Lease Presentation & Disclosure Requirements: Lessee

The public entity[1] adoption deadline for the new guidance in Accounting Standards Update (ASU) 2016-02, *Leases* (Topic 842), is drawing closer. This is the first major overhaul of lease guidance since 1973 and implementation and documentation will be significant undertakings for entities in all industries. The effect on each company will depend on the nature and volume of its leases. The guidance requires lessees to recognize substantially all leases on their balance sheets as lease liabilities with a corresponding right-of-use (ROU) asset; however, this is not a simple gross-up exercise. Do not underestimate the time, effort and cost to implement these new rules. Feedback from early adopters indicates there is more to do than expected and has prompted the Financial Accounting Standards Board (FASB) to consider additional relief. FASB already issued an ASU related to land easements and recently finalized new transition expedients and a set of technical corrections to clarify certain aspects of the new model. Another exposure draft is expected shortly to address treatment of costs paid by lessees.

This paper focuses on a lessee's presentation and disclosure requirements. There are new qualitative and quantitative disclosures that should be considered upfront in the planning process. Entities can then develop a plan to fill any information gaps and implement new processes, policies, controls and systems to capture pertinent lease data and comply with these requirements.

FASB eliminated a few current disclosures:

- The total of minimum rentals to be received in the future on noncancelable subleases as of the date of the financial statements for both operating and capital leases
- The gross amount of assets recorded under capital leases by major classes according to nature or function for each statement of financial position presented. Accounting Standards Codification (ASC) 840 permitted the lessee to combine that information with comparable information for owned assets
- For sale-leaseback transactions to which the seller-lessee applied the deposit or financing method, the future minimum lease payments and minimum sublease rentals in the aggregate at the date of the financial statements and for each of the five succeeding fiscal years

Effective Dates
Leases ASC 842

Public Entities[1]
Annual and interim reporting periods beginning after December 15, 2018

All Others
Annual reporting periods beginning after December 15, 2019

SAB 74 Disclosures

The U.S. Securities and Exchange Commission's (SEC) Staff Accounting Bulletin (SAB) No. 74, *Disclosure Of The Impact That Recently Issued Accounting Standards Will Have On The Financial Statements Of The Registrant When Adopted In A Future Period*, imposes financial statement disclosure requirements in advance of a company's adoption of a new accounting standard. In several speeches, SEC officials have made it clear they are looking for increasing levels of detail from SAB 74 disclosures as the effective date approaches. These speeches cover all the major upcoming standards—revenue recognition, leases and credit impairment.

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[1] A public entity is defined as any one of these:
- A public business entity
- A not-for-profit entity that has issued—or is a conduit bond obligor for—securities traded, listed or quoted on an exchange or over-the-counter market
- An employee benefit plan that files or furnishes financial statements to the SEC

In multiple public speeches, senior SEC officials noted they are looking for disclosures beyond the plain language of SAB 74. Statements that the new standard's effect is immaterial should reflect consideration of the new standard's full scope, which covers recognition, measurement, presentation and disclosure. The SEC staff expects to see the following in the upcoming SAB 74 disclosures:

- A comparison of current accounting policies to the expected new accounting policies (see Appendix A – Tenet Healthcare)
- The status of implementation. The status of the process should be disclosed, including significant implementation matters not yet addressed or if the process is lagging (see Appendix A – Pioneer, Valero)
- Consideration of the effect of new footnote disclosure requirements in addition to the effect on the balance sheet and income statement
- Disclosure of the quantitative effect of new accounting standards if it can be reasonably estimated (see Appendix A – Target)
- Disclosure that the expected financial statement effect of new accounting standards cannot be reasonably estimated (see Appendix A – Pioneer)
- Qualitative disclosures. When the expected financial statement effect is not yet known by a registrant, a qualitative description of the new accounting standard's effect on the registrant's accounting policies should be disclosed (see Appendix A – Pioneer)

The SEC recognizes that SAB 74 disclosures are preliminary and subsequent changes in disclosed estimates will not be assumed to reflect a control deficiency relating to prior disclosures. A company's disclosures should evolve over time and be consistent with information provided to its audit committee and investors. As management completes portions of its implementation plan and develops an assessment of the anticipated effect, effective internal controls should be designed and implemented to timely identify disclosure content and ensure that appropriately informative disclosure is made. The SEC announced it will pay close attention to both the accounting policy footnote addressing the effect of adoption of the new generally accepted accounting principles (GAAP) and a company's quarterly disclosures of any material changes to internal controls over financial reporting, given the magnitude of the implementation process.

SEC officials emphasized that audit committees should be discussing the outside auditor's views about management's implementation efforts. Wesley Bricker, SEC chief accountant, pointedly observed in his American Institute of CPAs keynote address: "Particularly for companies where implementation is lagging, preparers, their audit committees and auditors should discuss the reasons why [implementation is lagging] and provide informative disclosures to investors about the status so that investors can assess the implications of the information. Successful implementation requires companies to allocate sufficient resources and develop or engage appropriate financial reporting competencies."

SAB 74 requirements only apply to public companies but can provide valuable insights to private companies on the size, scope and challenges in implementing this standard.

Presentation

The new lease standard has specific financial statement presentation requirements for leasing activity. Although a lessee is required to present assets and liabilities for substantially all leases in a similar manner, presentation of expenses and cash flows will differ based on how a lease is classified.

Balance Sheet

ASC 842 requires each type of lease—operating or finance—to be reported separately in the balance sheet. The related ROU assets must be presented separately from other assets, as well as from each other. Lease liabilities follow the same separation requirements. If not presented separately, an entity would disclose in the notes what line items on the balance sheet include finance lease ROU assets and what line items include operating lease ROU assets.

Lessees use owned and leased assets for the same purpose and derive similar economic benefit from their use. Therefore, a lessee would present lease assets on the balance sheet either together with owned property, plant and equipment or as their own line item(s) if that were relevant to understanding the lessee's financial position.

Lease assets and liabilities would be broken out on the balance sheet as current or noncurrent using the same requirements as other nonfinancial assets and financial liabilities, based on the timing of payments.

Income Statement

Presentation of lease expense on the income statement depends on the lease classification.

Finance Lease

Separate presentation of interest expense on the lease liability and amortization of the ROU asset is not required for a finance lease because it is economically similar to a financed asset acquisition. The portion of lease expense related to interest on the lease liability should be presented with other interest expense. The portion of lease expense related to amortization of the ROU asset should be presented with depreciation expense.

Operating Lease

The lease expense of an operating lease must be presented as a single operating expense in income from continuing operations.

Cash Flow Statement

Classification of lease payments on the cash flow statement depends on the lease classification.

Finance Lease

The principal portion should be classified as financing activities and related interest expense is classified similarly as interest paid.

Operating Lease

Lease payments—including variable payments—are classified within operating activities, except for expenditures to make the asset ready for use, *e.g.*, moving and related setup costs, which would be classified as investing activities. If the lessee has elected an accounting policy to not recognize ROU assets and lease liabilities for some or all of its short-term leases, those lease payments also would be classified as operating activities.

Disclosures

The leases standard includes a disclosure objective intended to provide users of financial statements with information adequate to assess the amount, timing and uncertainty of cash flows arising from leases. Both quantitative and qualitative disclosure requirements will increase for lessors and lessees. The disclosures apply regardless of lease classification—ASC 840 included some of these disclosures for capital leases, not operating leases. These new disclosures, bolded below, may require new processes and internal controls. These disclosures are subject to audit and, for public entities, will be in scope for management's report on internal controls.

Lessees must consider the level of detail necessary to satisfy the disclosure objective and how much emphasis to place on each of the various requirements. Aggregation should be at a level so useful information is not obscured by including a large amount of insignificant detail or by aggregating items that have different characteristics. For companies with extensive significant leasing activities, more comprehensive disclosures will be expected.

See Appendix B for Microsoft's reports before and after the adoption of ASC 842.

While ASC 842 requires only certain lessor disclosures to be made in all interim financial statements, Regulation S-X requires SEC registrants to provide both the applicable lessor and lessee annual and interim disclosures in each interim period included in the entity's quarterly reports on Form 10-Q in the year of adoption of a new accounting standard.

Lessee

A lessee shall disclose information about all of the following:

Qualitative Disclosures

- Nature of leases, as well as any subleases, including:
  - A general description of leases
  - The basis and terms and conditions on which variable lease payments are determined
  - The existence and terms and conditions of options to extend or terminate the lease. A lessee should provide narrative disclosure about the options that are recognized as part of its ROU assets and lease liabilities and those that are not
  - The existence and terms and conditions of residual value guarantees provided by the lessee. The restrictions or covenants imposed by leases, *e.g.*, those relating to dividends or incurring additional financial obligations
  - **Information about leases that have not yet commenced but create significant rights and obligations for the lessee, including the nature of any involvement with the construction or design of the underlying asset**
- **Significant judgments, including:**
  - **The determination of whether a contract contains a lease**
  - **The allocation of the consideration in a contract between lease and nonlease components**
  - **The determination of the discount rate for the lease**
- Lease transactions between related parties
- **Accounting policy election for short-term leases exemption.** If the short-term lease expense for the period does not reasonably reflect the lessee's short-term lease commitments, a lessee shall disclose that fact and the amount of its short-term lease commitments
- **Accounting policy election of the practical expedient on not separating lease components from nonlease components.** Also, which class or classes of underlying assets the practical expedient was applied to

Quantitative Disclosures

- The amounts recognized in the financial statements relating to leases. For each period presented in the financial statements, a lessee shall disclose the following amounts relating to a lessee's total lease cost, which includes both amounts recognized in profit or loss during the period and any amounts capitalized as part of the cost of another asset, and the cash flows arising from lease transactions:
  - Finance lease cost, segregated between the ROU amortization and interest on the lease liabilities
  - Operating lease cost
  - Short-term lease cost, excluding expenses relating to leases with a lease term of one month or less
  - Variable lease cost
  - Sublease income, disclosed on a gross basis, separate from the finance or operating lease expense

- Net gain or loss recognized from sale and leaseback transactions
- Amounts segregated between those for finance and operating leases for the following items:
  - **Cash paid for amounts included in the measurement of lease liabilities, segregated between operating and financing cash flows**
  - **Supplemental noncash information on lease liabilities arising from obtaining ROU assets**
  - **Weighted-average remaining lease term**
  - **Weighted-average discount rate**

- Maturity analysis of breaking out finance and operating lease liabilities separately, showing the undiscounted cash flows on an annual basis for a minimum of each of the first five years and a total of the amounts for the remaining years. A lessee shall disclose a reconciliation of the undiscounted cash flows to the finance and operating lease liabilities recognized in the statement of financial position

BKD has prepared a library of **BKD Thoughtware®** on lease issues. Visit our Hot Topics page to learn more. If you have questions about the new rules, contact your BKD advisor.

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Appendix A – SAB 74 Disclosures

Tenet Healthcare Corporation 2017 10-K

In February 2016, the FASB issued ASU 2016-02, "Leases (Topic 842)" ("ASU 2016-02"), which affects any entity that enters into a lease (as that term is defined in ASU 2016-02), with some specified scope exceptions. The main difference between the guidance in ASU 2016-02 and current GAAP is the recognition of lease assets and lease liabilities by lessees for those leases classified as operating leases under current GAAP. Recognition of these assets and liabilities will have a material impact to our consolidated balance sheets upon adoption. Under ASU 2016-02, lessees and lessors are required to recognize and measure leases at the beginning of the earliest period presented using a modified retrospective approach, which includes a number of optional practical expedients. We are currently evaluating the potential impact of this guidance, which will be effective for us beginning in 2019, including performing an assessment of the quantity of and contractual provisions in various leasing arrangements to guide our implementation plan related to processes, systems and internal controls and the conclusion on the use of the optional practical expedients.

Pioneer Natural Resources Company 2017 10-K

In February 2016, FASB issued ASU 2016-02, "Leases (Topic 842)." ASU 2016-02 requires the recognition of lease assets and lease liabilities by lessees for those leases currently classified as operating leases and makes certain changes to the accounting for lease expenses. … The Company anticipates that the adoption of ASU 2016-02 for its leasing arrangements will likely (i) increase the Company's recorded assets and liabilities, (ii) increase depreciation, depletion and amortization expense, (iii) increase interest expense and (iv) decrease lease/rental expense. The Company is currently evaluating each of its lease arrangements and has not determined the aggregate amount of change expected for each category. In January 2018, the FASB issued ASU 2018-01, which permits an entity to elect an optional transition practical expedient to not evaluate land easements that exist or expire before the Company's adoption of Topic 842 and that were not previously accounted for as leases under Topic 840. The Company intends to elect this transition provision.

Valero Energy Corporation 2017 10-K

We will adopt this new standard on January 1, 2019, and we expect to use the modified retrospective method of adoption. We are enhancing our contracting and lease evaluation systems and related processes, and we are developing a new lease accounting system to capture our leases and support the required disclosures. During 2018, we will continue to monitor the adoption process to ensure compliance with accounting and disclosure requirements. We also continue the integration of our lease accounting system with our general ledger, and we will make modifications to the related procurement and payment processes. We anticipate this standard will have a material impact on our financial position by increasing our assets and liabilities by equal amounts through the recognition of right-of-use assets and lease liabilities for our operating leases. However, we do not expect adoption to have a material impact on our results of operations or liquidity. We expect our accounting for capital leases to remain substantially unchanged.

Target 2018 10-K (Fiscal Year Ending February 3, 2018)

We plan to adopt the standard as of February 4, 2018, the beginning of fiscal 2018. We will elect the package of practical expedients permitted under the transition guidance within the new standard, which among other things, allows us to carryforward the historical lease classification. We will also elect the practical expedient related to land easements, allowing us to carry forward our current accounting treatment for land easements on existing agreements. In addition, we are electing the hindsight practical expedient to determine the reasonably certain lease term for existing leases. Our election of the hindsight practical expedient will result in the shortening of lease terms for certain existing leases and the useful lives of corresponding leasehold improvements. We will make an accounting policy election to keep leases with an initial term of 12 months or less off of the balance sheet.

We will recognize those lease payments in the Consolidated Statements of Operations on a straight-line basis over the lease term.

We estimate adoption of the standard will result in recognition of additional net lease assets and lease liabilities of approximately $1.3 billion and $1.4 billion, respectively, as of February 4, 2018. The difference between these amounts will be recorded as an adjustment to retained earnings. We do not believe the standard will materially affect our consolidated net earnings.

We do not believe the new standard will have a notable impact on our liquidity. The standard will have no impact on our debt-covenant compliance under our current agreements.

Appendix B – Microsoft

2Q 2017 ASC 840

NOTE 15 — COMMITMENTS AND CONTINGENCIES

Capital Lease Commitments

We have capital leases for datacenters and corporate offices. As of December 31, 2016 and June 30, 2016, assets recorded under capital leases were $1.6 billion and $865 million, respectively, and accumulated depreciation associated with capital leases was $95 million and $57 million, respectively. For the three and six months ended December 31, 2016, property and equipment acquired under capital leases was $498 million and $765 million, respectively. We did not acquire any property and equipment under capital leases during the three or six months ended December 31, 2015. As of December 31, 2016 and June 30, 2016, capital lease obligations included in other current liabilities were $56 million and $25 million, respectively, and capital lease obligations included in other long-term liabilities were $1.5 billion and $761 million, respectively.

Future minimum lease payments under non-cancellable capital leases as of December 31, 2016 are as follows:

(In millions)		
Year Ending June 30,		
2017 (excluding the six months ended December 31, 2016)	$	62
2018		126
2019		129
2020		133
2021		136
Thereafter		1,529
Total [(a)]	$	2,115

(a) As of December 31, 2016, capital leases included imputed interest of $581 million.

As of December 31, 2016, we had additional purchase obligations for capital leases executed but not yet recorded of $4.2 billion.

2Q 2018 ASC 842

NOTE 15 — LEASES

We have operating and finance leases for datacenters, corporate offices, research and development facilities, retail stores, and certain equipment. Our leases have remaining lease terms of 1 year to 20 years, some of which include options to extend the leases for up to 5 years, and some of which include options to terminate the leases within 1 year.

The components of lease expense were as follows:

(In millions)	**Three Months Ended December 31,**		**Six Months Ended December 31,**	
	2017	**2016**	**2017**	**2016**
Operating lease cost	**$ 399**	$ 434	**$ 787**	$ 694
Finance lease cost:				
Amortization of right-of-use assets	**$ 57**	$ 23	**$ 105**	$ 38
Interest on lease liabilities	**44**	15	**74**	27
Total finance lease cost	**$ 101**	$ 38	**$ 179**	$ 65

Supplemental cash flow information related to leases was as follows:

(In millions)	**Three Months Ended December 31,**		**Six Months Ended December 31,**	
	2017	**2016**	**2017**	**2016**
Cash paid for amounts included in the measurement of lease liabilities:				
Operating cash flows from operating leases	**$ 375**	$ 314	**$ 744**	$ 581
Operating cash flows from finance leases	**45**	15	**75**	27
Financing cash flows from finance leases	**31**	9	**56**	15
Right-of-use assets obtained in exchange for lease obligations:				
Operating leases	**308**	119	**699**	174
Finance leases	**650**	498	**1,378**	765

Supplemental balance sheet information related to leases was as follows:

(In millions, except lease term and discount rate)

	December 31, 2017	June 30, 2017
Operating Leases		
Operating lease right-of-use assets	**$ 6,749**	$ 6,555
Other current liabilities	**$ 1,343**	$ 1,423
Operating lease liabilities	**5,640**	5,372
Total operating lease liabilities	**$ 6,983**	$ 6,795
Finance Leases		
Property and equipment, gross	**$ 4,062**	$ 2,658
Accumulated depreciation	**(266)**	(161)
Property and equipment, net	**$ 3,796**	$ 2,497
Other current liabilities	**$ 156**	$ 113
Other long-term liabilities	**3,746**	2,425
Total finance lease liabilities	**$ 3,902**	$ 2,538
Weighted Average Remaining Lease Term		
Operating leases	**7 years**	7 years
Finance leases	**14 years**	13 years
Weighted Average Discount Rate		
Operating leases	**2.5%**	2.5%
Finance leases	**5.0%**	4.7%

Maturities of lease liabilities were as follows:

(In millions)

Year Ending June 30,	**Operating Leases**	**Finance Leases**
2018 (excluding the six months ended December 31, 2017)	$ 750	$ 167
2019	1,413	340
2020	1,287	347
2021	1,025	353
2022	839	360
Thereafter	2,634	3,857
Total lease payments	7,948	5,424
Less imputed interest	(965)	(1,522)
Total	$ 6,983	$ 3,902

As of December 31, 2017, we have additional operating and finance leases, primarily for datacenters, that have not yet commenced of $237 million and $1.6 billion, respectively. These operating and finance leases will commence between fiscal year 2018 and fiscal year 2019 with lease terms of 1 year to 20 years.