

LEASE ACCOUNTING – A CRITICAL AUDIT MATTER?

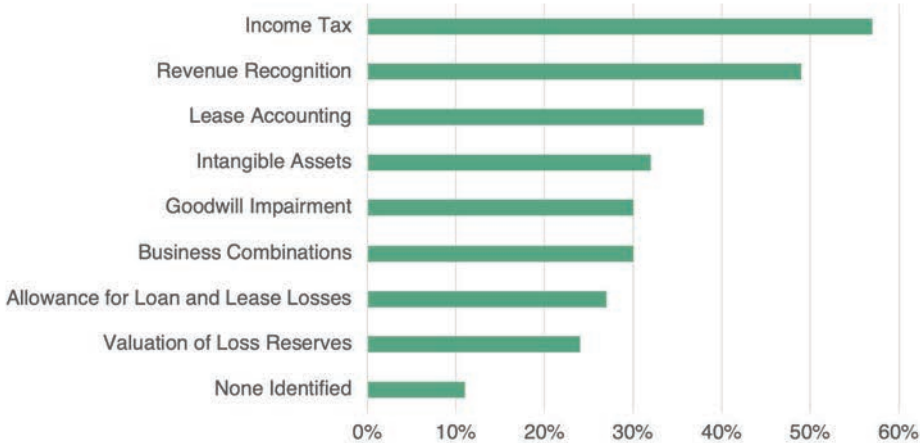
MATERIALITY AND JUDGMENTS IN ASC 842

October 2019

Leasing and CAMs, when mixed, could form an “especially” strong bond with auditors

Accounting organizations have felt an especially close relationship with their auditors over the past few years as they have bonded over adopting and implementing new GAAP standards such as ASC 842, Leases, and ASC 606, Revenue from Contracts with Customers. For most US-based public business entities, 2019 will be the first year that their annual audit will include disclosures and reporting under the new lease accounting standards (ASC 842). The bonding continues as many external auditors toil over whether leasing matters may rise to the level of Critical Audit Matters (CAMs) – a new rule under the Public Company Accounting Oversight Board (PCAOB) that began taking effect in June 2019. Many public entities underestimated the complexity of the standard or the need for the right specialized software. To highlight the complexity, LeaseAccelerator prepared a “Checklist for Common Areas of Judgment, Estimates, and Assumptions for Lessees in the Application of ASC 842” containing 72 judgment areas a lessee may encounter in a Leasing process (see Exhibit A). Preliminary surveys found lease accounting to be one of the most common CAM topics identified during dry runs by large accelerated filers.

What Critical Audit Matter (CAM) Topics Were Identified During the Dry Run?



Source: Intelligize – Critical Audit Matters: Public company adaptation to enhanced auditor reporting (September 2019)

<https://www.intelligize.com/new-intelligize-report-digs-into-cam-preparations/>

Not all companies will feel the dual rule implementation efforts in 2019 since CAM reporting is being phased in; large accelerated filers are Phase 1, and all other “in scope” companies are in Phase 2, starting with their first fiscal year-ending after Dec. 15, 2020.

So, what is a CAM?

According to paragraph 11 of PCAOB standard AS 3101, “A critical audit matter is any matter arising from the audit of the financial statements that was communicated or required to be communicated to the audit committee and that: (1) [Criteria 1] relates to accounts or disclosures that are material to the financial statements and (2) [Criteria 2] involved especially challenging, subjective, or complex auditor judgment.”

A CAM is neither good nor bad. They are the auditor’s communications, not management’s communications. CAM communications provide investors meaningful audit-specific information, clarity, and transparency into an auditor’s main considerations of why a matter led to it being considered a CAM, while complementing other information used by shareholders to inform capital allocation or voting decisions.

The PCAOB did not provide a list of areas or matters that are CAMs, but rather gave a list of factors for the auditor to consider, alone or in combination, when determining whether a matter involved is an “especially challenging, subjective, or complex auditor judgment” (see Exhibit B: paragraph 12 of AS 3101: The Auditor’s Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion (AS 3101)). CAM’s are principles-based and dependent upon the facts and circumstances of each audit.

The PCAOB has provided staff guidance publications to help support the implementation of the new CAMs requirements, which can be found here through this link “PCAOB’s CAM guidance”. (<https://pcaobus.org/News/Releases/Pages/PCAOB-staff-provides-guidance-advance-CAM-effective-dates.aspx>) One such publication, “Implementation of Critical Audit Matters: A Deeper Dive on the Determination of CAMs” (A Deeper Dive) provides several staff frequently asked questions. The Q&A addresses the relationship of CAMs to Critical Accounting Estimates and Assumptions (per SEC interpretation) and to factors relevant to identifying “significant risks” (per PCAOB AS 2110, Identifying and Assessing Risks of Material Misstatement). “New accounting standards” are mentioned in two separate Q&A sections.

Could a Leasing Matter be a CAM?

As with any accounting related process involving judgment, we give the proverbial “it depends” response and emphasize that CAM judgments are the responsibility of the auditor. As cited above, the new lease accounting standards are one of the most common CAMs identified in recent dry runs, but CAM assessments will be specific to the circumstances of each audit, facts and circumstances based. What might be a CAM in one audit may not be a CAM in another audit. First, as it relates to Criteria 1 for CAM considerations, we estimate that a significant number of Large Accelerated filers may have significant or material Lease related accounts. Then, we provide factors to help understand some Lease related principal considerations auditors may assess as they evaluate Criteria 2 for material Lease related accounts and disclosures. This is followed by potential information technology principal considerations and factors we noted were identified in recent international auditor KAM reports related to Leasing.

CAM Criteria 1

Material Lease Related Accounts and Disclosures

PCAOB staff guidance, "Implementation of Critical Audit Matters: The Basics", states, "A CAM is required to relate to accounts or disclosures that are material to the financial statements. A CAM may relate to a component of a material account or disclosure and does not necessarily need to correspond to the entire account or disclosure in the financial statements."

How Material are Lease Related Accounts?

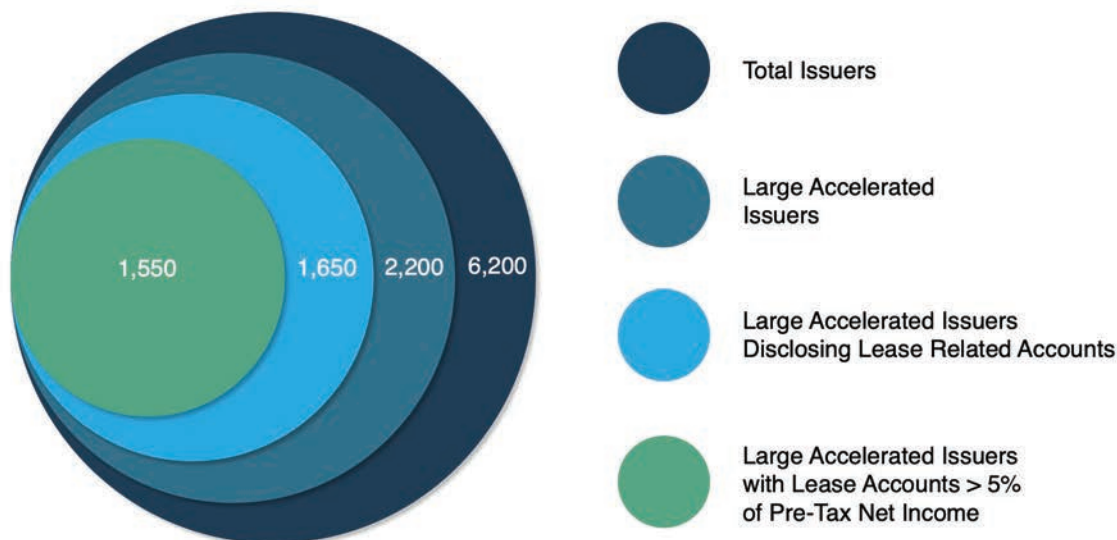
A significant number of large accelerated issuers may find lease accounts and disclosures are material. How an auditor measures materiality is based upon both quantitative and qualitative information and is unique to each company. Expressed as a number, materiality may be based upon any number of financial metrics and/or qualitative considerations. We used the following calculations to demonstrate the significance of lease related accounts:

- Pre-Tax Income Threshold – Applying a pre-tax income threshold of five percent of a large accelerated issuer's prior year net income before taxes, on an absolute basis, resulted in 94 percent of 1,650 large accelerated issuers disclosing a right-of-use (ROU) asset or an operating lease liability greater than the threshold.
- Total Asset Threshold – Applying a threshold of three percent of recently disclosed total assets resulted in approximately 700 large accelerated issuers having ROU asset or operating lease liability balances greater than the threshold.

Note: The above calculations are solely meant to demonstrate the significance of lease related accounts. How an auditor measures materiality, expressed as a number, could be much higher or lower than either of the threshold metrics used above.

Figure 1 – Sample Impact Analysis

Overall population of issuers narrowed down to a subset of large accelerated issuers that may consider lease accounts or disclosures material.



*Source: Calculations and issuer numbers derived from information obtained from Calcbench.
Excludes foreign private issuers or issuers with odd year ends yet to file their first post-lease adoption quarter.

CAM Criteria 2

Involved Especially Challenging, Subjective, or Complex Auditor Judgment

Company and auditor discussions related to leases, especially in an initial year of implementation, are expected to be extensive as auditors evaluate the factors for CAM criteria number 2 (see Exhibit B) in assessing whether a lease related matter “involved especially challenging, subjective, or complex auditor judgment.” The new lease accounting standards are one of the most common CAMs identified in recent dry runs. CAM discussions will be specific to the circumstances of each audit. What might be a CAM in one audit may not be a CAM in another audit.

Understanding Leasing Process Judgments and Potential Complexities

The following analysis is meant to help understand some principal considerations auditors may assess when evaluating whether a lease related matter is or is not a CAM.:

- When relevant, individually or in the aggregate, Lease accounting judgments and estimates may rise to the level of a significant risk that an auditor would take into account when assessing whether a matter requires a CAM. Accounting under the new lease standard can be complex. ASC 842 is principles-based and contains several areas requiring judgment, often with multiple assumptions. To help understand Lease accounting complexity, we have compiled a list of 72 judgments (see Exhibit A) a lessee’s lease process may contain. This is not an all-inclusive list. Lease portfolios may include several judgments or only a few. One of the factors in AS 3101.12 that auditors should take into account (see Exhibit B) is an “Auditor’s assessment of the risk of material misstatement, including significant risks.” However, the PCAOB guide, “A Deeper Dive”, states in Q&A number seven, “It is not expected that all significant risk will give rise to CAMs, or that all CAMs will necessarily be related to an identified significant risk”. How an auditor responds to a significant risk is based upon the facts and circumstances unique to each audit.
- Conversely, a material lease portfolio may not contain any significant risk. For example, a company’s lease portfolio might be 90 percent comprised of contracts with very common terms that are routine in nature. As a result, the accounting for the leases in this 90 percent of the portfolio may involve only low risk judgments easily managed in an appropriately designed and configured automated system. The remaining 10 percent may contain more complex embedded leases that require more complex judgments related to lease classification and contain frequent modifications and reassessments. Despite complexity and higher activity, the balance of this stratified portion of the lease portfolio may be quantitatively immaterial with a low potential magnitude for misstatement, thus may not have significant risk.
- Many judgment areas may only require a low or moderate level of auditor judgment. Not all judgments and estimates have significant risk. When identifying whether an arrangement contains a lease, the FASB Board, in ASU 2016-02 Basis for Conclusions, acknowledged the potential for low judgment, stating, “...in most cases...a contract either will fail to meet the definition of a lease by failing to meet many of the requirements or will clearly meet the requirements to be a lease without requiring a significant amount of judgment.”
- For some issuers, a lease related matter may only be considered a CAM in the initial year the lease standard is adopted. “PCAOB Guide “A Deeper Dive” references “a new accounting standard” twice.

Recommendations:

Help Your Auditor Understand Your Lease Portfolio Early On

Company management should thoroughly understand their lease portfolios and stratify these leases in order to identify complexities, judgments, estimates, and uncertainties. This will also help in assessing the likelihood and potential magnitude of material misstatement in lease related accounts and disclosures. Early communication with the company's auditor is key in helping them understand a lease portfolio's risk assessment and in their evaluation of the required level of auditor judgment.

Lease Accounting IT System as a Principal Consideration in CAM Assessments

A new lease accounting IT system, in and of itself, will not result in a CAM, but it could be described in a CAM communication as a principal consideration, specifically in the context of why auditing the related leasing accounts or disclosures resulted in a CAM. This may be more evident as a principal consideration in a year where the new lease accounting standard is adopted. An appropriately designed system with automated controls and calculations could potentially lower whether a matter involved especially challenging, subjective, or complex auditor judgment.

Conversely, an entirely manual process utilizing spreadsheets or similar tools may prove to require "especially challenging, subjective, or complex auditor judgment." It will generally be easier to audit a lease accounting lifecycle system with built in automated processes, controls, and calculations, especially for the more challenging leases and company lease portfolios with a high-volume of lease activity. Appropriately designed automated systems can help reduce the potential for human error, making it easier to maintain lease accounting and potentially making it easier to audit.

KAMs for Leasing

KAMs, with a "K", May Provide Some Insight into Potential CAM Lease Related Matters

Outside the US, the International Auditing and Assurance Standards Board (IAASB) has required auditors to report on Key Audit Matters (KAMs) for a few years now. Given the similarities between KAMs and CAMs, evaluating issued KAMs may provide some insight into future potential CAMs. This article from The CPA Journal by Eva K. Jermakowicz, PhD, CPA; Barry Epstein; and Sridhar Ramamoorti, "CAM versus KAM—A Distinction without a Difference?" (<https://www.cpajournal.com/2018/02/19/cam-versus-kam-distinction-without-difference/>) provides insight into the similarities between the two rules.

KAM matters related to Leasing appear to be on the rise, perhaps due to IFRS 16, Leases being effective this year. Our review of certain research studies on KAMs for 2017 and prior did not identify lease related matters as a common KAM. Our independent research compiled information from 50 auditor's reports where a leasing matter was a KAM in a 2018 auditor's report. Our sample included auditor reports related to three categories: 1) the effect the adoption of IFRS 16 will have upon adoption, 2) early adoption of IFRS 16, and 3) lease

accounting under the old accounting standard. Our analysis showed the following factors reported in lease related KAMs.

Factors disclosed in Lease related KAMs (most frequent first)

1. Discount rates/incremental borrowing rates	15. IT systems and controls
2. Effect of adoption of the new standard	16. Mechanical accuracy of calculations
3. Lease classification	17. Useful lives
4. Lease terms	18. Onerous lease provisions
5. Leased asset return costs/maintenance provision	19. Fair value of leased assets
6. Completeness and accuracy of leases (including service contracts)	20. Separation of lease and non-lease components
7. Early adoption	21. Impairment of operating leased assets
8. Disclosures	22. Guarantees
9. Complex estimates and judgments and underlying key assumptions	23. Fraud risk
10. New processes and controls and transfer of initial data	24. Adequate documentation
11. High volume of lease contracts	25. Ownership transfer
12. Lease commencement date	26. Recommendation to improve or tighten quarterly process
13. Sale/leaseback	27. Purchase options
14. Residual value estimates	28. Lease deposits

Exhibit A

Checklist for Common Areas of Judgment, Estimates, and Assumptions for Lessees in the Application of ASC 842, Leases

The ASC 842 standard involves a number of key judgments, both during the implementation phase (before adoption) and in the on-going operations phase (following adoption). In an effort to provide organizations with a “head start” in their thinking about CAMs, we identified 72 judgments, estimates, and assumptions related to ASC 842 for lessees. The list is not meant to be all-inclusive. Management will need to understand their unique leasing portfolios and the associated processes, risks, and applicable judgments — assessing “judgments” to determine which, if any, may be considered significant.

Lease Process Judgments Checklist						
Risk assessment: NA – Not Applicable, L – Low, M – Moderate, S – Significant						
IMPLEMENTATION AND ON-GOING PROCESS DESIGN JUDGMENTS			NA	L	M	S
Certain judgments may only be applicable in the initial year of adoption.						
1	Potential Lease Contract Sourcing	Judgment may be needed when determining where in an organization to search for contracts that may contain a lease. This includes designing and establishing a data and contract collection process, and deciding on and developing a process for how and where lease contracts are initiated and maintained, including those contracts determined not to contain a lease.				
2	Contract and Source Data Completeness	Judgment may be needed when determining which documents (not just the lease contract) may be needed to identify all related data to enter a lease’s attributes into an automated system or manual spreadsheet.				
3	Practical Expedients	Judgment may be needed when selecting which practical expedients to elect upon adoption of ASC 842.				
4	Materiality Thresholds	Judgment may be needed when assessing or updating materiality thresholds for whether to apply ASC 842 to a leased asset or asset group.				
5	Process Design – Document Retention	Judgment may be needed when designing source document retention policies, processes and controls.				
6	Process Design – Lease Portfolio Change Management	Lease portfolios are a collection of structural information continually evolving with the business. Judgment may be needed in establishing processes for lease portfolio change management for new types of leases (i.e. new attributes, new asset groups), new capabilities of IT systems, or manual spreadsheet changes.				

IMPLEMENTATION AND ON-GOING PROCESS DESIGN JUDGMENTS <i>continued</i>			NA	L	M	S
7	Process Design – Variable Payments	Judgment may be needed in the design of how to capture variable payments (e.g. in a software system, on special general ledger accounts, or manually in spreadsheets).				
8	Process Design – Lease and Non-Lease components	Judgment may be needed when designing new robust processes and controls for accurately capturing and separating lease and non-lease components of contracts, as well as allocating executory costs, assuming the practical expedient for combining lease and non-lease components is not elected. Some companies will make this policy election for some asset groups and not others.				
9	Process Design – Package of Practical Expedients	Judgment may be needed to design two sets of new processes and controls to capture and account for lease related amounts for companies electing the “Package of practical expedients” (i.e. lease accounting for Leases that commenced before adoption versus leases accounting for new leases post adoption, including modifications and reassessments post adoption).				
10	Process Design – Short-term Leases	Judgment may be needed to design processes and controls to account for amounts related to short-term leases when this practical expedient is elected.				
11	Process Design – Impairments	Judgment may be needed when designing processes and controls to timely identify triggering events that may require ASC 360 impairment assessment related to ROU assets. Further, when relevant, processes need to be designed to account for impairments and any potential accelerated depreciation to cease-use dates.				
12	Process Design – Lease Options	Judgment may be needed to design processes and controls for monitoring the exercise of options or a decision to not exercise an option as well as identifying events that are written into a contract that obliges the lessee to exercise (or not to exercise) an option to extend or terminate the lease.				
13	Process Design – Early Terminations	Judgment may be needed to design processes and controls to monitor, identify, and account for early terminations, including appropriately designing calculations for potential gains or losses.				
14	Process Design – Modifications	Judgment may be needed when designing processes and controls for timely capture and accounting of lease modifications (e.g. new lease rights, terminations, and extending or shortening of contract terms), including oral or implied modifications that are legally enforceable (e.g. substituted assets, significant modifications to existing assets, or new lessor owned improvements). Modifications can also include inactions not taken by the lessor or lessee.				
15	Process Design – Payment Changes	Judgment will be needed to design processes and controls to identify and account for payment changes and differentiate between payment changes with no change to lease accounting (an index or rate change), deal modifications resulting in a reassessment and remeasurement (an actual reduction on payments on an existing lease), or a payment change resulting in only a remeasurement (a change in a contingent payment to fixed rent or change in probable amounts for a residual guarantee).				

IMPLEMENTATION AND ON-GOING PROCESS DESIGN JUDGMENTS <i>continued</i>			NA	L	M	S
16	Process Design – Incremental Borrowing Rate	Judgment may be needed when designing or updating policies and procedures for determining incremental borrowing rates. Considerations include: <ul style="list-style-type: none"> • Frequency of updating • Methodology • Use of third parties • Collateral assumptions • Length of similar lease term used • Similar economic environments • Use of a portfolio approach • Asset categories • Data gathering 				

DISCLOSURES			NA	L	M	S
17	Footnote Disclosures	Judgment may be needed when designing lease footnote disclosures and the level of disaggregation based upon materiality, as well as how to capture the required information. (842-20-50-2)				
18	Selecting “Judgments” to Disclose	Judgment may be needed to determine which “judgments” meet the requirement for an entity to disclose significant assumptions and judgments it used in applying ASC 842.(842-20-50-1 and 50-3c)				

NEW LEASES			NA	L	M	S
19	Embedded Leases in Service Contracts	Judgment may be needed to determine whether a contract contains a lease for complex contracts such as service or outsourcing arrangements (generally referred to as an “embedded lease”). Evaluating whether the lessee controls the right to direct the use of an identified asset (i.e. how and for what purpose the asset is used during the term of the contract) can be complex. (842-10-15-2 through 15-27)				
20	Asset Implicitly Specified	Judgment may be needed to determine whether an asset is “implicitly” specified in a contract. (842-10-15-9)				
21	Capacity Portions of an Asset	Judgment may be needed to determine if a “capacity portion of an asset is an identified asset”. If it is physically distinct such as a “floor of a building or a segment of a pipeline that connects a single customer to the larger pipeline” then it is an identified asset. Conversely, a “capacity or other portion of an asset that is not physically distinct (e.g. a capacity portion of a fiber optic cable) is not an identified asset unless it represents substantially all of the capacity of the asset...”. (842-10-15-16)				

NEW LEASES <i>continued</i>			NA	L	M	S
22	Substantially All Capacity	Judgment may be needed to determine whether capacity represents “substantially all” of the capacity of an asset. (842-10-15-16)				
23	Lessee Participation in Design of an Asset	Judgment may be needed to assess whether the lessee participated in or designed the asset when the decisions about how and for what purpose the asset are used in a service arrangement are predetermined upon negotiation of the arrangement and not changeable. (842-10-15-20)				
24	Substitution Rights	Judgment may be needed to determine how significant a supplier’s economic incentive must be for a substitution right to be considered substantive and avoid lease accounting for an identified asset. Lessee’s should presume a substitution right is not substantive “...if a customer [lessee] cannot readily determine whether a supplier has a substantive substitution right...” (i.e. it is not practical to prove it is substantive). (842-10-15-15)				
25	Termination Penalties	Judgment may be needed to determine if a penalty is more than insignificant to terminate a lease. Insignificant is not defined and a significant penalty to the lessee could cause renewal terms to be “reasonably certain” and included in the non-cancellable period of the contract, even if penalties are not stipulated in the contract. Termination penalties come in more than just the form of dollar amounts. Lessees can suffer significant penalties if a leased asset has a unique purpose, if there are significant leasehold improvements that would not justify terminating a contract, or if the location is such that a replacement location would not be available for continued use. (842-10-55-23)				
26	Potential Termination Fees	Judgment may be needed to estimate potential payments for penalties for return or termination of a lease. (842-10-30-5d)				
27	Non-Lease Components	Judgment may be needed to determine whether non-lease components are associated with a particular asset. (842-10-15-38)				
28	Combining Contracts	Judgment may be needed to determine whether contracts entered into near each other should be combined or separated. (842-10-25-19)				
29	Combining Highly Interrelated Leased Assets	Judgment may be needed to determine whether leased assets are highly interrelated or highly interdependent with other leased assets in a contract and can be separate lease components or combined with other leased assets. . Contracts often include multiple leased assets (not land), such as multiple pieces of equipment and the space or a building where the equipment is located. (842-10-15-28b)				
30	Residual Value Guarantee Estimates	Judgment may be needed in estimating amounts probable of being owed under a residual value guarantee, or even whether a payment actually represents a (842-10-25-3b2, 30-5f, and 55-34 through 55-36)				

NEW LEASES <i>continued</i>			NA	L	M	S
31	Lease Term – Reasonably Certain Holding Period	Ongoing judgment may be needed in determining whether it is reasonably certain that lease extension or termination option will be exercised when determining lease term. (842-10-25-1)				
32	In-Substance Fixed Payments	Judgment may be needed in determining whether variable payments are in-substance fixed payments. (842-10-55-31)				
33	Variable Payments Based upon an Index or Rate	Judgment may be needed to determine whether to include variable payments dependent upon an index or rate in payments during the term. Lessee’s should include only those variable payments that are dependent upon an index or rate in their ROU measurement calculations (i.e. a future fair value real estate rental rate compared to the base rate on commencement, a spot rate or CPI). This is not to be confused with payments that are based upon a “change” in an index or rate. Future rates based upon a change in an index or rate will not be included in the measurement of a lease calculation. (842-10-15-35)				
34	Lease Commencement Date	Judgment may be needed to determine the commencement date of a lease (i.e. the available for use date of the underlying asset). Lessee’s may take control over space prior to the date rent becomes due and payable or at a later date of a lease (e.g. to make improvements). Rent holidays should be considered. There could also be multiple lease commencement dates in master lease agreements. (842-10-55-19 through 55-21)				
35	Dismantlement Costs	Judgment may be needed to estimate costs to dismantle and remove an asset. (842-10-55-37)				
36	Leasehold Improvements	Judgment may be needed to determine whether a lessee is improving the space and building leasehold improvements or whether they are leasing “built-out” space. Are payments made by the lessee considered lease payments to a lessor or leasehold improvements of the lessee? (842-40-55-3 through 55-5)				
37	Leasehold Amortizations	Judgment may be needed to determine the amortization period of any initial leasehold improvements. (842-20-35-12)				
38	Initial Direct Costs	Judgment may be needed to determine if initial direct costs were incurred to obtain the lease contract and whether they relate to the lease component or non-lease components, and whether they need to be allocated between the two components. (842-10-30-9 through 30-10)				

LEASE CLASSIFICATION			NA	L	M	S
Lease classification now involves greater judgment, although one "reasonable approach" would permit the use of bright-line criteria from the prior guidance. (842-10-55-2)						
	Transfer of Ownership	Judgment may be needed to determine whether a lease transfers ownership by the end of the lease term. (842-10-25-2a)				
39	Economic Incentive to Purchase	Judgment may be needed to determine if an option to purchase the underlying asset is reasonably certain to be exercised because of an economic incentive to purchase the asset.(842-10-25-2b)				
40	Major Part of Economic Life	Judgment may be needed to determine whether the lease term is for a major part of the remaining economic life of the asset. (842-10-25-2c)				
41	Economic Life of Asset or Asset Group	Judgment may be needed to determine economic lives of leased assets or asset groups. These can be different than the economic life of similar fixed assets purchased. (842-10-25-2c)				
42	End of Economic Life	Judgment may be needed to determine if the lease term is at or near the end of an asset's economic life. (842-10-25-2c)				
43	Practical Determination of Fair Value	Judgment may be needed to assess whether it is practicable to determine the fair value of the underlying asset or group of assets? (842-10-55-2c)				
44	Fair Value Estimate	Judgment may be needed to determine the fair value of the underlying asset or group of assets. (842-10-25-2d)				
45	Predominate Asset	Judgment may be needed to determine the predominate asset for purposes of determining whether the lease term is for the major part of the remaining economic life of the underlying asset when there are multiple assets in a single lease component. (842-10-25-5)				
46	Specialized Asset	Judgment may be needed to determine whether the underlying asset of a specialized nature. (842-10-25-2e)				
47	Close-Calls for Lease Classification	Judgment may be needed for lease classification "close calls" and situations where it is not practicable to estimate the fair value of the underlying asset.				

CONTRACT MODIFICATIONS, REASSESSMENTS, AND REMEASUREMENTS			NA	L	M	S
48	Modification - Separate Contract	Judgment may be needed when assessing whether a contract change is a separate contract or a modification to an existing arrangement. (842-10-25-8)				
49	Reassessment Triggering Events	Judgment may be needed to identify triggering events that require a reassessment (significant events within the lessee's control) and also directly affect the assessment of whether the lessee is reasonably certain to exercise an option. The key being whether the event is within the lessee's control. Examples include: a) Constructing significant leasehold improvements "that are expected to have significant economic value for the lessee when the option becomes exercisable" b) Subleasing the underlying asset beyond the exercise date of the option c) Significantly modifying or customizing an asset d) Making a "business decision" that is directly relevant to the lessee's ability to exercise or not to exercise an option (for example, extending the lease of a complementary asset or disposing of an alternative asset). (842-10-55-28)				
50	Business Decision Triggering Events	Judgment may be needed to determine whether a "business decision" triggering event is a decision that cannot be reversed without economic cost. Assessments are based upon economic factors and not management's intent. If no economic consequence, then no "business decision" triggering event exists. (842-10-55-28c)				
51	Events Obliging Lessee to Exercise (or not) an Option	Judgment may be needed to determine whether there "...is an event that is written into the contract that obliges the lessee to exercise (or not to exercise) an option to extend or terminate the lease." (842-10-35-1)				
52	Master Lease Agreements	Judgment may be needed when assessing whether additional leased assets taken by a lessee under master lease agreements (MLAs) are modifications (required to be taken or not required). (842-10-55-17 and 55-18)				

PAYMENT CHANGES RESULTING IN ONLY REMEASUREMENT			NA	L	M	S
53	Residual Value Guarantee	Judgment may be needed to assess whether there is a change in the probable amount for a residual value guarantee. (842-10-35-4c3)				
54	Contingency Resolution	Judgment may be needed to assess when a contingency has been resolved for the remainder of the lease term and whether some or all variable lease payments have become fixed and meet the definition of a lease payment (e.g. co-tenancy or minimum annual guarantee clauses that are not temporary in nature). (842-10-35-4)				

ALLOCATION			NA	L	M	S
55	Standalone Observable Prices	Judgment may be needed to determine standalone prices for lease and non-lease components when observable standalone prices are not readily available in the marketplace, maximizing the use of observable information (if lessees cannot find observable standalone prices, they may need to estimate price). (842-10-15-33a)				
56	Residual Value Method	Judgment may be needed on whether to use the residual estimation approach if standalone price for a lease component is highly variable or uncertain. (842-10-15-33a)				
57	Land as a Separate Component	Judgment may be needed to determine if the effect of separating land into a separate component would be insignificant. Land shall be accounted for as a separate lease component unless the effect of doing so would be insignificant, regardless of whether the criteria are met. (842-10-15-29)				

DISCOUNT RATES			NA	L	M	S
58	Discount Rate for the Lease	Judgment may be needed to determine whether to use the interest rate implicit in the lease itself or to use an estimated incremental borrowing rate. (842-10-30-3)				
59	Incremental Borrowing Rates	Judgment may be needed to determine discount rates (incremental borrowing rates) in accordance with accounting policy. See "Process Design - Incremental Borrowing Rate" for policy considerations. (842-10-30-3) Incremental borrowing rate -The rate of interest that a lessee would have to pay to borrow on a collateralized basis over a similar term an amount equal to the lease payments in a similar economic environment. (842 Glossary)				

SALE-LEASEBACK / ASSETS UNDER CONSTRUCTION			NA	L	M	S
60	Asset Control Transfer	Judgment may be needed when assessing if control of an asset transfers to the buyer-lessor in a sale-leaseback transaction. This involves the evaluation of certain indicators, including whether the buyer-lessor has obtained significant risk and rewards from ownership. Judgment may be required to determine whether the seller-lessee has retained any risk or rewards of ownership. (842-40-25-4 through 25-5)				
61	Control during Construction	Judgment may be needed to determine whether the Lessee or the Lessor has control over assets being constructed. (842-40-55-5)				
62	Re-Purchase Options/Forward	Judgment may be needed to determine if a forward or re-purchase option by the seller-lessee in a sale-leaseback transaction precludes a sale. (842-40-25-3)				

IMPAIRMENTS			NA	L	M	S
63	Impairment Indicators	Judgment may be needed to determine when an impairment indicator under ASC 360 (i.e. a triggering event) has occurred requiring an impairment assessment of certain ROU assets. This includes: <ul style="list-style-type: none"> • Decreases in market price • Adverse change in manner • Extent of asset use or physical condition • Adverse changes in legal factors • Business climate impacting value • Costs in excess of expected costs • Cash flow losses • Sales or disposals before the end of previously determined useful life. (842-20-35-9 reference to 360-10-35) 				
64	Impairment Reassessments	Judgment may be needed to determine whether an ROU asset impairment is within the entity's control and is a triggering event that requires reassessment or whether impairment is solely market-based and does not require a reassessment. (842-20-35-9 reference to 360-10-35)				
65	Impairment Judgments	Judgment may be needed to determine <ul style="list-style-type: none"> • Impairment date fair values • Market participant assumptions (which may be different than entity assumptions) • Market-based discount rates (which may be different than the discount rate for a lease). (842-20-35-9 reference to 360-10-35) 				

OTHER			NA	L	M	S
66	GL and Cost Centers	Judgment may be needed to identify and maintain on-going accounting changes that don't result in reassessments or modifications but still may impact accounting. Businesses evolve and leased assets get moved to or used by different entities. Examples include: <ul style="list-style-type: none"> • General ledger changes • Movement of assets between cost and profit centers • Cost center split changes • Movement of assets between entities or jurisdictions. 				
67	Late Recorded Leases and Catch Up Entries	Judgment may be needed when evaluating leases found and recorded after a period is closed to determine whether cumulative catch up entries are significant.				

OTHER <i>continued</i>			NA	L	M	S
68	Untimely Recordation of Returned Assets	If a termination recordation is not finalized and recorded timely when an asset is returned, terminated leases may incorrectly go into evergreen status. Judgment may be needed to assess significance of potential adjustments.				
69	Asset Retirement Obligation Estimates	Judgment may be needed if a leased asset requires the need to estimate asset retirement obligation (ARO) costs. ARO's are outside of the scope of ASC 842. (842-10-55-38)				
70	History of Incorrect Reasonably Certain Assertions	Judgment may be needed over asset group initial end-of-term (EOT) reasonably certain assertions when a high number of leases go into evergreen status but the EOT initial assertion was that the asset would be returned.				
71	Easements – Unit of Account	Judgment may be needed to determine the unit-of-account when performing the lease assessment for an easement.				
72	Foreign Exchange Rates	Judgment may be needed to determine foreign exchange rates.				

Note that the list above is focused on judgments, estimates, and assumptions related to the record-to-report lifecycle activities performed throughout a leasing process by various individuals. However, there are a number of judgments related to the design of system configuration and operational processes to support lease accounting. For example, judgments are required to determine:

- Whether to utilize a center of excellence
- Which groups to include in the decision-making processes (e.g. treasury, purchasing, controllership functions, legal, etc.)
- Subledger reconciliation to main ERP system configuration
- Configuration for type of organizational structure (e.g. centralized or decentralized)
- Establishing lease versus buy processes
- Journal entry design
- New account establishment
- Full or partial use of new software systems

Further, if spreadsheets are utilized, judgment may be needed on the design and configuration as well as on how to maintain the integrity of the data, version control, user access, change control, reliability, and ongoing testing of calculations and updating of the spreadsheet when lease data changes.

Exhibit B

Factors for Auditors to Consider when Determining Whether a Matter Requires Especially Challenging, Subjective, or Complex Auditor Judgment.

The following excerpt is from PCAOB audit standard AS 3101: The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion.

- .12 In determining whether a matter involved especially challenging, subjective, or complex auditor judgment, the auditor should take into account, alone or in combination, the following factors, as well as other factors specific to the audit:
- The auditor's assessment of the risks of material misstatement, including significant risks;
 - The degree of auditor judgment related to areas in the financial statements that involved the application of significant judgment or estimation by management, including estimates with significant measurement uncertainty;
 - The nature and timing of significant unusual transactions and the extent of audit effort and judgment related to these transactions;
 - The degree of auditor subjectivity in applying audit procedures to address the matter or in evaluating the results of those procedures;
 - The nature and extent of audit effort required to address the matter, including the extent of specialized skill or knowledge needed or the nature of consultations outside the engagement team regarding the matter; and
 - The nature of audit evidence obtained regarding the matter.

Conversely, responding to risks of material misstatement that do not rise to the level of a significant risk may involve especially challenging, subjective, or complex auditor judgment, particularly when the risks relate to areas in the financial statements which involve greater degrees of judgment and estimation.