MFM Annual Conference

Is Your Operating Lease An Asset or Liability? It’s Now Both

23 May 2016 - 1:30 pm–2:20 pm
Disclaimer

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Agenda

► Overview of the FASB’s new leases standard
► Lease accounting change journey
► Next steps – preparing for implementation/adoption
► Questions?
Overview of the FASB’s new leases standard
## Overview

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<tbody>
<tr>
<td>Exposure draft (ED)</td>
<td>Re-deliberations and 2nd ED</td>
<td>Re-deliberations on 2nd ED</td>
<td>Final standard</td>
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</tbody>
</table>

### Key changes affecting lessees
- Requires most leases to be recorded on the balance sheet, but expenses are recognized in a manner similar to today
- Eliminates real estate-specific provisions
- Provides new presentation and disclosure requirements
- Changes sale and leaseback criteria, and they apply to lessees and lessors

### Key changes affecting lessors
- Modifies classification criteria and accounting for sales-type and direct financing leases
- Eliminates leveraged leases prospectively

Q1 2016 - Final standard

2014–2015 - Re-deliberations on 2nd ED

2011–13 - Re-deliberations and 2nd ED

Q3 2010 - Exposure draft (ED)

Exposure draft (ED)
Apply transition provisions at beginning of earliest comparative period presented in year of adoption

For example, a calendar-year entity that adopts the new standard on 1 January 2019 (and presents three-year comparative financial statements) would apply the transition provisions on 1 January 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.

** The effective date of 1 January 2019 would also apply to not-for-profit entities that have issued, or are conduit bond obligors for, securities that are traded, listed or quoted on an exchange or an-over-the-counter market, and employee benefit plans that file or furnish financial statements with or to the SEC.
Scope and definition of a lease

The new standard applies to leases of all assets except:

- Leases of inventory, assets under construction, intangible assets and biological assets (including timber)
- Leases to explore for or use minerals, oil, natural gas and similar non-regenerative resources (including the intangible right to explore for those resources and the rights to use the land)

A contract is or contains a lease if it conveys the right to control the use of identified property, plant or equipment (an identified asset) for a period of time in exchange for consideration.
Scope and definition of a lease

Right to control the use of the identified asset throughout the period of use

Right to obtain substantially all of the economic benefits

And

Right to direct the use

Customer has the right to direct how and for what purpose the asset is used

Or

Relevant decisions about how and for what purpose the asset is used are predetermined and

- Customer has the right to operate the asset without the supplier having the right to change those operating instructions
  OR
- Customer designed the asset in a way that predetermines how and for what purpose the asset will be used
Many contracts contain leases (lease components) and agreements to purchase or sell other goods or services (non-lease components). Non-lease components are identified and accounted for separately under other applicable generally accepted accounting principles (GAAP).

Lessees allocate consideration in the contract to lease and non-lease components on a relative stand-alone price basis, unless a practical expedient is elected. Lessees can make a policy election (by class of underlying asset) to account for each lease component and its related non-lease component as a single lease component.

Lessors allocate consideration in the contract using the new revenue recognition standard (ASC 606).

Maintenance activities are considered non-lease components.
Lease term and lease payments

- Lease term includes any noncancelable periods
  - Reasonably certain is a high threshold for including optional periods (e.g., options to extend or terminate a lease)
  - Reasonably certain = reasonably assured

- Lease payments consistent with the lease term determination

- Fixed payments, including in-substance fixed payments
- Exercise price of a purchase option* 
- Payments for penalties for terminating the lease** 
- Variable lease payments that depend on an index or rate 
- Residual value guarantees – amounts probable of being owed (lessees only)

* Include only if reasonably certain of exercise
** Include unless reasonably certain not to be exercised

- Also includes fees paid by the lessee to the owners of a special-purpose entity for structuring the transaction
Lease classification

At lease commencement, a lessee and a lessor classify a lease using the following criteria:

► 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
► (New criterion) 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
Lease classification

► Lessees
  ► A lease that *does not meet any* of the criteria is an operating lease
  ► A lease that *meets any* of the criteria is a finance lease
  ► Short-term lease exemption
    ► Lease term of 12 months or less and no purchase option that the lessee is reasonably certain to exercise
    ► Accounting policy election, by class of underlying asset
    ► Does not recognize lease assets or liabilities

► 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 substantially all of the fair value of the underlying asset and (2) collectibility is probable
    ► Operating lease
Lessee accounting
Recognition and measurement

<table>
<thead>
<tr>
<th></th>
<th>Finance lease</th>
<th>Operating lease</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Initial recognition and measurement</strong></td>
<td>Initially measure the right of use (ROU) asset(^1) and lease liability at the present value of the lease payments not yet paid</td>
<td></td>
</tr>
<tr>
<td><strong>Subsequent measurement – lease liability</strong></td>
<td>Increase 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</td>
<td>Measure the lease liability at the present value of remaining lease payments using discount rate determined at lease commencement(^2)</td>
</tr>
<tr>
<td><strong>Subsequent measurement – ROU asset</strong></td>
<td>Amortize the ROU asset, generally on a straight-line basis, over shorter of lease term or useful life of ROU asset, and record any impairment of the ROU asset</td>
<td>Measure ROU asset at amount of lease liability and adjust for cumulative prepaid or accrued rents (i.e., uneven rent payments), any lease incentives received, lessee initial direct costs and any impairment of the ROU asset</td>
</tr>
<tr>
<td><strong>Income statement effect</strong></td>
<td>Generally “front-loaded” expense</td>
<td>Generally straight-line expense</td>
</tr>
</tbody>
</table>

\(^1\) Initial measurement of ROU asset also includes 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 has not occurred
Lessee accounting
Presentation

<table>
<thead>
<tr>
<th>ROU asset</th>
<th>Lease liability</th>
</tr>
</thead>
<tbody>
<tr>
<td>► Lease ROU assets can be presented separately or together with other assets</td>
<td></td>
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<tr>
<td>► If not presented separately, disclose the line item where they are presented and the amount of lease ROU assets</td>
<td></td>
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<tr>
<td>► Finance lease ROU assets are prohibited from being presented in the same line item as operating lease ROU assets</td>
<td></td>
</tr>
<tr>
<td>► Lease liabilities can be presented separately or together with other liabilities</td>
<td></td>
</tr>
<tr>
<td>► If not presented separately, disclose the line item where they are presented and the amount of lease liabilities</td>
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<td></td>
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</table>

► ROU asset and liability subject to same considerations as other nonfinancial assets and financial liabilities in classifying them as current and noncurrent in classified balance sheet.
Lessee accounting
Presentation

<table>
<thead>
<tr>
<th>Income statement</th>
<th>Statement of cash flows</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Finance lease:</strong></td>
<td><strong>Finance lease:</strong></td>
</tr>
<tr>
<td>▶ Lease-related interest expense and amortization presented in a manner consistent with how the entity presents interest expense and depreciation or amortization of similar assets</td>
<td>▶ Principal payments within financing activities</td>
</tr>
<tr>
<td><strong>Operating lease:</strong></td>
<td><strong>Interest payments in accordance with ASC 230, Statement of Cash Flows</strong></td>
</tr>
<tr>
<td>▶ Lease expense included in income from continuing operations</td>
<td><strong>Operating lease:</strong></td>
</tr>
<tr>
<td></td>
<td>▶ All payments within operating activities, except those payments made to bring an asset to the condition and location necessary for its intended use, which are investing activities</td>
</tr>
<tr>
<td><strong>Both lease types:</strong></td>
<td><strong>Both lease types:</strong></td>
</tr>
<tr>
<td>▶ Lease payments for short-term leases and variable lease payments (not included in the lease liability) within operating activities</td>
<td>▶ Supplemental noncash disclosure of new leases</td>
</tr>
</tbody>
</table>
Lessor accounting
Recognition and measurement

► Operating leases
  ► Continue to recognize the underlying asset
  ► Recognize lease payments as income over lease term, generally on a straight-line basis

► Sales-type leases
  ► Derecognize underlying asset and recognize a net investment in the lease and selling profit (loss) if collectibility is probable
  ► If collectibility is not probable, recognize lease payments received as a deposit liability (i.e., do not derecognize underlying asset as sale is deferred)

► Direct financing leases
  ► Derecognize underlying asset and recognize a net investment in the lease
  ► Selling profit is deferred and recognized over lease term
  ► Selling loss is recognized up front
New disclosures for lessees and lessors include:
- Significant assumptions and judgments made in accounting
- Maturity analyses, including a reconciliation of undiscounted cash flows to the lease liability for lessees (lease receivable for lessor of sales-type and direct financing leases), as of the reporting date

New disclosures for lessees include:
- Separate quantitative disclosure of lease expense, by type (e.g., financing lease, operating lease, short-term, variable)
- 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 during reporting period
Sale and leaseback transactions

► Seller-lessees and buyer-lesseors use the new revenue recognition standard when determining whether the transfer of an asset should be accounted for as a sale
► Existence of a leaseback, in isolation, does not preclude a sale
► Sale is precluded when either:
  ► Leaseback is classified as a finance lease (lessees) or a sales-type lease (lessors)
  ► Seller-lessee has a substantive repurchase option
► If sale is precluded:
  ► Seller-lessee records a financing liability equal to proceeds received
  ► Buyer-lesser records a finance receivable equal to amounts paid
► Lessee involvement in asset construction
  ► New guidance focuses on control of the asset being constructed before lease commencement versus a risk-based model
Effective date and transition

Standard is applied as of the beginning of the earliest comparative period presented in the financial statements.

Lessees and lessors are required to adopt the new standard using a modified retrospective transition approach.

Certain transition relief is available.

Certain disclosures are required in accordance with ASC 250, Accounting Changes and Error Corrections.

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Public business entities and certain other entities* | All other entities | Early adoption?
---|---|---
2019 and interim periods within that year | 2020 and interim periods in 2021 | Yes

* Public business entities, not-for-profit entities that have issued, or are conduit bond obligors for, securities that are traded, listed or quoted on an exchange or an over-the-counter market, and employee benefit plans that file or furnish financial statements with or to the SEC.
Effective date and transition
Lessees and lessors

► All entities may elect to apply *all* of the following practical expedients (elected as a package and applied to *all* leases) not to reassess:
  ► Whether contracts are or contain leases
  ► Lease classification
  ► Initial direct costs (i.e., whether those costs would have qualified for capitalization under the new leases standard)

► All entities can elect for all leases to (1) use hindsight in determining the lease term when considering lease options to extend or terminate the lease and to purchase the underlying asset and (2) assess impairment of ROU assets
  ► Election could be made separately or in conjunction with the package of practical expedients above
Lease accounting change journey
Lease accounting change journey

1. Understand current state of leasing activities (e.g., lease procurement, administration, and accounting and reporting)

2. Identify changes resulting from the new leases standard (e.g., data gaps, processes, controls, systems and tax)

3. Design solution for accounting change (e.g., new accounting policies, processes, controls and systems) to capture new lease data requirements and understand financial statement impact

4. Implement new accounting policies, processes, controls and systems, as well as changes to financial statements and disclosures

5. Transition to the new leases standard

Understand the new leases standard
What makes transition to the new leases standard complex?

The new leases standard would 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
- Business operations
- Legal
- Information technology
- Tax

**Determination of:**
- Lease-related assets and liabilities
- Subsequent measurement

**Judgments and estimates of:**
- 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?*
Other drivers of complexity

**Less complex**

- Domestic operations only
- Highly centralized
- One global ERP
- Strong organizational change management

**More complex**

- Global operations
- Decentralized
- Multiple, disparate ERP systems
- Organization struggles to implement change

**Organizational**

**Leasing-specific**

- Leasing is core to company’s operations
- Existing lease management software
- Lease accounting tied to lease administration system

- Leasing activity supplements company’s operations
- Leases tracked via spreadsheet program (if at all)
- Lease accounting often separated from the lease administration system
## IT environment challenges

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<tr>
<th>Systems architecture</th>
<th>Data</th>
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<tbody>
<tr>
<td></td>
<td>▶ Lease contracts may not be maintained in a central repository</td>
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<tr>
<td></td>
<td>▶ 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 and assumptions</td>
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<thead>
<tr>
<th></th>
<th>Applications</th>
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<tr>
<td></td>
<td>▶ Existing lease management systems may require review and modification because they lack computational ability to:</td>
</tr>
<tr>
<td></td>
<td>▶ Calculate the balance sheet and income statement adjustments that vary based on whether the lease is classified as a finance lease or operating lease</td>
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<tr>
<td></td>
<td>▶ Determine the impact of lease renewal, termination or purchase options, as well as reassessment requirements</td>
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<tr>
<td></td>
<td>▶ Manage differences between US GAAP and IFRS requirements</td>
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<tr>
<td></td>
<td>▶ General ledger and chart of accounts may require enhancement to accommodate new asset and liability classifications and reporting requirements</td>
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<thead>
<tr>
<th></th>
<th>Reports</th>
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<tbody>
<tr>
<td></td>
<td>▶ Parallel reporting may be necessary for comparative periods presented upon transition</td>
</tr>
<tr>
<td></td>
<td>▶ Financial reports may need to be enhanced to reflect presentation and disclosure requirements</td>
</tr>
<tr>
<td></td>
<td>▶ Management reports and key performance indicators may need to be modified to reflect new operating metrics</td>
</tr>
</tbody>
</table>
Next steps – preparing for implementation and adoption
# Lease accounting change – not just compliance

<table>
<thead>
<tr>
<th>Possible current state</th>
<th>Future state leading practice</th>
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<tbody>
<tr>
<td><strong>People</strong></td>
<td><strong>People</strong></td>
</tr>
<tr>
<td>► Lease contracts managed locally, depending on geography, type of leased asset and business segment</td>
<td>► Utilization of a center of excellence – coordinating with lease administration, operations, legal, HR and treasury for data management</td>
</tr>
<tr>
<td><strong>Process and data</strong></td>
<td><strong>Process and data</strong></td>
</tr>
<tr>
<td>► Information collected for lease administration purposes may not be sufficient for lease accounting</td>
<td>► Technical resources as part of capital budgeting to improve decision-making around lease procurement</td>
</tr>
<tr>
<td>► Summary of lease arrangements maintained for footnote disclosure purposes with limited visibility into overall volume of leases</td>
<td>► Comprehensive lease database with insight about overall lease portfolio to:</td>
</tr>
<tr>
<td>► Embedded lease arrangements not widely documented</td>
<td>► Aid asset/capital deployment decisions</td>
</tr>
<tr>
<td>► Lease-versus-buy decisions are informal (significant or material assets only)</td>
<td>► Comply with accounting and reporting</td>
</tr>
<tr>
<td><strong>Technology</strong></td>
<td><strong>Technology</strong></td>
</tr>
<tr>
<td>► Some companies may have lease management systems as part of their lease administration process for real estate</td>
<td>► Improve management of end-of-lease term options (i.e., whether to exit the lease, renew or buy the leased asset)</td>
</tr>
<tr>
<td>► Manual processes and spreadsheets to compile data for other leased asset types</td>
<td>► Long-term technology solution(s) that provides cross-functional support (e.g., lease procurement, lease administration, lease accounting and reporting, tax)</td>
</tr>
</tbody>
</table>
Financial statement and tax implications

► Financial metrics, key performance indicators and capital structure
  ► Return on assets, debt-to-equity ratios and liquidity
  ► Debt covenants; interest coverage ratios; and EBITDA/EBIT levels
  ► Recognition of foreign exchange remeasurement gains and losses related to lease liabilities that are denominated in a currency that is different from the company’s functional currency

► Tax
  ► 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 (i.e., the need for and measurement of a valuation allowance)
  ► 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
What information should be collected for lease accounting?

- 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 or rent credit
  - Variable payment – index
  - Variable payment – performance or 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
Lease diagnostic project
What you will do in your lease diagnostic?

| Lease arrangement identification and scoping | Identify the population of arrangements for evaluation under the new standard  
Classify the population into the different types of lease arrangements  
Consider 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 what 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 |

Current state understanding
## Lease diagnostic project

Opportunities from a diagnostic

<table>
<thead>
<tr>
<th>Current state understanding</th>
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<tbody>
<tr>
<td>Population of leases</td>
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<tr>
<td>+</td>
</tr>
<tr>
<td>Materiality consideration</td>
</tr>
<tr>
<td>+</td>
</tr>
<tr>
<td>Understanding of gaps in current data, policies, processes, controls and systems</td>
</tr>
</tbody>
</table>

**Future state vision**
- Methodology around judgments and estimates
- Preliminary accounting policy selection
- Process and system requirements

**Future state design that provides opportunities for:**
- Effective and efficient assessment of the remaining lease population
- Organizational improvements by leveraging upgraded systems, processes and controls
- Savings through improved lease procurement decisions and management of end-of-lease-term options
Questions?
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