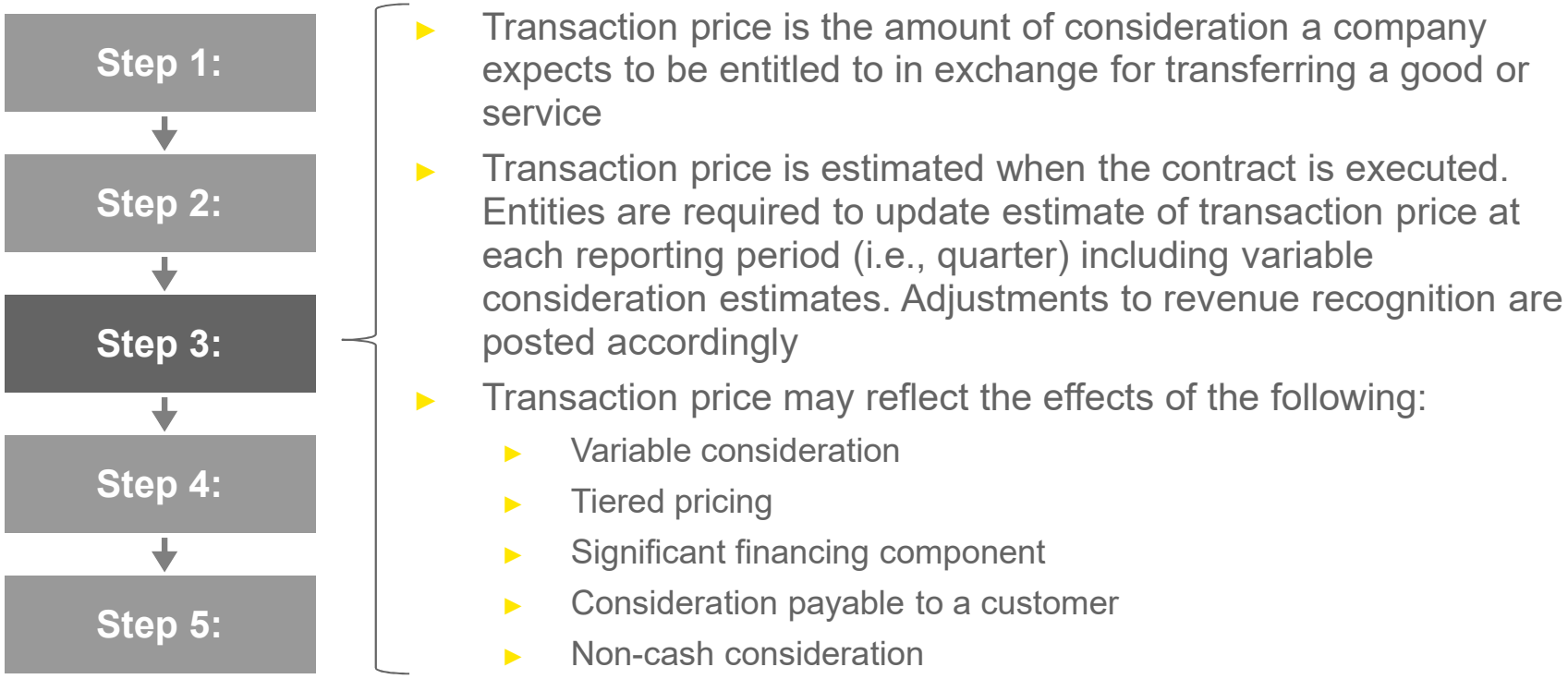
- A performance obligation is defined as a promise (explicit or implicit) to transfer a good or service to the customer
- Performance obligations are identified at contract inception and determined based on:
  - Contractual terms
  - Customary business practice

Example	Today – a subscription is 1 performance obligation Tomorrow – a subscription is 2 performance obligations: 1. Maintenance 2. License

- At contract inception, an entity shall assess the goods or services promised in a contract and shall identify, as a performance obligation, each promise to transfer to the customer either:
  - A good or service (or a bundle of goods or services) that is **distinct**
  - A series of distinct goods or services that are substantially the same and that have the same pattern of transfer to the customer

The five-step model

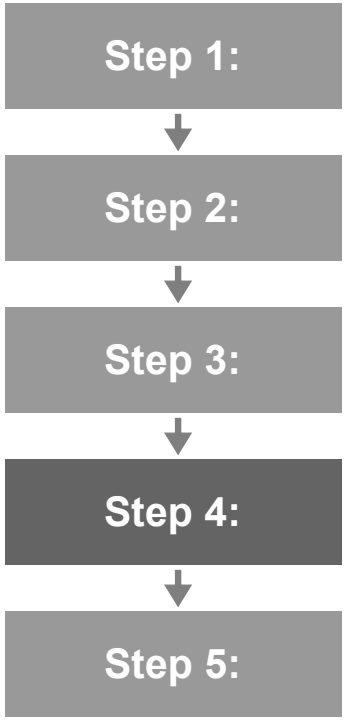
Step 3: Determine the Transaction Price



- Transaction price is the amount of consideration a company expects to be entitled to in exchange for transferring a good or service
- Transaction price is estimated when the contract is executed. Entities are required to update estimate of transaction price at each reporting period (i.e., quarter) including variable consideration estimates. Adjustments to revenue recognition are posted accordingly
- Transaction price may reflect the effects of the following:
  - Variable consideration
  - Tiered pricing
  - Significant financing component
  - Consideration payable to a customer
  - Non-cash consideration

The five-step model

Step 4: Allocate the Transaction Price



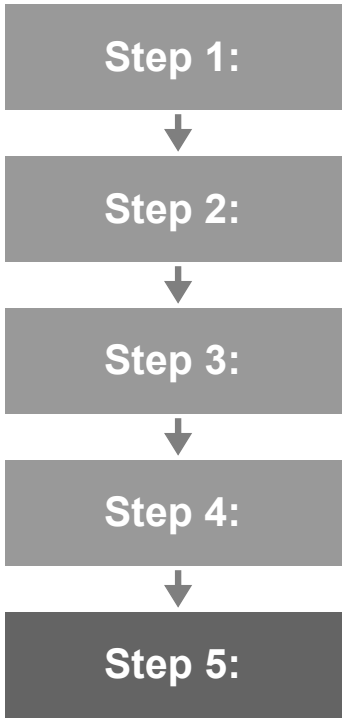
- Basis for the allocation: The transaction price should be allocated to each performance obligation based on the relative standalone selling price ("SSP") determined at the time of contract inception of the goods and services being provided
- The best evidence of SSP is the observable price of a good or service when the entity sells that good or service separately in similar circumstances and to similar customers

SSP	Today – Fair Value 1. VSOE 2. BESP 3. Stated Rate Tomorrow – replaced by concept of Standalone Selling Price (SSP) for each

- When an SSP is not observable, an entity is required to estimate it

The five-step model

Step 5: Recognize Revenue



Definition: Revenue is recognized when (or as) an entity satisfies a performance obligation by transferring a promised good or service to a customer

- A good or service is considered to be transferred when the customer obtains control
- Performance obligations are either satisfied over time or at a point in time
- To help make this determination, the standard includes criteria for determining when control transfers over time
  - The entity has a present right to payment for the asset
  - The customer has legal title to the asset
  - The entity has transferred physical possession of the asset
  - The customer has the risks and rewards of ownership of the asset
  - The customer has accepted the asset
- If none of the criteria are met, control transfers at a point in time

Accounting implementation key challenges

Drivers of complexity

Less complex | **More complex**

- Shorter revenue cycle
- Single line of business
- Domestic operations only
- Highly centralized
- Well-controlled process currently provides revenue estimates
- No change to existing performance obligations
- One global ERP
- Strong organizational change management

- Long-term contracts
- Multiple, diverse businesses
- Global operations
- Decentralized
- Limited estimates required by current revenue recognition process
- Differences in the number of performance obligations
- Multiple, disparate IT systems
- Organization struggles to implement change

Accounting implementation key challenges

Contract duration: termination clauses

- Under legacy GAAP, the contract duration equals the stated contractual term and terminations are accounted for as and when they occur.
- Under ASC 606, contracts may be shorter than the stated contractual term, if the customer can cancel without a substantive termination penalty.
- Companies should carefully evaluate termination clauses and any related termination penalties to determine how they impact the duration of the contract, which can affect the determination of the performance obligations and transaction price.
- Companies should determine whether a particular termination penalty is substantive and legally enforceable.
  - Companies may have a history of not enforcing termination penalties.
  - Companies should evaluate whether past history impacts the legal enforceability.
    - When contracts contain termination penalties that are substantive, but not enforced in practice, companies should discuss their judgments made in determining the impact on the legal enforceability of the contract with their auditors.
  - Companies should consider possible payments that may not be labeled as a penalty in the contract.

Operational considerations

If companies have nonstandard contracts, they may need to evaluate all contracts for termination provisions and any related termination payments or penalties to determine how they affect contract duration, as this may affect the number of performance obligations a company identifies, the transaction price it determines and the disclosures it is required to make.

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Accounting implementation key challenges

Identifying performance obligations

- Under the new standard, a promised good or service must meet two criteria to be distinct:
  - Capable of being distinct
  - Distinct within the context of the contract
- Determining whether a promised good or service is separately identifiable is challenging.
- When identifying performance obligations and whether promised goods or services are **highly interdependent or highly interrelated**, companies should not merely evaluate whether one item, by its nature, depends on the other.
  - Instead, companies should consider whether those goods or services significantly affect each other, i.e., if there is a **two-way dependency** between the goods or services in the arrangement.
- Significant judgment is required to determine highly interdependent/highly interrelated characteristics.

Operational considerations

Management may need to perform an analysis for each contract to assess if there is a two-way dependency between the related goods and services in the context of that specific contract to determine the number of performance obligations in the contract. Companies that have thousands of different goods and services may need to develop rules for various combinations of goods and services that may be sold in a contract.

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Accounting implementation key challenges

Principal versus agent

Principal (gross)	Agent (net)
Controls specified good or service before transferring to the customer	Arranges for another entity to provide specified good or service

- To determine the nature of its promise, companies should:
  - Identify the specified good or service (i.e., unit of account)
  - Assess if the company controls the specified good or service prior to the transfer to the customer
- Indicators in the new revenue standard support the control assessment and should be assessed for the company's specific facts and circumstances.
  - Indicators should not be considered a "checklist."
  - Indicators may be more or less relevant to the control assessment, depending on the specified good or service and the terms and conditions of the contract.
- Significant judgment may be involved, especially when there are multiple parties involved in providing the good or service or in situations when the transactions are instantaneous.

Operational considerations

Management may need to perform an analysis for each contract that has varying contractual terms to determine whether the company is a principal or an agent. For contracts in which the company is a principal for some goods and services and an agent for others, management will need to consider additional processes required to identify and track each specified good or service.

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Accounting implementation key challenges

Customer options

Customer option:

- Nature of the company's promise in the contract is to provide the **minimum quantity** of goods or services specified in the current contract.
- A right but no obligation for the customer to choose additional distinct goods or services (i.e., there is a separate purchasing decision)
- Evaluation of whether an option grants a material right, and therefore, a separate performance obligation is required

Variable consideration:

- Nature of the company's promise is to transfer to the customer **an overall** good or service.
- Customer is obligated to pay for those promised goods or services.
- Customer's subsequent actions to use the goods or services affect the measurement of revenue.

Operational considerations

Evaluation of specific terms and conditions within a contract may be necessary to evaluate whether there are options or variable consideration present in a contract. An additional evaluation is necessary for options to determine whether the option grants a material right. Additionally, more disclosures are required for variable consideration than for options that do not grant material rights.

Accounting implementation key challenges

Constraining estimates of variable consideration

- Companies should not default to constraining variable consideration to zero.
- When applying the constraint, companies should consider both the **likelihood and magnitude** of a revenue reversal:
  - Assessing the likelihood of a future reversal of revenue requires significant judgment. Companies should sufficiently document the judgment taken to form the basis for their conclusions.
  - When assessing magnitude, the term “significant” should be considered relative to cumulative revenue recognized at the contract level (including both fixed and variable consideration).

Operational considerations

Companies with contracts that contain variable consideration will need to establish a process to assess the constraint on estimates of variable consideration, including analyzing historical data. Companies no longer can default to deferring revenue until any uncertainty is resolved.

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Accounting implementation key challenges

Standalone selling price

- In order to allocate the transaction price, companies must determine the standalone selling price (SSP) of each performance obligation.
- Determining the SSP may be challenging for some companies.
  - Companies who do not utilize a relative allocation method today will need to develop an analysis for determining SSP under the new guidance.
  - Performance obligations under the new guidance may be different from the unit of account today and, therefore, a standalone value may not be readily available.
  - Companies who identify options granting material rights under the new guidance will need to use judgment in determining the SSP of those options.

Operational considerations

Any change in unit(s) of account from legacy guidance will require a new estimation process to determine the SSPs for performance obligations identified under the new revenue recognition guidance. An analysis of standalone sales and relevant third-party and market information may be necessary, in some circumstances, in order to estimate SSPs.

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Accounting implementation key challenges

Standalone selling price: variable consideration allocation exception

- The relative SSP method is the default method for allocating the transaction price under ASC 606; however, there are **two exceptions** to this method for allocation if certain criteria are met:
  - Allocating variable consideration to one or more, but not all, performance obligations
  - Allocating discounts to one or more, but not all, performance obligations
- Companies should note that these exceptions are not optional exceptions.
  - In order to apply the exception related to variable consideration, two criteria must be met:
    - Terms of variable payment relate specifically to the company's efforts to satisfy the performance obligation.
    - Allocating the variable amount of consideration to the performance obligation or the distinct good or service is consistent with the allocation objective when considering all of the performance obligations and terms of the contract.

Operational considerations

Companies with contracts that contain multiple distinct goods or services or a series of distinct goods or services will need to determine if variable consideration can be specifically allocated, based on the terms related to the variable consideration and the SSPs of the goods and services in the contract. Additional processes may be required to allocate the transaction price accordingly.

Accounting implementation key challenges

Standalone selling price: residual method

- The residual approach may be used to estimate SSP if two criteria are met:
  - Contract contains multiple promised goods or services (one of which must have an observable SSP).
  - The selling price of one or more goods or services is unknown (i.e., historical selling price is highly variable or the goods or services have not yet been sold).
- Companies should carefully evaluate whether they have performance obligations that meet the criteria to utilize the residual method in establishing SSP.
  - Companies that utilize the residual method under current software guidance (ASC 985-605) should not default to utilizing the residual method under the new revenue standard.
  - Companies should re-evaluate whether the use of the residual approach is appropriate if it results in allocating no or very little consideration to a service
- Companies who utilize the residual method for specific performance obligations under the new revenue standard will need to use additional judgment when determining whether options for those goods and services grant a material right, and whether to treat contract modifications to add those goods and services as a separate contract or part of the original contract.

Operational considerations

Companies may need to establish an analysis to support their conclusion to utilize the residual method, which may need to be updated periodically. In order to support this analysis, companies will need to obtain relevant data, such as historical sales.

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Accounting implementation key challenges

Performance obligations satisfied at a point in time or over time

- Companies should evaluate whether each performance obligation is recognized over time or at a point in time. If any one of the criteria below is met, revenue is recognized over time:
  - The customer simultaneously receives and consumes the benefits provided by the entity's performance as the entity performs.
  - The entity's performance creates or enhances an asset (e.g., work in process) that the customer controls as the asset is created or enhanced.
  - The entity's performance does not create an asset with alternative use to the entity, and the entity has an enforceable right to payment for performance completed to date.
- Companies have found it challenging to determine whether the third criterion is met.
  - If a performance obligation has an alternative use, companies should consider the completed asset.
  - Enforceable right to payment exists through the duration of the contract. A company must be entitled to an amount that at least compensates it for its performance completed to date (including margin).
    - When contract terms do not specify the company's right to payment upon contract termination, an enforceable right to payment is presumed not to exist. However, a company can still assert that it has an enforceable right to payment if the assertion is appropriately supported.
    - ASC 606 does not preclude a company from having an enforceable right to payment even if the contract is priced at a loss.

Operational considerations

For companies that have contracts for goods that do not have an alternative use and non-standard terms and conditions, the determination of whether a contract is recognized at a point in time or over time will be highly dependent on contractual clauses related to entitlement to payment for work performed. As such, companies may come to different revenue recognition conclusions for similar goods if they have varying contract terms. Management may be required to evaluate all non-standard contracts to make this determination.

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Accounting implementation key challenges

Contract costs: capitalizing and amortizing costs to obtain a contract

- Companies are required to capitalize the costs of obtaining a contract if they are **incremental and recoverable** (e.g., sales commissions).
- This requirement will be a significant change for many companies that currently expense these costs.
- Even for companies who have capitalized costs that were both direct and incremental under legacy GAAP, companies generally only capitalized sales commissions paid to the direct salesperson or team.
- Companies are required to evaluate all sales commissions paid to employees and capitalize any costs that are incremental and recoverable, regardless of how directly involved the employee was in the sales process.
  - Other compensation plans (e.g., payments from a pool of funds calculated on new revenue contracts) or commissions paid to third parties may also qualify for capitalization.
- Costs may need to be amortized over a period that does not equal the stated contractual term.

Operational considerations

Management should evaluate commission structures, which often change annually, to determine which commissions are incremental to obtaining the contract and require capitalization. Companies that do not track commissions on a contract level will need to identify how to obtain information on a contract level or determine whether a portfolio approach can be taken.

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Accounting implementation key challenges

Contract costs: capitalizing and amortizing costs to fulfill a contract

- Companies are required to capitalize the costs of fulfilling a contract if the following criteria are met:
  - The costs relate directly to a contract or to an anticipated contract that the entity can specifically identify (e.g., costs relating to services to be provided under renewal of an existing contract, costs of designing an asset to be transferred under a specific contract that has not yet been approved).
  - The costs generate or enhance resources of the entity that will be used in satisfying (or in continuing to satisfy) performance obligations in the future.
  - The costs are expected to be recovered.
- Applying the second criterion has been challenging for companies due to the judgment involved in supporting that the costs that relate to future performance.
- As noted in the Basis for Conclusions of ASU 2014-09, ASC 340-40 precludes companies from deferring costs merely to normalize profit margins throughout a contract by allocating revenue and costs evenly over the contract term.
- Companies should carefully evaluate pre-contract costs with consideration as to what guidance they are currently accounted under (e.g., ASC 340-10 or ASC 605-35).

Operational considerations

For capitalized costs to fulfill a contract, management will need to determine the appropriate amortization period based on when the related goods or services transfer to the customer. Additionally, management will need to determine how to amortize these costs consistent with the transfer of the goods and services to which the asset relates.

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Accounting implementation key challenges

Income taxes: temporary differences and tax method changes

- Measuring changes in temporary differences
  - The timing of revenue recognition for financial reporting may not align with the timing for tax purposes
  - Companies may have new temporary differences or may be required to re-measure an existing temporary difference if the adoption of ASC 606 creates a change in timing of revenue recognition for financial reporting
- Assessing requirements for tax method changes
  - Companies should assess current tax methods to understand if voluntarily changing to another tax method would be permissible and beneficial or whether required
  - Companies should carefully consider the requirements related to tax method changes in each tax jurisdiction

Operational considerations

Revised processes and data collection tools may be necessary to capture any new temporary differences for tax accounting purposes.

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Accounting implementation key challenges

Disclosures: Topic 11.M requirements

- SEC Staff Bulletin Topic 11.M (SAB 74) requires disclosure of potential effects of recently issued accounting standards to the extent those effects are known
- Starting with the first financial statements filed after release of the standard, entities should consider the following disclosures:
  - A brief description of the new standard, the date that adoption is required and the date that the registrant plans to adopt, if earlier
  - A discussion of the methods of adoption allowed by the standard and the method the registrant expects to use, if determined
  - A discussion of the effect the standard is expected to have on the financial statements or, if the effect is not known or reasonably estimable, a statement to that effect
  - Disclosure of other significant matters that the registrant believes might result from adopting the standard (e.g., planned or intended changes in business practices)
- Companies should not wait to consider the impact of disclosure requirements of the new standard.

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Accounting implementation key challenges

Disclosures: Topic 11.M requirements (cont'd..)

- Nonpublic companies can choose to provide all the disclosures required by public companies or the following:
  - Reduced disclosures required by nonpublic companies related to:
    - Disaggregation of revenue
    - Contract balances
    - Performance obligations
    - Significant judgments
  - Disclosures not required by nonpublic companies:
    - Assets recognized from costs to obtain or fulfill a contract
    - Use of practical expedients
- Companies may encounter challenges in obtaining the necessary data that are inputs into the new disclosure requirements and should consider:
  - How new disclosures will be auditable, specifically if they are manually created
  - How system output will drive the consolidation and accumulation of data for disclosures
  - Development of effective controls around the entire disclosure process
- Companies should consider how to incorporate the discussion of the new disclosures with existing investor relations communications.

Operational considerations

Management may experience challenges in obtaining the necessary data for disclosures requirements. For example, business units within the company may have inconsistent processes on tracking data related to contracts.

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Accounting implementation key challenges

Controls: processes, controls and system updates

- Change introduces different risks. For example:
  - The company does not properly identify and recognize unsigned, oral contracts or contracts implied by the client's customary business practices that meet the definition of a contract under the new standard
  - The company does not identify all material performance obligations
  - The company inappropriately adjust (or fails to adjust) estimates used in the accounting for revenue, including:
    - Transaction price
    - Variable consideration, including applying the constraint on this consideration
    - Return reserves
    - Standalone selling price of bundled goods and/or services
  - The company use a portfolio approach to mask the results of an individual contract or group of contracts with unfavorable results

Accounting implementation key challenges

Controls: processes, controls and system updates (cont'd..)

- Internal auditors will need to identify WCGWs for each of the five steps of the new model and understand the critical path through the revenue recognition model:
  - The initiation of an arrangement with a customer, including the identification of the contract
  - The identification of performance obligations
  - The estimation of the transaction price and any variable consideration
  - The determination of the standalone selling price and allocation of the transaction price to performance obligations
  - The determination of when a performance obligation is satisfied and the timing of the revenue recognition
  - Presentation and disclosure
- WCGWs trigger probing questions to management in order to assess control design
- Company should be considering control design at the entity level in their overall project plan to address the risk of material misstatement, whether due to fraud or error.

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Accounting implementation key challenges

Controls: processes, controls and system updates (cont'd..)

- For impacted revenue streams, companies will need to determine whether new processes, controls and systems are required or whether modifications to existing processes and controls are sufficient.
- For non-impacted revenue streams, companies need to evaluate whether updates to existing processes, controls and systems are necessary.
- When evaluating updates to process and control documentation companies should consider:
  - Risks
  - Policies
  - Control objectives
  - Standard operating procedures
  - Detailed control activities
  - Desk instructions

Operational considerations

Any changes to existing controls, new controls as a result of implementation and post-adoption controls will need to be auditable.

SEC staff comments

ASC 606, *Revenue from contracts with customers*

- SEC staff comments have focused on areas that require significant judgment or involve estimates
  - Comments have often been resolved by providing the staff with a better understanding of the judgments made by management or by agreeing to provide additional disclosure in future filings
- The SEC staff encourages registrants to refine and supplement future disclosures, especially those that relate to significant judgments and estimates
  - ASC 606 requires disclosure of judgments made (and changes in those judgments) that significantly affect the determination of the amount and timing of revenue from contracts with customers

SEC staff comments

ASC 606, *Revenue from contracts with customers* (cont'd..)

Nature of comment:	Comment request:
Identification of performance obligations	How a registrant determined whether each promise was a separate performance obligation
Satisfaction of performance obligations	How a registrant determined whether revenue is recognized over time or at a point in time, and for over-time recognition, why the selected measure of progress is appropriate
Disaggregated revenue disclosures	How the selected categories met the disaggregated revenue disclosure objectives
Significant payment terms	How the timing of satisfaction of performance obligations related to the typical timing of payment
Amortization of capitalized costs of obtaining a contract	What was the registrant's basis for the amortization period, including how contract renewals were considered

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Time's Up! How to Implement Lease Accounting under ASC 842

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Agenda

- Background of Standard and Identification of Leases
- Key Concepts under ASC 842
- Transition Model
- Considerations for Transition to ASC 842
- Operational Challenges
- Considerations for “Go-Forward” Accounting under ASC 842

Background of Standard and Identification of Leases

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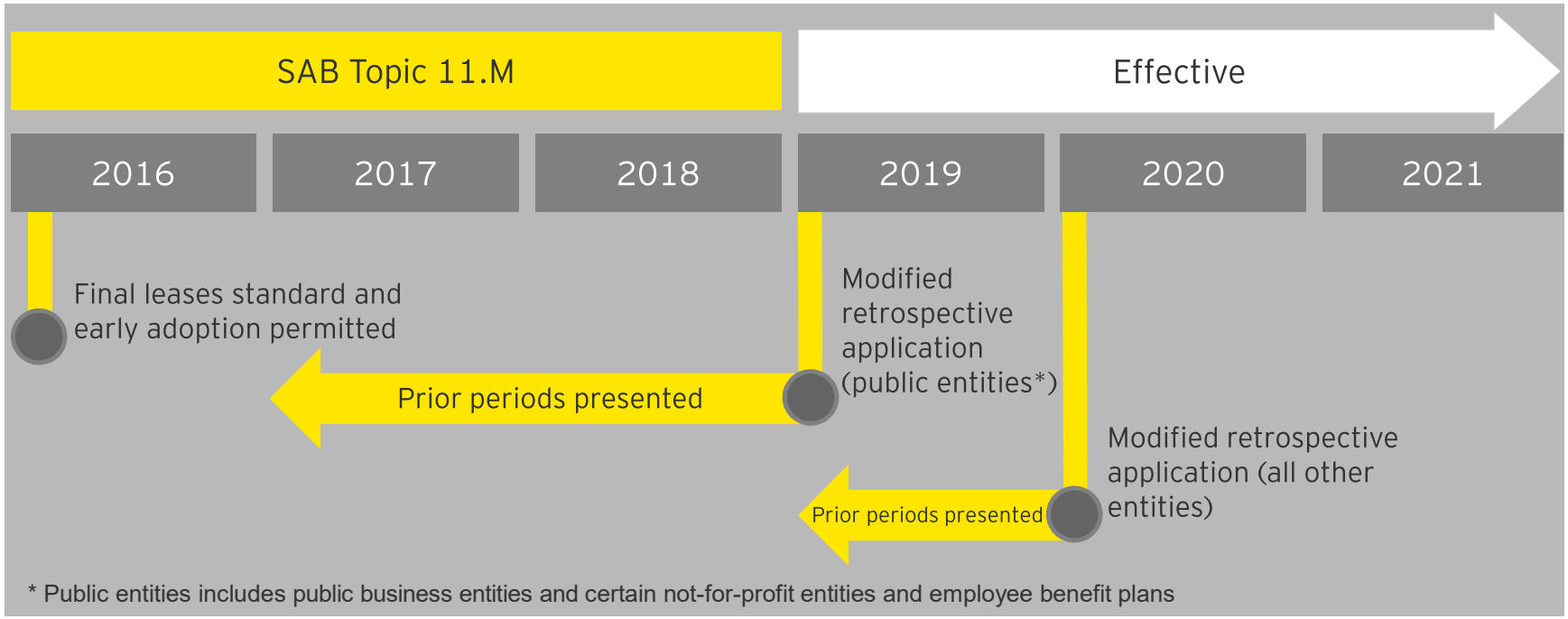
Effective date – ASC 842



- Full retrospective adoption is prohibited
- Only existing leveraged leases as of the effective date (US GAAP) are grandfathered
- Certain disclosures are required in accordance with ASC 250, *Accounting Changes and Error Corrections*

Identifying a lease

Definition of a lease

A contract, or part of a contract, that conveys the right to control the use of identified property, plant and equipment (an identified asset) for a period of time in exchange for consideration

- The assessment of whether a contract is or contains a lease will be straightforward in most arrangements
- Judgment will be required in applying the definition of a lease to certain arrangements
  - For example, the assessment may be complex when an arrangement contains a significant service component

Key Concepts under ASC 842

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Key concepts

Lease term and purchase options

Lease term

- Any noncancellable 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 FASB indicated that "reasonably certain" has the same meaning as "reasonably assured" in ASC 840, *Leases*
  - Reasonably certain is generally interpreted as a high threshold
- Purchase options are assessed in the same way as options to extend the lease term or terminate the lease

Key concepts
Lease payments

- Lease payments should be consistent with the lease term

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

* Include only if reasonably certain of exercise

** Include unless reasonably certain that the lessee will not exercise an option to terminate the lease

- Also include fees paid by the lessee to the owners of a special-purpose entity for structuring the transaction
- Variable lease payments that do not depend on an index or rate (e.g., performance- or usage-based payments) are excluded from lease payments
  - Recognize expense as incurred (lessees) or income as earned (lessors)

Key concepts
Discount rates

- Lessors use the rate implicit in the lease that causes the following:

The present value (PV) of lease payments made by the lessee for the right to use the underlying asset

+

The PV of the amount the lessor expects to derive from the underlying asset following the end of the lease term

=

FV of the underlying asset minus any related investment tax credit retained and expected to be realized by the lessor

+

Any deferred initial direct costs of the lessor

- Lessees use their incremental borrowing rate when the rate implicit in the lease cannot be readily determined
- Lessees that are not PBEs are permitted to make an accounting policy election (for all leases) to use a risk-free rate determined using a period comparable with the lease term

Key concepts
Initial direct costs (IDCs)

- Only incremental costs qualify as IDCs (consistent with ASC 606)
- Incremental costs are those that would not have been incurred if the lease had not been obtained (e.g., commissions, payments made to an existing tenant to incentivize that tenant to terminate its lease)

	Lease classification	Accounting for capitalized IDCs
Lessees	Finance lease	Include IDCs in the initial and subsequent measurement of the ROU asset
	Operating lease	
Lessors*	Sales-type lease with selling profit or loss	Expense IDCs at lease commencement
	Sales-type lease with no selling profit or loss	Include IDCs in the initial and subsequent measurement of the net investment in the lease
	Direct financing lease with selling profit or loss	
	Direct financing lease with no selling profit or loss	
	Operating lease	Recognize IDCs as expense over the lease term on the same basis as lease income

* For purposes of performing the sales-type lease classification test only, a lessor assumes that no initial direct costs will be deferred (i.e., initial direct costs are excluded from the calculation of the rate implicit in the lease) if, at the commencement date, the fair value of the underlying asset is different from its carrying amount.

Overview of the right of use model – ASC 842

Lessor: similar to current GAAP with some changes

- Certain concepts would be better aligned with the revenue recognition standard and would modify the accounting for sales-type and direct financing leases
- Leveraged lease accounting would be 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

Transition Model

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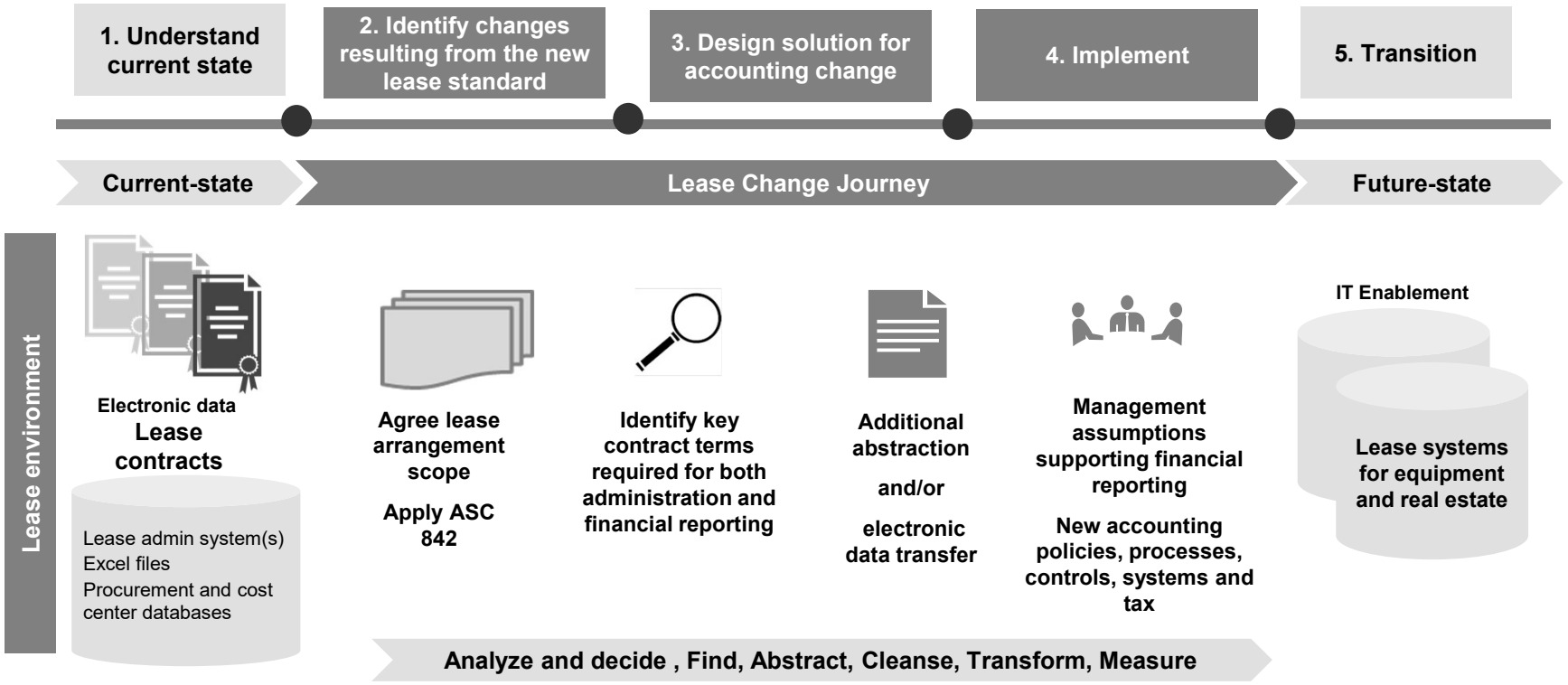
Transition Model



Transition Model

Lease arrangement identification and scoping	• Identifies the population of arrangements for evaluation under the new standard • Classifies the population into the different types of lease arrangements • Considers materiality of the type of leases in relation to the company's financials
Lease arrangement selection and review	• Selects lease arrangements for review that are representative of the types of lease arrangements identified • Develops preliminary view of the accounting implications, as well as the methodology for forming judgments and estimates required under the new standard
Assess current policies, controls, processes and systems	Formalizes understanding of the current state accounting policies, processes, controls and systems for lease administration and lease accounting Develops preliminary view of which processes and controls would be leveraged or revised and system requirements of the future state
Gap assessment	• Summarizes gaps in data, policies, processes, controls and systems that will need to be addressed as part of the design and implementation phases of the lease accounting change journey
Preliminary accounting policy selection	• Utilizes lease arrangements reviewed as part of the diagnostic to develop preliminary accounting policy selections to streamline evaluation of the remaining lease population

Considerations for Transition to ASC 842

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Practical Expedients Available
Transition

- Certain practical expedients are available for transition
- Lessees and lessors are permitted to make an election to apply a package of practical expedients that allow them not to reassess:

- Entities are also permitted to make an election for all existing leases to use hindsight when determining the lease term (i.e., evaluating a lessee's option to renew or terminate the lease or to purchase the underlying asset) and assessing impairment of ROU assets (lessees only)
  - Use of hindsight election may be elected separately or in conjunction with the package of practical expedients above
- Given consequences of ASC 842, effects of treating an arrangement as a service instead of a lease may be material when it may not have been in the past

How to Operationalize ASC 842

Key Considerations for Transition

- Data not previously required for operating leases under current guidance will need to be captured for transition.
  - Lease commencement date
  - Lease options
  - Lease term
  - Fixed and variable payments
  - Residual value guarantees
- Completeness of the lease population for transition
  - Embedded leases not currently identified
- Leading practices to capture lease data for transition include:
  - Performing lease surveys or interviews of different functional areas
  - Scoping the lease portfolio and performing manual review of data points

Operational Challenges

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Key Challenge

- Data Challenges: High volume of lease agreements across multiple decentralized locations, in different business and operating units
- IT systems: Need to store lease data and perform calculations. Consider modifying existing system or moving to new system. Given the long lead times of system initiatives, may need bridge system
- Timeline for adoption: It can be a challenge to anticipate the data gaps and overcome the data abstraction hurdle.

What makes transition to the new leases standard complex?

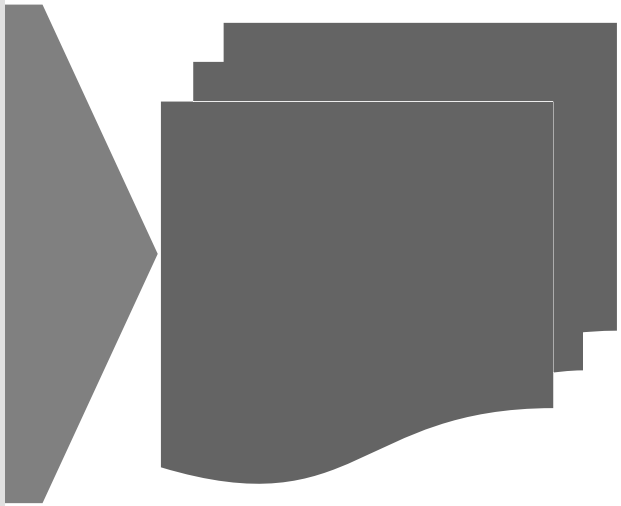
The new leases standard will continue to require significant judgments and estimates. However, many of these judgments and estimates may receive scrutiny because of the financial statement impact and additional disclosures.

Input from:

- Finance and accounting
- Treasury
- Corporate real estate
- Lease procurement
- Supply chain
- Performance Transformation
- Internal audit
- Legal
- Information technology
- Tax
- ERP

Judgments and estimates of the following:

- Is it a lease?
- Are there non-lease components in the contract?
- What is the lease term, considering renewal, termination and purchase options?
- Are there variable lease payments and residual value guarantees?
- What is the lease classification?
- What is the discount rate?
- Does the transaction qualify for sale-leaseback accounting?
- How do you evaluate lessee involvement in asset construction?



Is the necessary level of cross-functional support in place for the project?

Internal Controls and Business Process Environment

- Increased relevance of new leasing to the financial statements, entities may face additional scrutiny from auditors and regulators regarding the design and effectiveness of associated controls under Sarbanes-Oxley
- Examine internal controls related to their processes for capturing, calculating, and accounting for their leases
- Internal controls or processes are needed, entities may also need to issue organizational communications and establish change management and employee training programs

Considerations for “Go-Forward” Accounting under ASC 842

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Identifying a lease

Scope and scope exclusions – short-term leases

- Lessees can make an accounting policy election, by class of underlying asset to which the right of use relates, to use the short-term lease exception
  - Applies to leases with a lease term of 12 months or less that do not include an option to purchase the underlying asset that the lessee is reasonably certain to exercise
- Lessees do not recognize a ROU asset or lease liability for qualifying leases and recognize lease payments as expense on a straight-line basis
- Exception is not available for lessors
- Example: noncancellable lease term of nine months with a four-month renewal option (assume no purchase option)

A: Exercise of option is reasonably certain = not short-term lease

B: Exercise of option is <u>not</u> reasonably certain = short-term lease

Non-cancellable lease term
Optional renewal period

Identifying a lease
Lease/Non-lease components

- Many contracts contain a lease coupled with an agreement to purchase or sell other goods or services (non-lease components)
  - Non-lease components are identified and accounted for separately from the lease component in accordance with other US GAAP
- Some contracts contain items that do not relate to the transfer of goods or services by the lessor to the lessee (e.g., fees or other administrative costs that a lessor charges a lessee)
  - These items should not be considered separate lease or non-lease components
  - Lessees and lessors do not allocate consideration in the contract to these items
- As a practical expedient, lessees can make an accounting policy election (by class of underlying asset) to account for each separate lease component of a contract and its associated non-lease component(s) as a single lease component
- Lessees generally allocate consideration in the contract to the lease and non-lease components (unless the practical expedient is elected) on a relative standalone price basis
- Lessors generally apply ASC 606, *Revenue from Contracts with Customers*, to allocate consideration in the contract between the lease and non-lease component(s) of the contract on a relative standalone selling price basis

How to Operationalize ASC 842

Key Considerations for “Go Forward” Accounting

- Is a new leasing system needed based upon lease portfolio?
  - Increased amount of data needed for disclosures
  - Lease modifications
  - Lease amortization schedules for both finance and operating leases
- Will lease accounting be done at corporate or at the entity level?
- How will the Company ensure all leases are identified?
- What internal control considerations are needed to ensure data is accurate?

Questions?

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