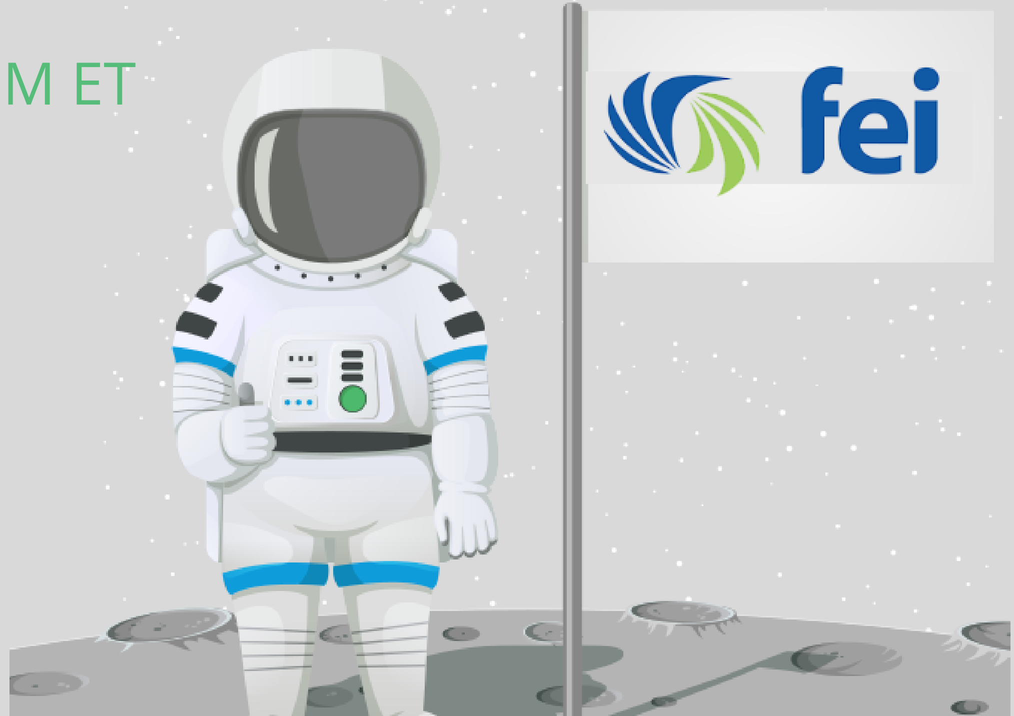
# FEI CCR Leases Working Group Debrief and Q&A

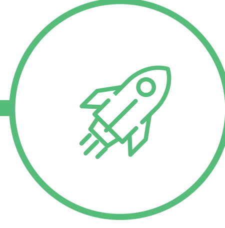
23 July 2019 | 1:00 – 2:00 PM ET



# Agenda

Background

Firm Update



General
Items

Q & A

# Background

# Speaker

## Shawn Husband

Senior Director, Lease Center of Expertise at Walmart

Shawn Husband is the Senior Director, Global Lease Center of Expertise at Walmart. In his role, Shawn oversees accounting for all leases executed, provides accounting guidance on leases and is leading the adoption of the new IFRS and US GAAP lease standards while guiding markets on internal controls and processes related to leases. During Walmart's transition to the new lease accounting standards, Shawn has taken on leadership roles to chair the FEI Leases Working Group as well as two lease accounting software user groups.

FEI Committee on Corporate Reporting

Leases Working Group

# LWG Background

Purpose: Discuss and resolve topics of interest to attending companies, including:

- Technical Accounting
- Process
- Systems
- Internal Controls

Typical Agenda:

- FASB Staff Update
- Firm Update
- General LWG Discussion

# Polling Question

## What stage are you at in your adoption of the new lease accounting standards?

a) Have not reached our date of adoption

b) Have adopted but have not issued our first quarter financial statements

c) We have adopted and issued our first quarter financial statements with the required new disclosures

# Firm Debrief

# Firm Debrief

- Firms meet periodically to align on accounting treatment under ASC 842
- Frequency has dropped from monthly to quarterly
- National office queries on topics broadly applicable are less prevalent but company specific queries are much higher than a year ago
- Two broad topics covered in meeting
  - Lease term when both lessor and lessee can cancel lease
  - Acquired leases in business combination as lessee

# Firm Debrief

## Lease term when both lessor and lessee can cancel lease

- Lease term under both standards is **noncancelable term plus lessee option to renew if reasonably certain** to be exercised. 842-10-55-23 speaks to maximum possible term if both parties have right to terminate the lease without permission from the other party with no more than an insignificant penalty.
- Insignificant penalty under US GAAP and IFRS aligned that this is a **broader economic view** and not limited to a contractual payment; insignificant is material to (in context of) the lease; not the company or F/S as a whole.
- The following scenarios illustrate how this is applied for a five year lease with options at end of year 2 as follows:
  - BOTH have termination right without a 'penalty' (or only insignificant penalty) at end of Year 2. Lease term cannot extend beyond Year 2; it is not enforceable past that point in time.
  - Lessor has termination right with no penalty; Lessee has termination right but will incur MTI penalty (as defined). Lessee termination right is "ignored", so only Lessor has termination right, which is also ignored, so even though Lessor has option to terminate w/n penalty at end of Year 2, lease term is 5 years.
  - Lessee has termination right with no penalty; Lessor has termination right but will incur MTI penalty (as defined). Lessor termination right is "ignored", so only Lessee has termination right. Lessee termination right is evaluated same way as any other such right when lessor does not also have one ("reasonably certain to continue the lease" evaluation), so if no penalty for lessee, lease term likely 2 years
  - For example, if lessee has a piece of equipment in remote location and is responsible for uninstalling and transportation costs, theoretically and legally you could terminate but to swap another good piece of equipment would incur significant transportation and installation costs that would meet the definition of a penalty, so if more than insignificant in the context of the lease arrangement, the parties would conclude the lessee does not have the right to terminate the lease with no more than an insignificant penalty.

# Firm Debrief

## Acquired leases in business combination as lessee

- ASC 842 and ASC 805 amended guidance have conflict on this topic. 805-20 has guidance to measure as new lease from acquisition date with fresh perspective on lease term and purchase options. ASC 842 does not permit reassessment of lease classification.
- This can result in acquiring an operating lease that has a purchase option reasonably certain
- If add in lease payments and purchase option into ROU asset, you would expense the full cost within the lease term.
- Two acceptable approaches to address this issue:
  - Option 1 – Take effectively lease payments and purchase option amount and assume lease term is useful life instead of shorter lease term and when get to end of lease term will have larger asset balance that gets reclassified to PPE. Effectively get same per year lease cost/depreciation expense each year of the asset's remaining useful life.
  - Option 2 – treat as finance lease; look at what finance lease balance would be at end of lease term. Take difference between (1) total lease payments (rental payments plus purchase option price) and (2) balance of ROU asset if classified as a finance lease as "lease cost" straight-line over lease term and take remainder to depreciation after the purchase option is exercised and asset reclassified to PP&E.
- What about acquired leases only accounted for under IFRS 16 with no classification test? Assess what ASC 842 classification should be. It is unclear whether that would be ASC 842 classification as of commencement or as of the acquisition date. Companies did raise concerns on information that would be available as of commencement in higher volume, older portfolios (e.g. fair value, discount rates, other determinations on lease term, etc.)

## Polling Question

What has been your biggest challenge associated with adopting the new lease accounting standards?

a) Creating an inventory of all lease data

b) Developing and implementing new policies, processes and controls

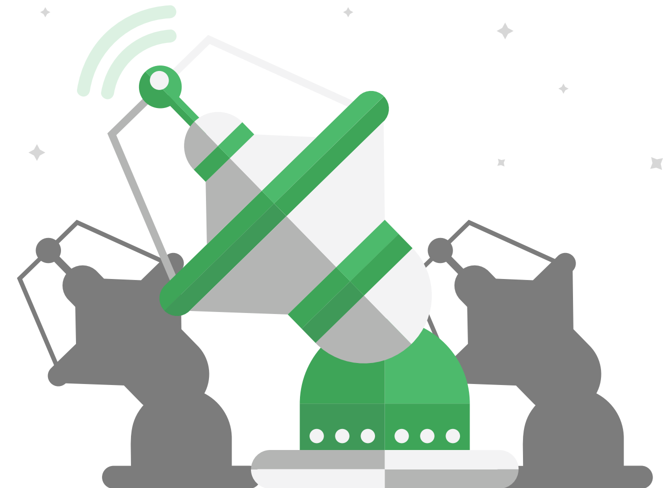
c) Managing differences between the new standards for US GAAP vs IFRS

d) Ongoing contract management and lease accounting

# General Discussion Topics

# General Discussion Topics

1. Lease classification – discussion of criterion 842-10-25-2(d) (e.g. 90% test)
2. Treatment of assumed lease renewals in a store closure scenario
3. Spending on capital projects subsequent to lease commencement
4. Non-cash disclosure on assets obtained in exchange for lease obligations
5. Accumulated depreciation entries
6. Depreciation after modification post impairment



# Lease classification – discussion of criterion 842-10-25-2(d)

Impact of the accounting changes on classification of a lease under ASC 842

### Drivers of change

1. Disconnect between IBR and fair value
2. Non components in lease payments (taxes and insurance)
3. Combining lease and nonlease components

## Are companies motivated to get a more "pure" classification? Will companies use a bright line 90% test?

- Classification not a concern because of a few factors, including:
  - No difference in opening entry – whether the lease is a finance lease or operating lease on day 1 the same amount is recorded.
  - Business partners can find a finance lease more compelling as the interest expense is below operating income/controllable P&L used for performance measurement and/or incentives
  - Subsidiaries with IFRS find it compelling when the classification is the same as it minimizes differences between the two standards
- There was a general lack of concern or response from most attendees to the concern and only one company expressed that they aren't using the bright line test, but allow for exceptions with approval (although they haven't approved any yet)
- There was a concern raised about whether how companies make these elections or measure will drive a lack of comparability among companies, but it was pointed out that with different elections to combine lease and nonlease components, weighting of gross versus net leases, mix of lease size and type, etc., comparability is likely compromised by many factors.

# Treatment of assumed lease renewals in a store closure

Timing of charges versus liability adjustment

**Timing Challenge**

1. Impairment charge
2. Accelerated depreciation from decision to closure
3. Reassessment of liability/ termination

## How do we consider the timing of reassessment and trigger for impairment?

- Including the assumed renewal period that is within the control of the lessee in an impairment/accelerated depreciation would result in the lessee taking a higher asset to expense prior to closure and then taking a gain when the lease is negotiated to terminate.
- Proposal is to reassess the lease to remove the renewal period in their control prior to measuring for impairment, or if no impairment, accelerating depreciation.
- Firms reaction to this topic was to consider factors in impairment test that might avoid taking the impairment at the time of the decision. (ASC 360 would require changing the remaining life of the asset to accelerate depreciation through the closure date.)
- For reassessing the lease to remove the assumed renewal period, firm comments included reference to BC 193 which outlines intent does not come into play in lease analysis. Because of comment letter process, reassessment was isolated to events in your (lessee) control – not decisions.
- Consensus is that reassessment criteria reached once taken steps to execute on commitment to abandon and not sublease. Commitment by company internally to close store not trigger lease term reassessment. However, steps being taken that incur economic cost (entering into a new, replacement lease or incurring other shut-down costs) or commit the lessee legally/contractually (enforceable notice to the lessor) may satisfy the business decision reassessment trigger.

# Spending on capital projects subsequent to lease commencement

Lessor versus lessee asset

**Options considered**

1. Effective modification
2. Variable lease expense
3. Remeasurement only
4. Treat as PP&E

## How do we consider spend on lessor asset post commencement?

- ASC 842 considers spend on the underlying asset to be lease payments (see 55-4). If remodel a building during the lease term, would need to evaluate the spend to determine if spend is on lessor asset or lessee asset and if significant, treat the spend on the lessor asset as lease payments
- If the improvements are made later in the lease life, this likely triggers the reassessment criteria, or modification if spend on lessor asset - can remeasure the lease, so this question is focused on an earlier remodel (say year 8 of a 30-year lease).
- Firm representatives expressed that in many remodels much of the changes would be LHI of lessee. In that case, the lessee simply capitalizes the costs and depreciates over the short of the life of the asset or the lease term.
- Firm guides do have different criteria noted on whether asset or lessor or lessee. PWC expressed that their view is that if lessor requires the spend, then costs would be on lessor asset and be treated as lease payments, but otherwise would be lessee asset.
- One firm view is if lessor owns it and contract changes then would be a mod.
- Two other firms believe that treating the spend on lessor event as a modification even without a formal contract change is consistent with the definition of contract in 606, which can be verbal with lessor and not require an amendment. One firm noted that if putting in new HVAC and lessee concludes it is a lessor asset, there has to be at least tacit approval to put something in that impacts lessor asset beyond lease term and changes contractual payments (spend on lessor asset is a lease payment) so meets definition of modification.

# Non-cash disclosure on assets obtained in exchange for lease obligations

**Basis Questions:**

1. New leases
2. Modifications
3. Gross versus net
4. Asset or liability?

## What do you include in the disclosure?

- Consensus was that most companies are including both new leases and adjustments (mods, reassessments and remeasurements) and presenting the net activity (offsetting increases and decreases)
- One company noted that they are only including new leases in the disclosure and adjustments weren't material. If they became material, would include a second disclosure.
- Question on whether companies are using the asset or the liability to drive the disclosure. It was pointed out that since this is the asset exchanged for obligation, in most cases this should be the same amount. For example, you may include the prepaid in the measurement of the ROU asset, but if the initial entry was to debit the ROU asset for $5,000 and credit the liability for $5,000 and then you credit prepaid for $500 and debit ROU asset for $500, it is the $5,000 you want to disclose, not the $5,500 for the asset. That prepaid or incentive or IDC, etc. is not the asset exchanged for the lease liability. Partial and full terminations prior to the end of the lease were noted as the case where these amounts could differ, but likely not material for most companies.
- We have noted different systems have different ways to measure, but consistency in approach is key

# General Discussion – Other Topics

## Accumulated deprecation entries

- Consensus is that for entities that are tracking accumulated depreciation on ROU assets separately, keep the existing balance when doing a modification or reassessment and reclass the existing balance if the classification of the lease changes. Reverse the balance in a US GAAP impairment, but not in an IFRS impairment. If a lease renews, need to consider system treatment if want to have accumulated deprecation zero out before renewal (e.g. growing A/D if renew a building for 50 years)

## Depreciation after modification post impairment

- If an ROU asset is impaired, but in a subsequent period the lease is remeasured which results in an increase in the ROU asset and an impairment analysis at that time wouldn't require impairment, do you continue to (1) straight-line depreciate the combined asset, (2) continue to straight-line the original layer, but treat the new layer with operating lease calculation (this option not possible in systems), or (3) return to operating lease calculations for combined asset value?
- Consensus is that once an asset impaired SL model makes sense. If have a subsequent remeasured event and add, some portion of asset is still impaired so continue SL depreciation.
- For IFRS and impairment reversals it was proposed that a remeasurement that adds to the ROU asset would provide an additional amount for future impairment maximum reversals, but a remeasurement that lowers the ROU asset amount would reduce the amount of future maximum impairment reversals (subject to continued depreciation). This hasn't been considered by IASB, but Walmart sending fact pattern to the IASB.

# Polling Question

## What are you using to support accounting under the new standards?

a) Excel or in-house solution

b) Use existing software

c) Select a new lease accounting solution

d) Consultants/accounting firm

e) Haven't decided

# Polling Question

## Follow up: Is this your long-term solution?

a) Yes

b) No

c) Not sure

# Q&A