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2017 Deloitte Renewable Energy Seminar

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November 13-15, 2017

Deloitte Center *for* Energy Solutions

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Accounting for ASC 842, leases

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Contents

Overview of ASC 842

Effective date and transition

Effective date

- Public business entities — effective for calendar periods beginning on January 1, 2019 and interim periods therein
- All other entities — effective for calendar periods beginning on January 1, 2020, and interim periods thereafter
- Early adoption is permitted

Transition

- Lessees and lessors are required to use a modified retrospective transition method for all existing leases
- Would apply the new model for the earliest year presented in the financial statements
- Application of approach linked to current lease classification and new lease classification
- An entity can use hindsight when evaluating lease term

Transition relief package:

Lessees and lessors are not required to reassess the following upon transition:

- ✓ Whether any expired or existing contracts are leases or contain leases
- ✓ The lease classification for any expired or existing leases
- ✓ Initial direct costs for any existing leases

Definition of a lease
Effective date and transition

A lease is a contract, or part of a contract, that **conveys the right to control the use** of **identified property, plant, or equipment** for a period of time in exchange for consideration.

Depend on the use of an identified asset

- Asset may be **explicitly** *or* **implicitly** specified
- Physically distinct part of larger asset may be an identified asset
- Substitution rights must be considered if substantive
  [based on practical ability + economic benefit to substitute]
- Warranty or upgrade considerations *do not* impact the determination of whether an identified asset exists

Convey the right to control the use

- Right to obtain substantially all of the economic benefits from asset use (*directly or indirectly*)
- Right to direct the use of the asset throughout the period of use, which is based on:
  - The customer having the ability to direct the "how and for what purpose" the asset is used throughout the period of use
  - The relevant decisions about how and for what purpose the asset is used are predetermined and either (1) the customer operates the asset or (2) the customer designed the asset that predetermines how it will be used over the period of use.

Lessee accounting model

What does the lessee model look like?

Most* leases are recorded on the balance sheet using a right-of-use asset approach

Initial measurement	Subsequent measurement
• **Lease obligation** — PV of lease payments not yet paid • **ROU asset** — lease obligation + initial direct costs – lease incentives + prepaid lease payments	• **Lease obligation** — amortized using the effective interest method • **ROU asset** — depends upon lease classification • Expense recognition pattern: – Finance lease — front-loaded – Operating lease — generally straight-line

* **Short-term leases**: A lessee can elect, by asset class, not to record on its balance sheet a lease with a lease term of 12 months or less and that does not include a purchase option that the lessee is reasonably certain to exercise

Lessor accounting model

What does the lessor model look like?

- Most changes to the model result from alignment with ASC 606
- Classification depends on an assessment of control of the underlying asset
  Title transfer no longer required for real estate

Sales-type

- Lessee gains control of the underlying asset
- Underlying asset is derecognized
- Net investment in a lease is recognized
- Selling profit or loss recognized at lease commencement
- Initial direct costs recognized at lease commencement unless no selling profit or loss

Direct financing

- Lessee does not obtain control of the asset, but the lessor relinquishes control
- Underlying asset is derecognized
- Net investment in a lease is recognized
- Profit deferred and amortized into income over the lease term
- Initial direct costs deferred and amortized into income over the lease term

Operating

- Lessor retains control of the underlying asset
- Underlying asset remains on the lessor's balance sheet
- Income recognized on a straight-line basis unless another systematic basis is more appropriate
- Initial direct costs deferred and expensed over the lease term in a manner consistent with income

Presentation requirements

Lessee model

	Balance sheet	Income statement	Cash flow statement
Financing lease	ROU asset Lease liability	Amortization expense Interest expense	Principal (Financing) Interest (Operating)
Operating lease	ROU asset Lease liability	Lease expense (single line on straight-line basis)	Lease payments (Operating)

Lessor model

Presentation consistent with current lessor model:

- **Balance sheet** — presentation depends on lease classification
- **Income statement** — profit or loss recognized in a manner consistent with business model
- **Cash flow statement** — recognized as cash inflows from operating activities

Disclosure requirements

Disclosure objective — Enable financial statement users to assess the amount, timing, and uncertainty of cash flows arising from leases

Lessee disclosures	Lessor disclosures
• Nature of its leases • Information about leases that have not yet commenced • Related-party lease transactions • Accounting policy election regarding short-term leases • Finance and operating lease costs • Short-term and variable lease costs • Sublease income • Gain or loss from sale-and-leaseback • Maturity analysis for lease obligations • Weighted-average remaining lease term • Weighted-average discount rate	• Nature of its leases • Significant assumptions and judgments used • Related-party leases transactions • Tabular disclosure of lease-related income • Components of the net investment in a lease • Information on the management of risk associated with residual asset • Maturity analysis of operating lease payments and lease receivable • Information required by ASC 360

Key impacts of ASC 842

Key impacts for lessees

Leases classified as **operating leases** or **finance leases**

Most leases will be on balance sheet (similar to today's capital leases)

- **Right-of-use (ROU) asset**
- **Lease liability**

Operating leases

- Generally straight-line income statement expense
- Lease liability relieved following interest method; amortization of ROU asset is balancing amount

Finance lease accounting similar to existing capital leases. Front loading expenses; straight-line ROU asset amortization

ROU assets subject to impairment assessment

Key impacts for lessors

Explicit guidance on **nonlease components** of contracts (lessees may elect to not separate such components; lessors may not)

Long-term renewable arrangements with significant variable payments may result in the recognition of a day 1 loss

Different **presentation** requirements

Additional qualitative and **quantitative disclosures** regarding the amount, timing, and uncertainty of cash flows

Hot topics impacting the industry

Industry "hot topics"

Lessor commencement loss resulting from significant variable payments

Sales-type or direct financing lease with significant variable payments may result in lessor recognizing a loss at commencement

- Net investment in the lease does not include variable lease payments
- If net investment < carrying amount of leased asset, a loss is recognized

A book loss, but not an economic loss

Examples of arrangements that may be affected:

- Renewable energy (e.g., wind or solar) power purchases
- Oil and gas gathering and processing
- Retail real estate
- Medical devices with consumables

FASB considered, but ultimately rejected, possible solutions:

1. Including variable lease payments in measurement of net investment subject to a constraint (by reference to ASC 606)

2. Negative discount rate

FASB clarified to use a zero discount rate

Industry "hot topics"

Design considerations for renewable PPAs

Defining the issue…

- *How and for what purpose* decisions often predetermined
- Asset owner typically responsible for O&M
- Need to evaluate whether the customer designed the asset in a way that predetermines the most relevant decisions about how and for what purpose

Questions to be addressed…

- What types of involvement by the purchasing party will be deemed to constitute design of the asset?
  - Specifying the site?
  - Specifying the technology?
  - Specifying the configuration and layout?
  - Combination of factors?
  - Consideration of purchaser RFP scenarios?

Industry "hot topics"

Easements and right of ways

Proposed ASU Issued September 25, 2017

Background on the issue…

- Many questions were raised on the applicability of ASC 842 for easements
- FASB and its staff solicited feedback through industry group meetings and roundtable discussions
- Outreach proved that land easements can have varying forms and terms, and there is significant diversity in practice in the application of existing U.S. GAAP to these arrangements

What the proposed ASU does…

- Provides a stand-alone transition practical expedient related to legacy land easements
  - ✓ Allows a company to carryforward legacy non-lease accounting
  - ✓ Practical expedient not available for easements "previously assessed" under ASC 840
  - ✓ Any change in accounting policy before ASC 842 effective date will require preferability
- Amends an example within ASC 350 (Intangibles) to clarify that easements must first be evaluated under ASC 842

Effective date same as ASC 842

What the proposed ASU doesn't do…

- Does not scope out easements going forward – New or modified easements should first be evaluated under ASC 842
- Does not provide any incremental guidance on how to evaluate easements under ASC 842
  - ✓ Unit of account – surface vs sub-surface; discrete pieces of a larger surface
  - ✓ Economic benefits – Need to think about viable alternative uses for the land?
- Does not provide guidance on accounting for easements that are determined not to contain leases under ASC 842

Industry "hot topics"
Capitalization policies

Companies can use a reasonable capitalization threshold when applying the recognition guidance under ASC 842

Do not default to existing PP&E capitalization thresholds

- Existing threshold does not incorporate:
  - Effect of additional asset base
  - Liability recognition
- Reasonable approaches include:
  - Capitalization threshold set as the lesser of:
    - Capitalization threshold for PP&E, inclusive of ROU assets
    - Recognition threshold for liabilities, inclusive of lease liabilities
  - Recognize all lease liabilities, but, subject to threshold, expense amounts associated with the ROU asset
- Choose one approach, apply consistently, and consider disclosures

Basis for Conclusions Paragraph BC122: "Entities will likely be able to adopt reasonable capitalization thresholds below which lease assets and lease liabilities are not recognized…"

Industry "hot topics"
Capitalization policies (cont'd)

Illustrative example

Key facts

- Lease of a machine
- Lease term: 5 years
- ROU asset = $3,260
- Lease liability = $3,260

Lessee considers the following to identify a threshold for its leases

- Gross balances of its ROU assets ($3,260) and lease liabilities ($3,260)
- Disclosures that would be omitted if certain leases were not recognized
- Internal controls needed to apply and monitor the threshold
- Materiality considerations in SAB Topic 1.M

"Lesser of" approach

- Threshold for PP&E, including ROU assets = $3,500
- Threshold for liabilities, including lease liabilities = $3,000
- ROU asset and lease liability ($3,260) > recognition threshold for liabilities ($3,000, the lower of the two)
- **Lessee should recognize the ROU asset and lease liability**

"Recognize all liabilities" approach

- Threshold for PP&E, including ROU assets = $3,500
- ROU asset ($3,260) < capitalization threshold for PP&E ($3,500)
- **Lessee should expense amounts associated with the ROU asset**
- **Lessee should recognize the lease liability**

Industry “hot topics”

Pipeline laterals/Drop lines and meters

LAST MILE SCENARIOS

- Pipeline laterals **do** meet the definition of an identified asset (ASC 842-10-15-16)
- Lease determination should be based on an ASC 842-10-15-4 control assessment
- Two types of laterals specifically discussed by the Board

Type 1 *(Not a Lease)*	**Type 2** *(Meet the Definition of a Lease)*
• Connected to an integrated pipeline system and share supply sources with the main line and other customers • Not capable of operating on their own • Pipeline owner retains certain rights that provide it the ability to control the use of the lateral	• Can be separately shut off from the main line • Customer is fully capable of utilizing the lateral using their own dedicated assets • Customer has the right to substantially all the pipeline lateral’s capacity and has ability to obtain substantially all of the economic benefits from use of the lateral

How does this decision impact electric drop lines? Meters?

Industry “hot topics”

Definition of economic benefits

Consideration:
Can/should **tax attributes** be considered economic benefits?

Background on the Issue:

Under ASC 842, a party must take substantially all of the economic benefits of the asset over the contract term to have a lease. 842-10-15-17 specifies that benefits include primary outputs (e.g. electricity) and by-products (e.g. RECs)

Deloitte View:
Tax attributes (including PTCs) are *not* economic benefits

- PTCs are based on a combination of ownership and asset performance
- PTCs cannot be sold to third parties
- Therefore, economic benefit is due to **ownership** of the asset, not the **use** of the asset

Industry "hot topics"

Common payments in power purchase agreements ("PPA")

Guaranteed minimum production

- Do guaranteed minimum production levels in renewable PPAs represent an in-substance fixed lease payment?

- General consensus that they are not
  - Seller makes payment to buyer for shortfalls and therefore reduces the buyer's net exposure
  - Buyer's gross payments for electricity generated not impacted by guaranteed production level
  - Seller can't guarantee physical production
  - Guarantee protects buyer financially from market purchases necessitated by production shortfalls

Capacity payments

- Are capacity payments variable if subject to claw back based on availability(excluded from the measurement of lease obligation)?

- Deloitte view is no (i.e., are fixed):
  - Assume asset will be ready for intended use
  - Plant owner largely controls availability
  - Refund potential should be viewed as negative contingent/variable rent

Industry "hot topics"

Other considerations

LIGHTING AS A SERVICE

Diversity in practice in the ASC 840 accounting

Is control conveyed to the customer?

Are all relevant decisions predetermined?

POLE ATTACHMENTS

Generally **is not** a lease under today's ASC 840 requirements

What is the unit of account?

Are there substantive substitution rights?

What is the impact of shared use?

ROOFTOP SOLAR

Considerations under the new lease accounting model

Does customer control asset?

Was customer involved in design?

Could there be an embedded lease of roof space?

How will the shared use of the roof impact the conclusions?

Implementation overview & approach

What to look for?

As you prepare to implement the new lease accounting standard, the following indicators may suggest a higher level of work effort:

- High lease volume
- Complex lease contracts
- Disparate systems/spreadsheets
- Decentralized lease transaction processing
- International locations
- Prior challenges in lease accounting
- Potential M&A activity

How well do you know your lease portfolio?

Capitalizing and disclosing a lease under ASC 842 will require a number of data points, including some of the following:

- Timing of renewal notice
- Changes in the asset’s form or size
- Incentives to claim renewal options
- In-substance fixed payments
- Options reasonably certain to exercise
- Rent compared to market rate
- Incremental borrowing rate
- Impairment charges

- Lease’s commencement date
- Initial direct costs
- Allocated consideration to each separate lease component and non-lease component
- Fair market value of the lease
- Useful life of the asset
- Purchase option(s)
- Landlord allowances and timing

Driving a Cross-Functional Change

Impacts of the New Lease Standard will span the organization, requiring functional collaboration

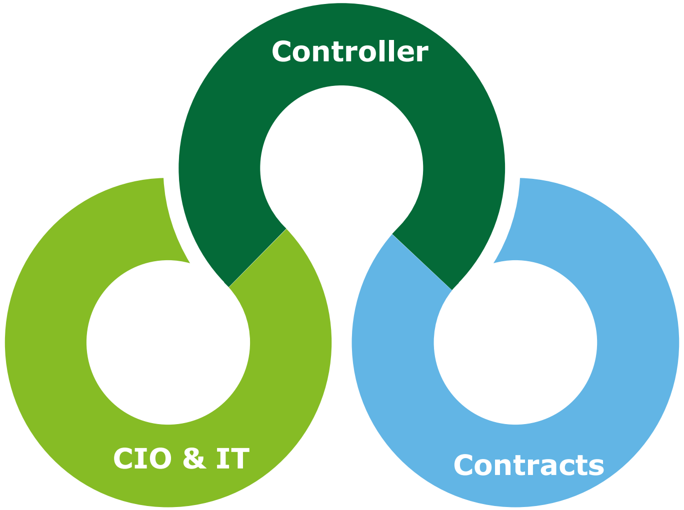
Controllership – Accounting, Finance & Legal

ASC 842 will have a material impact on the balance sheets of companies with large lease portfolios. Estimates show the S&P 500 will see $2 trillion in currently off-balance sheet lease obligations added. These changes could affect:

- Debt to Equity Ratios
- Debt Covenants
- Rating Agency Reporting
- Regulatory Capital

CIO & IT

Companies may need to reconsider current lease administration and management systems and processes. System upgrades and implementations can be onerous with significant setup, data migration and controls design.



Contract Execution

New standard may impact buy vs lease decisions as well as general leasing negotiations or decisions. Lease data gaps could require significant re-abstraction work that could dramatically add to compliance timelines depending on portfolio size and complexity.

The lifecycle of a typical lease implementation effort

	Stage 1	Stage 2	Stage 3	Stage 4	Stage 5
	Assessment and planning	**Development of transition process and platform**	**Lease abstraction/ data migration**	**Implement long-term solution**	**Ongoing maintenance**
Key activities	• Understand the accounting requirements • Lease landscape/ portfolio assessment • Data quality/gap assessment • Accounting, tax, and process assessment • Roadmap/work plan development	• Design and develop accounting and reporting solution for transition • Pro-forma scenario analysis • Training • Internal controls design and development	• Lease abstraction • Data migration from existing systems • Data sanitization and normalization	• Deploy long-term solution—ranging from handover of transitional solution through implementation of integrated workplace management solution • Revisions to internal controls design and development as necessary	• Shared services/Center of Excellence development • Technical accounting assistance

Potential Operational Challenges

The system change efforts are often given primary consideration; however, you should also consider the vital component of data maintenance

During this period, operations do not cease. New leases are entered into and existing leases are modified and terminated.

Potential operational challenges (cont'd)

The following challenges should be considered in the transition period:

Application of Judgment and Estimation

Apply judgment and make estimates under a number of the new lease requirements:

- Judgment is often required in the assessment of a lease's term, which would affect whether the lease qualifies for the short-term exemption and therefore for off-balance-sheet treatment
- Since almost all leases will be recognized on the balance sheet, an entity's judgment in distinguishing between leases and services becomes more critical under the new guidance
- Lease classification without bright line classification tests
- Determine whether the customer has the right or not to direct the use of the identified asset

Data Management

- Third-party data may be needed to ensure a high level of operational quality and efficiency
- Numerous lease agreements at multiple decentralized locations, lease data in spreadsheets or physical documents. Consequently, collecting and abstracting may be time-consuming and resource-intensive
- Entities may need to gather information that may not be contained in lease agreements (e.g.: the fair value of an asset, the asset's estimated useful life, incremental borrowing rate, etc.)
- Distinct data between the new requirements and to accomplish with the transition period data

Technology

- New system technology (interim and permanent solution) will be required to implement the standard due to the increased number of data attributes needed to perform the required accounting calculations and disclosures.

Potential operational challenges (cont’d)

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

Debt Covenants / Financial Metrics

- Careful examination of the effects of increased leverage and potential debt covenant violations will be required
- This may depend in part on how various debt agreements define and limit indebtedness as well as on whether the debt agreements use “frozen Generally Accepted Accounting Principals (GAAP)‟ covenants.
- The ASC requires entities to present operating lease liabilities outside of traditional debt, which may provide relief to some entities. Nevertheless, it will be critical for all entities to determine the ASC’s potential effects on debt covenants.

Regulatory

- Companies need to understand how the new lease standard will impact rate base and cost recovery.

Potential operational challenges (cont'd)

Change management

- Process changes
- Lease vs. buy considerations
- Contract language and negotiations with customers/vendors may also change
- Training and education

Tax

- Potential tax implications are situational requiring involvement of entities' tax department.

Internal control considerations

Lease accounting is naturally an area of significant complexity both from an operational and accounting perspective

The new lease standard introduces additional considerations around a company's internal control structure:

- Increased focus around internal controls by regulators and other stakeholders
- New balances and disclosures subject to internal controls
- Complexity of requirements of the New Lease Accounting Standard

Other internal control considerations

- Data and access management
  - Workflow management with approvals/reviews
  - Audit trails
  - Segregation of duties
- Technology/processing
  - Version control
  - Re-assessment for lease modifications
- Service organization
  - Internal controls performed by service organization
  - Consideration of new Committee of Sponsoring Organizations (COSO) integrated framework

Control considerations during the lease cycle

Transition

- Control Environment
  - Building in the appropriate structure and accountability to handle the changes including Steering Committee and Project Management Office (PMO)
  - Approach to areas where judgment is required
- Risk assessment
  - Change creates risk
  - Consider risks related to financial reporting change
  - Monitoring controls implemented
  - System change controls in place
  - Appropriately trained personnel
  - Coordination between various key stakeholders (e.g. technical accounting, tax, real estate, IT)
- Completeness of initial opening balance sheet
  - Challenge of getting the lease data into an electronic repository
  - Potential decentralization of the data gathering efforts
  - Existing lease data used for operational purposes and may not be subject to internal controls
  - Reconciliation to current ASC 840 footnote disclosures
- Controls during comparative reporting period

Lease Origination

- Controls around classification – operating vs. financing leases
- Embedded leases
- Short Term lease scope exception
- Portfolio approach

Lease Modification

- Leases commonly are modified, renewed, extended, cancelled
  - Challenge around frequency
  - Completeness and timely identification of modifications as they occur
  - Process for tracking and review / approvals for changes
- Version controls

Controls Around Outsourced Service Providers

- Many organizations use Outsourced Service Providers to assist in the management of parts or all of their lease portfolio
  - Consider internal controls performed by the Service Provider
  - Appropriate monitoring mechanisms over reporting from the Service Provider

Information Technology Controls

- Controls over source data and interfaces / data transfers
- General IT controls including access controls, Segregation of Duties
- Change management controls related to lease calculations
- Appropriate user acceptance testing
- Reviews / approvals and workflow management
  - Especially important when decentralization exists
- Audit trails

Reporting and Disclosures

- Significantly increased disclosure requirements – increased visibility to judgments used and nature of the lease portfolio
- Many of the disclosure requirements are data Intensive
  - Weighted average calculations, variable lease payments, etc.
  - Consider source and controls over the data

Select Lease Administration Solutions

The following is a sample of available Integrated Workplace Management System (IWMS), ERP, and other solutions a company can implement for Lease Compliance:

Lease Administration Solutions Continuum

Solution Type	**Point Solutions**	**Bundled Solutions**	**Integrated Solutions**	**Enterprise Solutions**
Overview	• Mix of process and technology adaptation • Single level of functionality focused on accounting compliance • High integration requirements	• Mix of process and technology adaptation • "Bundles" of functionality (Additional Modules) • High integration requirements	• Mix of process and technology adaptations • Full-suite of functionality across RE lifecycle • Moderate integration requirements	• Processes designed to fit technology • Integration with non-Commercial Real Estate systems (i.e., Corporate Finance, Supply Chain and Human resources) • Low integration requirements
Representative Solutions	• Deloitte Lease Controller* • HarborFlex • ManagePath • ProLease • Virtual Lease • LeaseAccelerator	• Archibus • PowerPlan • VisualLease/CoStar • FM:Systems • Accruent • Lucernex	• IBM TRIRIGA • Trimble Manhattan • Planon • Deloitte Lease Point*	• Oracle (Skire) • SAP (Nakisa)

* Deloitte solutions are shown for illustrative purposes. Independence considerations preclude the Company's use of these solutions.

Q&A